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Weekly Fixed Income Commentary

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Treasury yields decline despite a hawkish Fed

U.S. Treasury yields rallied last week. U.S. Federal Reserve Chair Powell indicated that a rate cut in March is unlikely, and surprisingly strong U.S. employment data served as a second blow for fixed income investors hoping for early rate cuts.

HIGHLIGHTS

- **Total returns were positive across most major asset classes, including Treasuries, investment grade and high yield corporates, preferreds, senior loans and emerging markets.**
- **Municipal bond yields declined. New issue supply was $4.5B and fund inflows were $1.5B. This week's new issuance is estimated to be $9.2B.**

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Watchlist

- *The 10-year U.S. Treasury yield fell last week, and we anticipate further declines in overall rates in the months ahead.*
- *Spread assets broadly outperformed Treasuries.*
- *Increased seasonal supply should provide an attractive entry point for municipal bonds.*

INVESTMENT VIEWS

Rates have probably peaked for this cycle, as attention pivots toward rate cuts in response to softer growth and easing inflation.

The underlying growth outlook remains healthy thanks to strong consumer balance sheets and solid levels of business investment. This combination should keep corporate defaults low.

Risk premiums may widen further, with entry points for taxable fixed income likely to become more attractive over the coming quarters. Credit selection is key as we search for bonds with favorable income and solid fundamentals.

KEY RISKS

- Inflation fails to continue moderating as expected, weighing on asset prices.
- Policymakers unsuccessfully juggle fighting inflation with supporting economies still struggling to gain traction.
- Geopolitical flare-ups intensify: Israel, China, Russia and Iran.

INVESTMENT GRADE CORPORATES RALLY BUT LAG TREASURIES

U.S. Treasury yields declined last week, despite strong economic data and hawkish new commentary from Fed Chair Jerome Powell. 10-year Treasury yields ended the week -12 basis points (bps) lower at 4.02%. The January jobs report showed a much stronger labor market than expected, with a headline pace of 353,000 jobs for the month and another 126,000 in upward revisions to the November and December figures. The unemployment rate stayed flat at its low level of 3.7%, and wage inflation picked up to 4.5% year-over-year. The strong data, plus Chair Powell's indication that a rate cut in March is unlikely, combined to push 2-year yields 2 bps higher.

Investment grade corporates rallied, returning 0.58% for the week, though the asset class lagged similar-duration Treasuries by -31 bps. Regional and lower-rated bank debt was pressured after New York Community Bancorp announced very weak earnings, due in large part to losses on commercial real estate credit. Spreads on BBB rated bank debt widened 10 to 20 bps, though the globally systemically important banks (G-SIBs) rallied slightly. Investment grade fund inflows slowed but remained healthy at $2.6 billion. January closed with record new issuance totaling almost $185 billion, up 31% versus January 2023. We expect a modest slowdown in February but still anticipate healthy supply of almost $150 billion.

High yield corporates experienced more modest gains, returning 0.10% for the week and underperforming similar-duration Treasuries by -12 bps. Senior loans returned 0.04%. Both markets experienced inflows, with $2.4 billion entering high yield funds and $410 million flowing into loans. Continuing the recent theme, both markets remained very active with new issuance, with $9.5 billion in high yield and almost $30 billion in loans. As in recent weeks, most of that was related to refinancing.

Emerging markets outperformed, returning 0.70% for the week, though the asset class slightly lagged similar-duration Treasuries by -2 bps. Hard currency funds had inflows of $60 million, while local funds had outflows of -$280 million. The new issue market was relatively light, with $8.6 billion total across sovereigns and corporates. Meanwhile, local markets returned 0.56% for the week, boosted by a decline in rates across much of emerging markets Europe.

MUNICIPAL BONDS SEE HIGHEST INFLOWS IN MORE THAN A YEAR

Municipal bond yields ended last week dramatically lower, as investors believe the Fed will cut interest rates later this year. However, yields rose on Friday when the U.S. employment report was more robust than anticipated. Weekly new issue was light and well received. Fund inflows totaled $1.5 billion, including $817 million for exchange-traded funds, representing the largest inflow in 55 weeks. New issuance is expected to pick back up this week and should be well received.

The municipal market remains well bid. The market received $32 billion of 01 February reinvestment money. Thus, even though the new issue calendar is robust – and should remain so for several weeks – this supply should be easily absorbed. While high grade munis are rich to their taxable counterparts, there is outsized demand for tax-exempt income.

The New York State Thruway Authority issued $1 billion general revenue bonds (rated A1/A+). The deal was well received and some bonds traded at a premium in the secondary market. For example, 5.25% coupon bonds due in 2054 came at a yield of 3.95% and traded in the secondary market at 3.82%.

High yield municipal bond fund flows have returned thus far in 2024, and the market has enjoyed a firm tone with the backdrop of limited supply. High yield muni yields have decreased 3 bps on average, while yields excluding Puerto Rico and tobacco have decreased 10 bps. The high yield muni credit spread is 241 bps, increasing to 273 bps ex Puerto Rico and tobacco. In an environment where the general level of rates is no longer driving performance, investors should rely upon yield, sector and credit selection.

Municipal bond fund inflows totaled $1.5 billion, representing the largest inflow in 55 weeks.

In focus

The Fed takes its time

As expected, last week the Fed kept its benchmark fed funds rate at a range of 5.25%-5.50%. But in the wake of its December forecast for 75 bps worth of cuts in 2024, the central bank left unanswered the key question —when will it begin easing policy?

In its policy statement, the Fed tweaked the language from December's reference to "any additional policy firming that may be appropriate" to "any adjustments to the target range for the federal funds rate." This dovish change reflected further evidence of cooling inflation data, with the Personal Consumption Expenditures Index, the Fed's preferred inflation barometer, dipping to 2.9% (year-over-year) in December, within striking range of its 2% target.

But in a nod to the hawks, Chair Jerome Powell noted at his press conference that while the Fed's confidence in a soft landing is "growing," cuts at the next meeting in March are "not the most likely case." The more likely outcome, Powell suggested, is to examine whether, "we are in fact on a path — a sustainable path — down to 2% inflation. And the answer will come from more data."

The Fed's cautious stance prompted traders to dial back bets on March rate cuts, as the market-implied odds of such monetary easing, which had reached as high as 78% before the meeting, fell to around 20% by the end of the week, though they were also dragged down by Friday's strong employment report. We continue to expect rate cuts to start closer to midyear.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	January 2024	Year-to-date
2-year	4.37	0.02	-0.04	0.11
5-year	3.98	-0.05	-0.01	0.14
10-year	4.02	-0.12	0.03	0.14
30-year	4.22	-0.15	0.14	0.19

Source: Bloomberg L.P., 02 Feb 2024. **Performance data shown represents past performance and does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	January 2024	Year-to-date
2-year	2.61	-0.10	-0.03	0.09
5-year	2.31	-0.12	-0.05	0.03
10-year	2.33	-0.13	-0.05	0.05
30-year	3.47	-0.14	-0.05	0.05

Source: Bloomberg L.P., 02 Feb 2024. **Performance data shown represents past performance and does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	58
30-year AAA Municipal vs Treasury	82
High Yield Municipal vs High Yield Corporate	72

Source: Bloomberg L.P., Thompson Reuters, 02 Feb 2024. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg High Yield Municipal Index divided by the yield-to-worst for the Bloomberg High Yield Corporate Index. **Performance data shown represents past performance and does not predict or guarantee future results.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	January 2024	Year-to-date
Municipal	3.32	–	6.08	0.94	-0.51	-0.17
High yield municipal	5.56	241[1]	7.09	1.57	-0.46	0.01
Short duration high yield municipal[2]	5.26	295	3.80	0.80	0.65	0.77
Taxable municipal	4.93	73[3]	8.02	1.34	-0.06	-0.20
U.S. aggregate bond	4.67	41[3]	6.32	0.65	-0.27	-0.66
U.S. Treasury	4.21	–	6.19	0.72	-0.28	-0.66
U.S. government related	4.72	48[3]	5.34	0.59	-0.13	-0.46
U.S. corporate investment grade	5.18	96[3]	7.07	0.58	-0.17	-0.50
U.S. mortgage-backed securities	4.87	48[3]	6.17	0.62	-0.46	-0.91
U.S. commercial mortgage-backed securities	5.26	111[3]	4.38	0.54	0.72	0.40
U.S. asset-backed securities	5.00	60[3]	2.65	0.22	0.47	0.29
Preferred securities	6.58	180[3]	4.60	0.21	2.62	2.62
High yield 2% issuer capped	7.76	330[3]	3.19	0.10	0.00	0.03
Senior loans[4]	9.21	528	0.25	0.04	0.78	0.75
Global emerging markets	7.18	298[3]	6.11	0.70	-0.56	-0.64
Global aggregate (unhedged)	3.65	42[3]	6.72	0.37	-1.38	-1.97

1 Yield difference between the Bloomberg High Yield Municipal Index and the 20-year AAA MMD scale. **2** Data is a subset of the S&P Short Duration Municipal Yield Index that is below investment grade/nonrated. Spread is the yield difference between this subset and the subset rated AAA. **3** Option-adjusted spread to Treasuries. **4** Spread refers to the 3-year discount margin. Duration is estimated based on the frequency of the reset date.

Source: Bloomberg L.P. and Credit Suisse, 02 Feb 2024. **Performance data shown represents past performance and does not predict or guarantee future results.** Unless otherwise noted, the index is Bloomberg. All index returns are shown in U.S. dollars. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting. **Effective duration** (expressed in years) measures the price sensitivity of a fixed-income investment to a change in interest rates, considering that expected cash flows will fluctuate as interest rates change. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account.

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Performance: Bloomberg, L.P. **Issuance:** The Bond Buyer, 02 Feb 2024. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 31 Jan 2024.

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Representative indexes: municipal: Bloomberg Municipal Index; **high yield municipal:** Bloomberg High Yield Municipal Index; **short duration high yield municipal:** S&P Short Duration Municipal Yield Index; **taxable municipal:** Bloomberg Taxable Municipal Bond Index; **U.S. aggregate bond:** Bloomberg U.S. Aggregate Bond Index; **U.S. Treasury:** Bloomberg U.S. Treasury Index; **U.S. government related:** Bloomberg U.S. Government-Related Index; **U.S. corporate investment grade:** Bloomberg U.S. Corporate Index; **U.S. mortgage-backed securities;** Bloomberg U.S. Mortgage-Backed Securities Index; **U.S. commercial mortgage-backed securities:** Bloomberg CMBS ERISA-Eligible Index; **U.S. asset-backed securities:** Bloomberg Asset-Backed Securities Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield 2% issuer capped:** Bloomberg High Yield 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index; **global emerging markets:** Bloomberg Emerging Market USD Aggregate Index; **global aggregate:** Bloomberg Global Aggregate Unhedged Index.

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