# Yield Advantage and Softer Inflation Drive Fixed Income Opportunities

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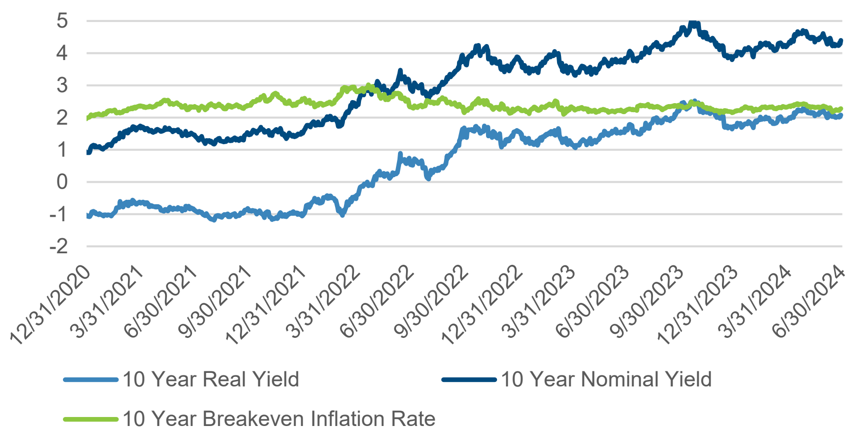
## Market Recap

U.S. Treasury yields rose significantly in April as investors reassessed their expectations for interest rate cuts in 2024, following warmer-than-expected inflation data in the first quarter. However, treasury yields generally saw a downward trend in May and June, driven by evidence of cooling inflation, below-expectation activity and sentiment data, and renewed expectations of policy rate cuts. The nominal 10-year U.S. yields ended the quarter slightly higher at 4.40%, compared with 4.20% at the end of the previous quarter. The increase in real yield contributed primarily to the shift, with real yield up by 20 basis points for the quarter. Inflation expectations, measured by the 10-year inflation breakeven rate, saw a marginal decrease from 2.32% at the end of the first quarter to 2.28% (see Exhibit 1).

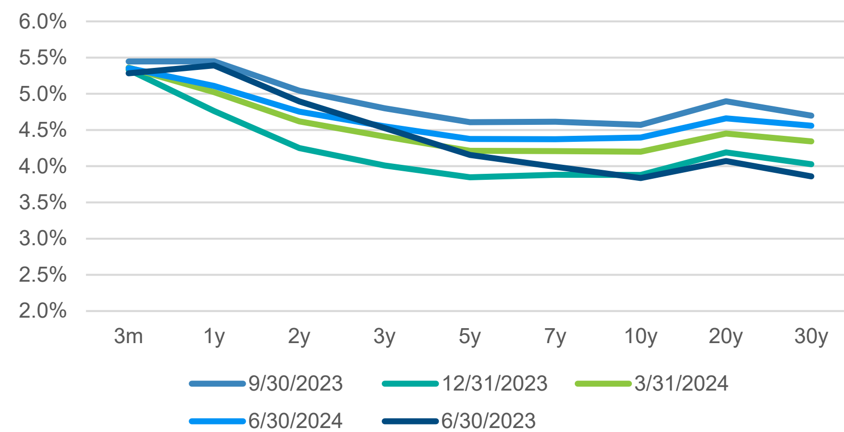
**Exhibit 1: Treasury yields increased in the second quarter of 2024**




Source: Bloomberg.

Treasury yields across most maturities increased for the first quarter, except for the 3-month yields, leading to a slightly less inverted yield curve. The 3-month yield decreased marginally from 5.36% to 5.35%, a level 0.96% higher than the 10-year yields (compared with 1.16% higher than the 10-year yields at the end of last quarter, see Exhibit 2). The 10-year and 30-year bond yields increased by around 20 basis points each but remained high historically.

**Exhibit 2: U.S. Treasury Yield Curve**




Source: Bloomberg.

## Macro Landscape

**Moderating growth**: In recent months, most investors have focused on the prospect of an economic slowdown, and the U.S. has seen mostly softer data in the second quarter. To some extent, bad news for the economy is becoming good news for the market, as they might enable an easing in financial conditions and increase the probability of a soft landing. U.S. manufacturing activity regressed into contraction territory in April and contracted again in May, as shown by the ISM manufacturing index dropping to 48.7 in May. Homebuilder confidence reversed the upward trend and declined in the second quarter to 43, below the 50-point neutral threshold. Higher mortgage rates were the major culprit behind the decline. On the household side, the University of Michigan consumer sentiment index has turned down for several months, decreasing to 65.6 in June, the lowest reading since November.

And yet, we found ourselves not having to change our growth forecast – we still expect moderate economic growth this year. Consider the current state of the labor market – payroll gains averaged an impressive 249,000 per month over the last three months, and the slowdown in April is more likely an anomaly than an indicator of any imminent weakness. At the margin, the labor market has seen signs of a modest softening, as the initial jobless claims trended slightly higher in recent weeks. Consumer spending has also witnessed some weakness in recent months, but we believe spending will remain supported by a robust job market, real wage increases, and household wealth effect, with inflation-adjusted U.S. household wealth up a stunning $19.1 trillion since Covid.

**Cooling inflation, but bumpy road:** April and May have welcomed a more-than-anticipated moderation of inflation. May headline CPI remained unchanged from April, resulting in a decrease in the year-over-year inflation rate from 3.4% to 3.3%. Gasoline pricing (down 3.6% from a month ago) was the primary driver for the softer headline CPI in May. Core CPI (excluding food and energy) grew 0.2% in May, with year-over-year growth slowing down from 3.6% to 3.4%. Once again, shelter inflation drove most of the increase in core CPI, rising 0.4%. Also, the PPI (producer price index) unexpectedly experienced its biggest drop in seven months in May, contributing to signs that inflationary pressures are easing. The PPI for final demand decreased 0.2% in May, following a 0.5% jump in April, and bringing down the annual rate to 2.2%.

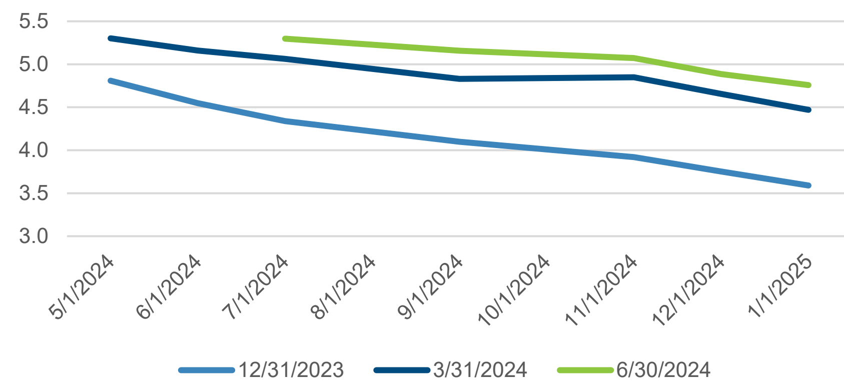
We anticipate a bumpy road in the “last mile” on inflation until inflation is sustainably at 2%. While May appears promising in this fight, extrapolating individual inflation reports is tricky, and a single print is unlikely to change the Fed’s immediate-term strategy. For example, 11 bps out of the 13 bps drop in core CPI were due to transportation service, which is not sustainable, and we should expect some payback next month. Furthermore, year-over-year CPI comparisons will be a bit difficult in the second half of the year, given the relatively low inflation in the second half of 2023.

**Fed policy:** As widely expected, the Federal Open Market Committee left the Fed funds rate unchanged at 5.25% to 5.5% in its May and June meetings. However, the market’s interpretation of the committee’s latest Summary of Economic Projections was slightly hawkish as June’s median projection showed just one cut this year, compared with three cuts forecasted in its March meeting. Although the Fed’s data-dependence approach suggests that we can’t put much weight on its policy signals in one meeting, one theme stays consistent – Chairman Powell reiterated that the committee was not confident enough that inflation was consistently on track back to its 2% target, despite the moderating May CPI.

We believe that we are in a higher-for-longer interest rate environment and expect a shallow path for rate cuts, given the prospects of moderate economic growth and a bumpy road towards slower inflation. The Fed has maintained a cautious stance and has been slowly coming to terms with the idea that rates will need to stay high for longer – both in the short and long term. That’s highlighted by the gradual increase of its estimate of long-run rates, with FOMC’s longer-term dot now up to 2.75%.

Market expectations have adapted accordingly. Since the beginning of the year, market expectations about the Fed’s schedule for policy easing have been pushed back significantly (See Exhibit 3). As of 6/30/2024, the Fed funds futures market indicated a total of 50bps in rate cuts by the Fed in 2024, compared with 150bps cuts estimated at the end of last year.

**Exhibit 3: Fed Funds Rate Implied by the Futures Market**




Source: Bloomberg.

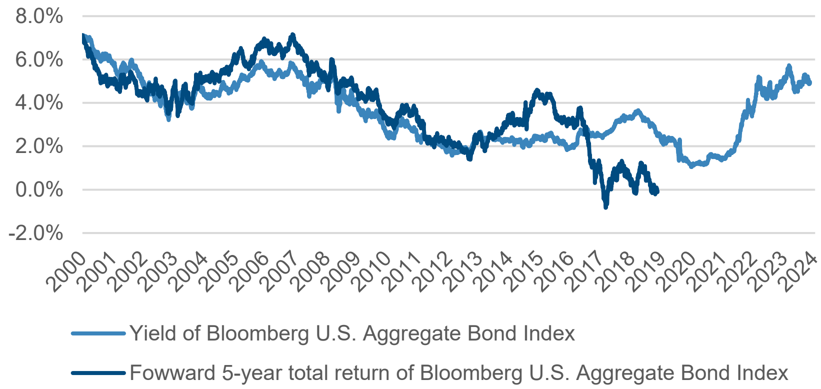
## Fixed Income Outlook

Given today’s high yields, a moderating inflation outlook, and growth uncertainty, we view fixed income investments as appealing to investors seeking attractive income, downside protection, and diversification through reduced correlation with equity markets. Following we discuss three themes:

1. Starting yields still look attractive,
2. The expected yield curve normalization,
3. The differentiation in monetary policies and less synchronized business cycles across countries/regions.

First, starting yields, which proved to be highly correlated with returns by empirical evidence, are still among the highest levels over a decade. Current high starting yields can boost potential bond returns and act as a buffer against downside risks. As shown in Exhibit 4, starting yields are good predictors for forward bond returns (with 90% of correlations). The yields on the Bloomberg U.S. Aggregate stood high at about 5.3% as of June 30, 2024.

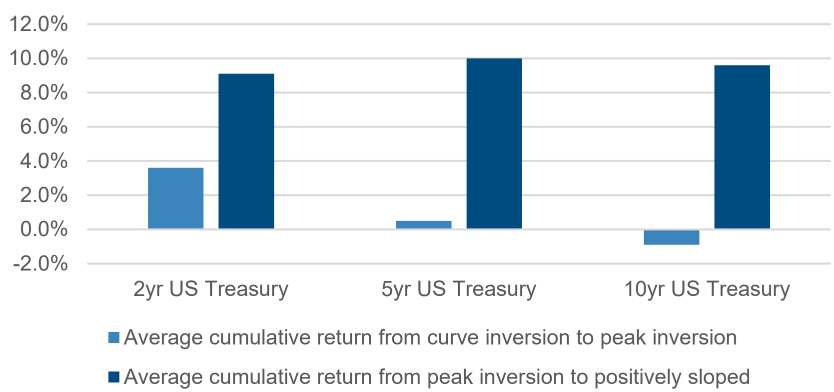
**Exhibit 4: Bloomberg U.S. Aggregate Bond Index Yield and Forward 5-year Return**




Source: Bloomberg.

Second, while we believe that the yield curve is likely to remain inverted in the near term, we anticipate it to steepen as fed funds rates eventually decrease, and bonds tend to outperform during the curve steeping period. The current U.S. yield curve remains inverted, and June marks the 23rd consecutive month of inverted yield curve without a recession, the longest period in history. However, once interest rate cuts appear more imminent, the curve should steepen with declining short-term rates. As shown in Exhibit 5, initial inversion and subsequent flattening of the yield curve due to tightening policy presents a challenging environment for bonds, especially the longer-duration exposure. However, bonds generally perform better as the curve steepens to positively sloped.

**Exhibit 5: Bonds tend to outperform when yield curve steepens**




Source: Bloomberg.

Third, global fixed income markets provide more opportunities for active management as monetary policies and business cycles are less synchronized across regions, leading to lower correlation across different regions/countries. While the Fed has held its finger on the pause button, the ECB started its easing cycle in June. The Bank of Japan, on the other hand, has considered raising interest rates further due to inflationary pressure in its June meeting. These divergent monetary policies across regions create distinctive opportunities for diversification and return enhancement through country/region selection.

## Investment Implications

Against the backdrop of a moderating economic outlook, a cooling but bumpy road for inflation, and the expectation of the Fed's easing later this year, we favor a balanced approach in the current investment climate to take advantage of the broad-based opportunities across fixed income sectors. Our allocation among these sectors remains up-in-quality, while also preparing to take advantage of opportunities in other sectors as prices adjust to reflect changes in underlying fundamentals. We are neutral in duration in our more static portfolio and slightly underweight duration in our more dynamic portfolios. For YTD as of June 30, 2024, our Tactical Income strategy returned 1.2% net of fees, outperforming the Global Aggregated Bond Index and U.S. Aggregate Bond Index by 4.3% and 1.9%, respectively. In the second quarter, we focused on several key themes in our strategies, outlined below:

- **Slightly extended duration:** We favor intermediate-term U.S. Treasuries as they are less affected by the high volatility of long-term rates and the reinvestment risk associated with the very short-term end of the yield curve with rate cut prospects. At the same time, we slightly added duration exposure during the second quarter to lock in yields and to protect against any unexpected economic disruptions.
- **Investment grade credit:** Given moderate economic growth and the Fed's on hold stance, the fundamentals of the investment grade credit sector remain relatively steady. Looking forward, we believe investment-grade credit spreads are likely to be within a stable range, driven by strong technical factors and attractive yields.
- **Continuing to hold bank loans and high-quality CLO:** With the markets' shifting expectation of delayed rate cuts, leveraged loans have continued to outperform high yield credit, driven by elevated rates and their lack of duration. In our portfolio, we have slightly added our exposure to the Invesco Senior Loan ETF (BKLN) from 5% to 7%, generating a YTD return of 3.6% as of 06/30/2024. Regarding collateralized loan obligations (CLOs), we prefer senior CLO tranches

due to their appealing carry and higher credit ratings. We maintained a 5% position of the BlackRock AAA CLO ETF (CLOA), which primarily invests (87%) in AAA-rated tranches and currently offers a yield of 6.0%.

- **Emerging Market Debt:** Emerging market bonds offer attractive yields of about 7% and longer duration, positioning them to benefit from a rally in rates with potential central banks rate cuts. Emerging market inflation continued to moderate, and we see country fundamentals remain relatively strong. We have a modest exposure (2%) to iShares J.P. Morgan USD Emerging Markets Bond ETF (EMB).

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