Whiplash

Why were long-term Treasury rates so volatile in the second half of 2023? Remarkably, the 10-year Treasury yield started and ended 2023 at the exact same place: 3.88%. However, this conceals a wild ride of investor expectations for the economy, monetary policy, and concerns over structural fiscal deficits and their financing. In particular, during the second half of the year, the 10-year Treasury sold off 116 basis points (bps) to a high of 4.99% on October 19th before a rally of 111 bps in November and December. What happened?

In the first half of 2023, we had two significant events that would lower Treasury yields. First, there was a regional banking crisis driven by unrealized losses on long-term Treasury and U.S. government-backed mortgage debt, culminating in the failure of Silicon Valley Bank (and others) in March. In addition, the U.S. government debt ceiling crisis was technically suppressing yields by prohibiting any new supply of Treasury securities.

On May 27th, President Biden and House Speaker McCarthy reached a last minute deal to avoid default, which opened the door for significant new Treasury issuance and rates started climbing as a result. This was further bolstered by stronger than expected economic data which drove higher expectations for the terminal Fed Funds rate, and the Fed raised rates a final 25 bps on July 26th.

On August 1st, 2023, Fitch Ratings downgraded the United States credit rating from AAA to AA+, but, for yields, the bigger news was the August 2nd release of the composition of planned Treasury issuance. The U.S. Treasury Department surprised the market with plans to issue a greater than expected mix of longer-term notes and bonds, thus requiring higher yields in that part of the curve to clear the market. Over the next six weeks, yields on the 10-year and 30-year Treasury widened by 97 bps and 102 bps, respectively. Yields on the 2-year Treasury, the most sensitive to near-to-medium term Fed Funds rates expectations, widened by only 34 bps, suggesting most of the move in longer-term rates were supply/demand driven.

After the 10-year Treasury peaked at 4.99% on October 19th, and before cooler October economic data was reported, we got another surprise from the Treasury Department on November 1st. This time they decided to issue more T-Bills than expected and fewer long-term notes and bonds, and cooler economic and inflation data in the following weeks supported the technical rally in yields. On December 13th, the Fed held rates steady again and Powell acknowledged they were now discussing when it might be appropriate to cut rates. The introduction of this "pivot" narrative drove yields lower still.

Today, Fed Funds futures markets are pricing in ~140 bps of rate cuts in 2024. In contrast, the Fed's own Summary of Economic Projections anticipates only 80 bps of cuts in 2024, meaning economic data will likely need to be quite weak to achieve market expectations for short-term rates. For longer-term rates, the next quarterly refunding announcement will take place on Wednesday, January 31st, 2024. And with the significant drop in long-term rates since the October highs, the U.S. Treasury Department may feel more comfortable issuing more long-term debt.

Investment Grade Corporate Bond Fourth Quarter Performance

U.S. investment-grade bonds had an impressive quarter driven by the rally in Treasuries as traders bet the Fed was done hiking interest rates. Per the Bloomberg U.S. Credit Index, investment grade corporate credit tightened by 19 bps versus comparable U.S. Treasury yields in the fourth quarter. The Bloomberg U.S. Credit Index measures the investment grade, U.S. dollar denominated, fixed-rate, taxable corporate and government-related bond markets. Corporate credit continued to be the best performer for fixed income markets in 2023 which was primarily driven by stronger demand given the higher yields. There are no positions in the portfolios with any credit or sustainability concerns through the market cycle.

High Yield Bond Sector Fourth Quarter Performance

High yield fixed income bonds returned a robust 7.0% in the fourth quarter, representing the best quarterly return since 2Q20 when they returned 9.6%. For the full year 2023, high yield returned 13.4%, comprised of 7.1% from coupon and 6.3% price return. From a quality perspective, all ratings categories performed well, with BBs slightly outperforming the others at 7.3% given their greater interest rate sensitivity, followed by single-Bs at 6.8% and CCCs at 6.6%. High yield spreads started the quarter at 384 bps and ended at 339 bps, as continued strong economic data combined with the market's expectation of a Fed "pivot" drove spreads tighter. The U.S. High Yield Corporate Bond Index is designed to track the performance of U.S. dollar-denominated, high-yield corporate bonds issued by companies whose country of risk use official G-10 currencies, excluding those countries that are members of the United Nations Eastern European Group (EEG).

Going forward, we would take some spread risk off the table and move up in quality as valuations near post-crisis tights are not currently compensating investors for a potentially bumpy economic landing.

Our 2024 Economic and Fixed Income Outlook

We believe our disciplined investment process, now in its 25th year of execution, has proven to be dependable through economic cycles. We do not anticipate a recession in the near term. Economic growth will slow, but two quarters of negative GDP remains unlikely. Why do we believe that? We explain below:

Corporate Earnings and Capital Expenditures: We are forecasting improvement in corporate earnings from the 3% estimated growth for 2023 to a more robust 10-12% growth for 2024. We expect some modest improvement in business investment during 2024 in step with these improved earnings and lower inflation and interest rates. An offset to these tailwinds could be stubbornly high wage growth amid a historically robust labor market.

The ISM Manufacturing Index: Manufacturing activity led the U.S. economy out of the pandemic-era shutdowns as consumers spent their stimulus checks on goods when they were unable to go to restaurants or travel. Impaired supply chains recovered and manufacturing surged to replenish depleted inventories. A normalization of consumption patterns away from goods and back towards services occurred over 2021-2022. In 2023, we have seen modest positive real growth in the manufacturing sector despite the survey-based ISM Manufacturing Index signaling contraction, with readings below 50 throughout 2023. It is unclear at this time whether the ISM as a leading indicator is broken or if there are especially long lags in this unique post-pandemic economic era. Manufacturing activity in Europe and China has been quite weak in 2023. The U.S. ISM Non-Manufacturing Index has been relatively strong throughout 2023; although, the index has declined since August, indicating still positive, but decelerating growth.

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The ISM Manufacturing Index is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of the state of the U.S. economy.

Gross Domestic Product: For 2024, we believe the U.S. economy will continue to grow but at a slowing pace, in the 2.0-2.5% range. The Bloomberg consensus for 2024 GDP is 1.3%. While the Fed will begin to cut rates during 2024, we do not anticipate a significant stimulative effect. The cuts will be mainly defensive in nature, preserving the recovery and allowing the economy to continue to grow around its potential of 1.8-2.0%.

Unemployment: We anticipate the unemployment rate will very modestly rise to the range of 3.85-4%. We expect the labor force participation rate to continue to increase modestly and that an adequate job growth rate will be sustained in 2024. Wage growth, currently slightly above 4%, will trend lower as is typical in the later part of an economic cycle.

Inflation: We expect inflation to continue to trend lower during 2024. Core PCE (Personal Consumption Expenditures excluding food & energy - the Fed's preferred measuring gauge) finished 2023 at approximately 3.46%. We believe the Fed will remain focused on attaining their 2% Core PCE target, but during 2024, they will patiently allow the rate to decelerate.

Monetary Policy: We believe the Fed has exceeded the neutral rate after completing eleven quarter-point increases since March 16th of 2022 resulting in the current Fed Funds rate of 5.25-5.50%. We anticipate their first cut will occur at the May or June Fed meeting and that the Fed Funds rate will end the year in the 4.25-4.50% range with more cuts likely going into 2025.

Interest Rates: As a result of two or three 25 basis point Fed rate cuts during the second half of 2024, the front end of the curve will decline. Regardless of the major move down in longer term rates during the weaning months of 2023, we maintain a bias for interest rates across the curve to drift lower in 2024, resulting in a modest flattening of the curve. We expect the 10-year Treasury yield to end the year between 3.50% - 3.75%.

Investment Grade Corporate Bond Outlook: Corporate securities were the best performers in 2023. In 2024 we expect corporate spreads versus Treasury bonds to widen only modestly. Given strong balance sheets, corporate credit fundamentals and rating trends remain strong and we will continue to stay up-in-quality. We believe credit selection will be paramount in both investment grade and high yield, as the focus will shift toward fundamentals and the ability of corporates to navigate this macro uncertainty with U.S. economic growth risks tilted to the downside.

High Yield Bond Outlook: We anticipate a very modest increase in high yield defaults during 2024. The long-term average high yield bond default rate (since 2017, post energy default wreck) is now at 2.1%. We expect defaults to increase modestly during 2024 paired with modest spread widening. Our 2024 total return for the asset class is close to the index coupon, in the 5.5%-6% range.

Thank you!

Another year gone by, they seem to go faster as the years pass. Long term, we believe the U.S. economy will return to feel a great deal like the extended slow growth period it experienced prior to 2020. We want to thank you for your business and introductions to new clients during the past decade. We look forward to serving you in 2024 and helping to successfully navigate the ever changing fixed income landscape. Please remember our bottom-up investment process and extensive research focus helps us identify relative value opportunities in the marketplace, giving us confidence in the risk-reward trade-offs in our portfolios. While market fluctuations can occur, we believe our long-only style of investing has delivered positive results with reduced volatility over the long term.

If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

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