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Pause, pivot, and volatility: Charting the fixed-income landscape

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Introduction

The current economic backdrop presents a compelling opportunity for fixed income investors, with inflation heading toward the Federal Reserve's ("Fed") 2% target and the Fed signaling a more "balanced approach" to monetary policy, including the potential for several rate cuts in 2024.

The looming question for fixed income investors revolves around the magnitude of the decline in interest rates and how that changes the shape of the yield curve. We expect 2024 to be a year of continued fixed income volatility, given the uncertainty surrounding monetary policy. While inflation is poised to approach the Federal Reserve's 2% inflation target, investors should stay vigilant to potential inflationary surprises. For example, February's consumer price index (CPI) report surprised some market participants by showing that deflation in core goods might be stalling, increasing by 0.1% month-over-month for the first time since May 2023. Indeed, this highlights how the final stretch toward the Fed's 2% inflation target might be fraught with challenges. Against this backdrop, we believe investors might gain from a well-diversified portfolio, drawing income from investment grade credit and prudently adding duration as the market anticipates approximately 3 interest rate cuts from the Fed in the latter half of 2024.

We advocate for several key themes for fixed income in the year ahead:

- Investors have an opportunity to capture compelling yields from bond investments as the Federal Reserve considers interest rate cuts in 2024 following the sharp increase in rates from zero-bound levels over the past two years
- As inflation moderates, investors may want to consider shifting some cash from money market funds into fixed income
- Focus on high-quality segments of the bond market to mitigate the effects of any potential economic downturn

> **"While volatility will likely remain elevated, we are still constructive on both credit and the broader fixed income landscape. The volatility that will likely take place should enable active managers to identify strong relative value opportunities."**

Waldo Torres
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What's changed in the fixed income market?

In 2023, market participants were dependent to an extreme on economic data, specifically inflation and the labor market. News of economic reports throughout 2023 often resulted in wild swings in sentiment, market prices and economic prognostication. Much of this volatility played over the past several years was the market's attempt to understand the Fed's reaction function.

Analysts often say financial markets are interrelated but not synonymous with the economy. Over the past several years, the remarkable resilience exhibited by the overall economy despite monetary policy tightening by the Federal Reserve has underscored this notion. At the same time, the bond market has stumbled under the weight of high inflation. Bond market volatility and the subsequent negative performance of the Bloomberg U.S. Aggregate Bond Index in 2021 and 2022 unnerved many market participants.

While lower interest rates are likely in 2024, investors should anticipate spells of volatility as the market grapples with shifts in Federal Reserve policy and variability in economic data. For example, the strength of the U.S. economy, a potential record issuance of U.S. debt by the Treasury, and the continuation of restrictive monetary policy will likely keep upward pressure on yields in the first half of 2024.

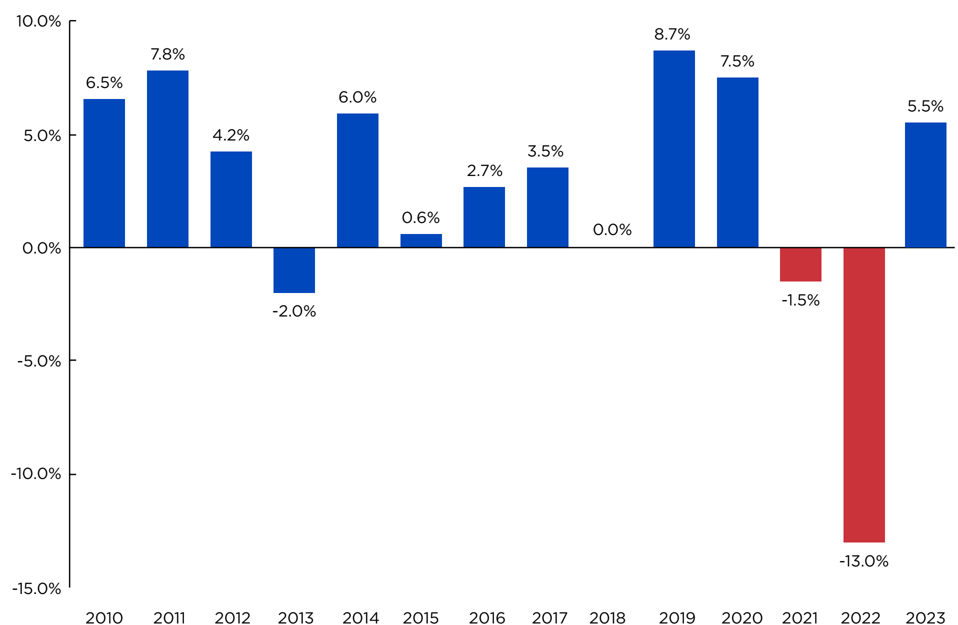
Toward the end of 2023, however, the Federal Reserve gave bond investors a boost by signaling 3 rate cuts on the horizon in 2024. That helped the Bloomberg U.S. Aggregate Bond Index deliver a positive return for 2023.

10-Year Treasury Yield

The volatility in the bond market has been anything but modest; the yield on the 10-year Treasury has fluctuated significantly over the past 2 years.

Source: Federal Reserve Bank of St. Louis, FRED data, daily as of 2/1/2024

Bloomberg U.S. Aggregate Bond Index, total return by calendar year, 2010-2023

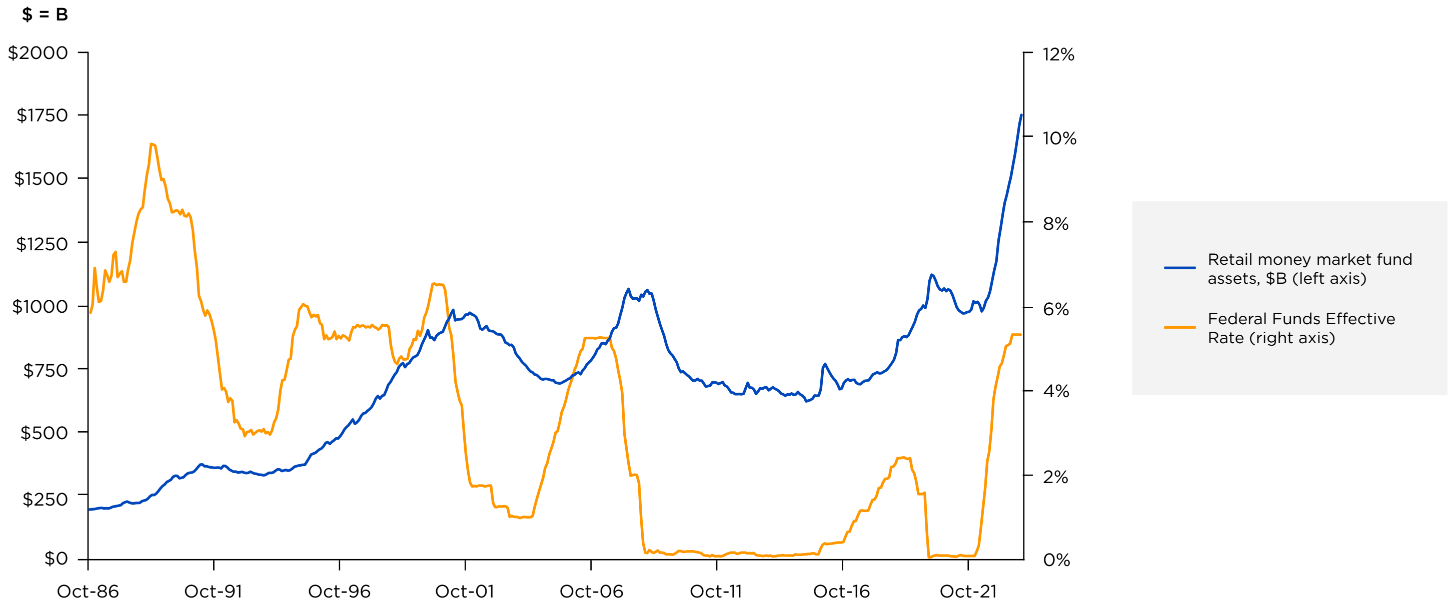


Source: FactSet, as of 2/2/2024

The case for fixed income is strong

After one of the worst years in decades for bond investors (2022), many investors sought the stability and yield offered by money market funds, seeking relief from further losses in the bond market. There was some respite in 2023, but fixed income markets remained volatile, compelling investors to continue shifting their allocations to money market funds.

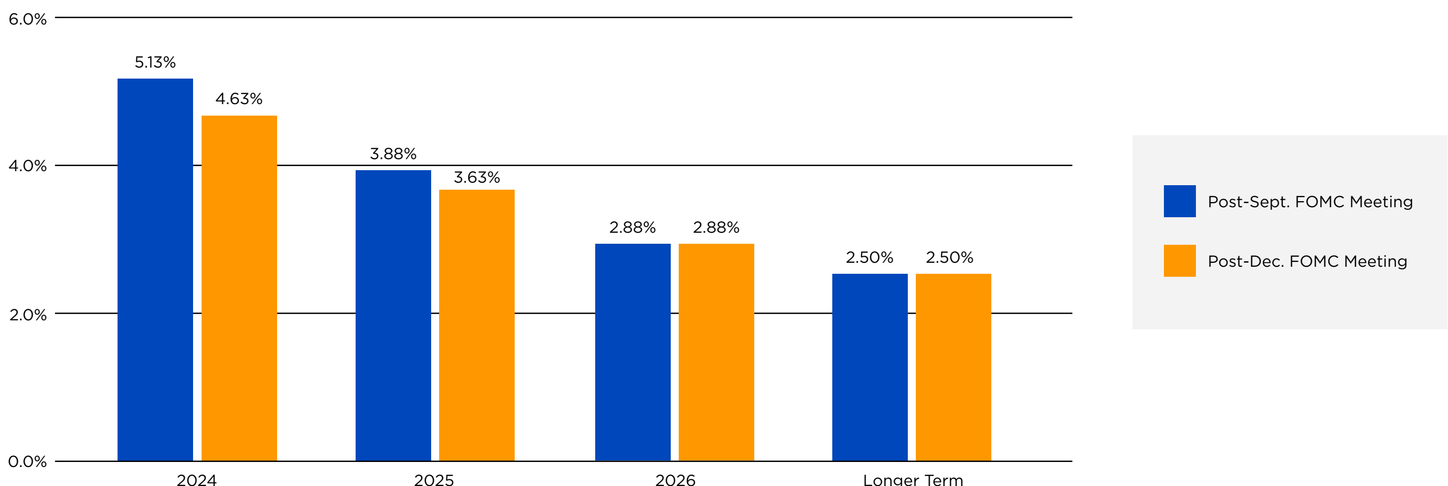
Retail money market fund assets relative to Fed funds rate, Oct. 1986 to Dec. 2023



Source: Federal Reserve Bank of St. Louis, FRED Data, monthly as of 12/31/23

While money market funds should be part of a balanced portfolio, investors should not completely abandon fixed-income assets due to market volatility. Investors should understand several key risks when parking their cash in money market funds. By sitting on the sidelines, investors might be forfeiting income from higher-yielding fixed-income assets, such as the U.S. high-yield market. Second, with the Federal Reserve likely to begin cutting rates in the latter half of 2024, investors can face reinvestment risk as money market fund yields tend to decrease after the second interest rate cut from the Fed.

Median projected Fed funds rate for the next 2 years, Sept. and Dec. 2023



Source: Federal Reserve, Summary of Economic Projections, Sept. 20 and Dec. 13, 2023.

Rather than trying to time the market, deploying idle cash toward fixed-income products has historically proved reasonable and can add ballast to an investor's portfolio. For example, the average total return for the Bloomberg U.S. Aggregate Bond Index 12 months after a Fed pause is approximately 10%.[1] As such, we believe that parking funds exclusively in cash due to apprehensions about market volatility instead of being fully invested leads to a considerable reduction in the likelihood of meeting one's investment objectives over any reasonable time horizon.

Bloomberg U.S. Bond Aggregate Index return 12 months after Federal Reserve rate pause

Fed Pause Date	Bloomberg U.S. Bond Aggregate Index - 12 Months After Total Return (%)
2/28/1995	12.2%
3/31/1997	12%
5/31/2000	13.1%
6/30/2006	6.1%
12/31/2018	8.7%
07/26/2023 - Fed Pause	TBD
Average	**10.42%**

Source: FactSet, as of 2/2/2024

Investment grade: fundamental strength to withstand a slowdown

Despite some fluctuations, investment-grade corporate bonds performed well in 2023. The Bloomberg U.S. Corporate Investment-Grade Bond Index returned 8.52% for the year, outpacing the Bloomberg U.S. Aggregate Bond Index by 299 basis points (bps). We expect similar performance in 2024, with U.S. investment-grade bonds likely outperforming the overall bond market.

The start of 2024 has witnessed a significant issuance of investment-grade bonds for U.S. companies. This trend can be primarily attributed to narrow credit spreads, which have been below long-run medians, coupled with low volatility. Furthermore, tight credit default swap spreads, which have been at their tightest levels in 2 years, have also contributed to the favorable conditions for investment-grade issuance. Looking ahead, the prospect of lower interest rates is expected to support continued investment-grade issuance as the year progresses, thanks to the Federal Reserve signaling their willingness to ease monetary policy in 2024 and healthy interest coverage ratios.

For many investment-grade firms, balance sheet and capital management throughout 2023 were quite strong; firms reigned in capital expenditures and cleaned up excess capital spending last year in preparation for the recession that never came (at least not yet). In fact, corporate net interest expense declined in 2023 even as the Fed raised rates, highlighting the prudent financial approach that many U.S. firms had adopted. Corporate revenues remained resilient throughout 2023 as well, and more importantly, companies, by and large, were able to pass along higher costs to maintain margins.

In our view, high-quality companies seem well-prepared to weather an economic slowdown or mild recession in the U.S., should it materialize later this year.

[1]FactSet

Bloomberg U.S. Corporate Investment-Grade Bond Index

Source: FactSet, as of 2/2/2024

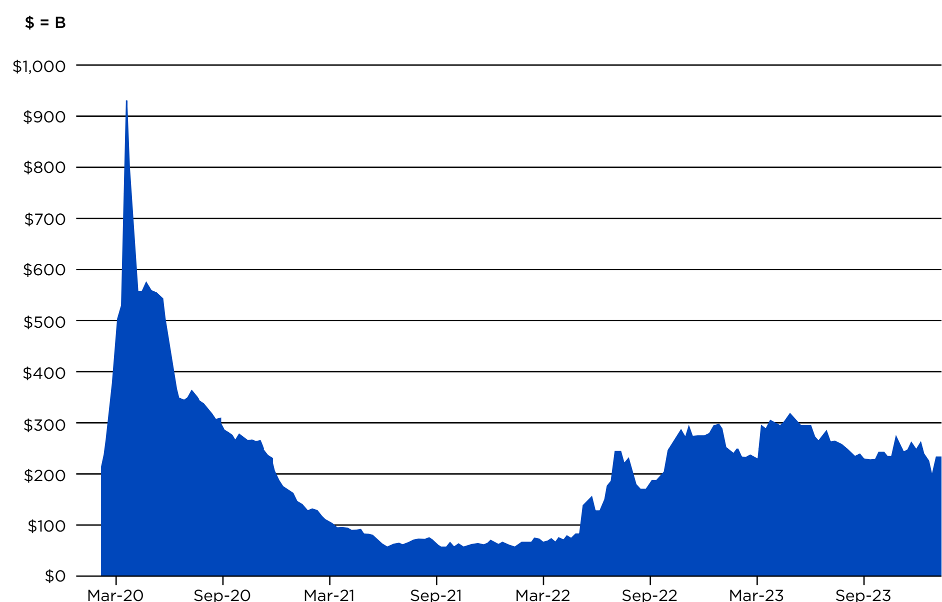
High-yield: Caution is warranted, but opportunity remains

While issuance of high-yield bonds ground to a halt in 2022 and 2023, there was significant investor demand for the supply of high-yield issues that did come to market. Earnings growth for firms in the high-yield space was relatively flat and in the low single digits for 2023. Expectations for high yield earnings growth for the 2024 calendar year fall between 5-10%.[2] It will be important to watch maturity walls for high-yield, which are slightly further out than they are in the investment-grade market, where the largest percentage of bonds come due in 2026. It will be important to watch going into year-end and the start of 2025 as companies will try to prevent long-term debt from moving to short-term liabilities.

In particular, weakness in bonds rated CCC and lower should likely continue this year as distressed debt continues to be elevated relative to their post-pandemic levels. Peak distressed debt since 2020 was slightly more than $300B in May 2023. As of January 19, 2024, this amount was $217B. These levels are well off the peak of $935B during the Global Financial Crisis.

[2]Bloomberg, S&P Capital IQ, and Morgan Stanley Research.

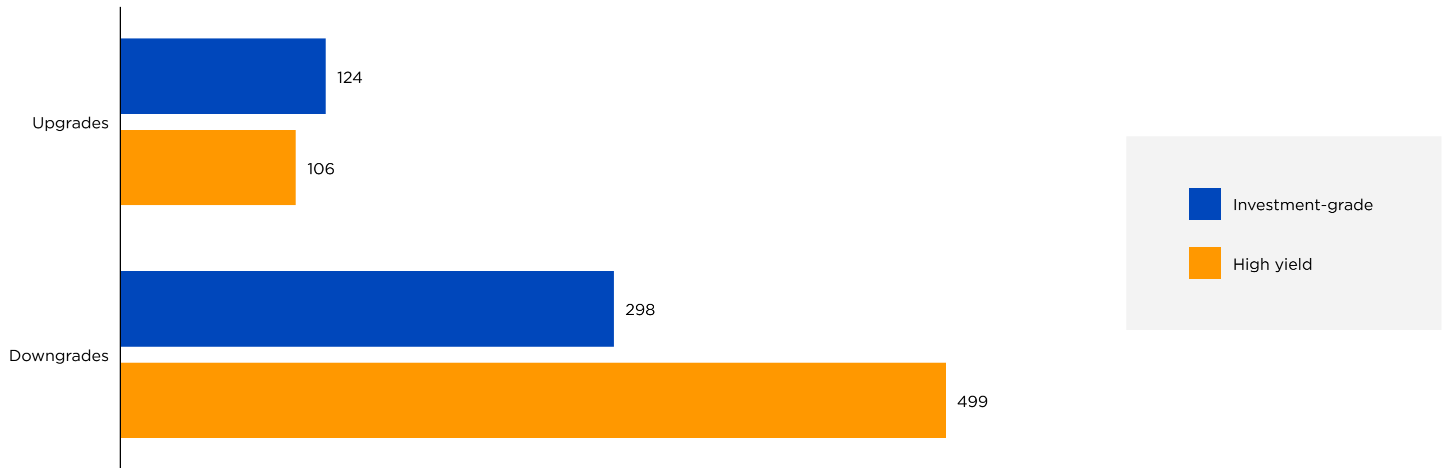
Distressed debt and loans, $ billions, Mar. 2020 to Jan. 2024



Source: Bloomberg, as of 1/24/24

Investing in high-yield corporate bonds can be risky, but their attractive yields can help by adding ballast to a well-designed portfolio. As of February 2, 2024, the average yield-to-worst of the Bloomberg U.S. Corporate High-Yield Bond Index is around 7.76%. The high-income payments high-yield bonds offer can act as a cushion in case prices decline. However, potential risks to consider are the inverted yield curve, the higher cost of capital and increased borrowing costs for highly leveraged companies, concerns about economic growth (if economic growth slows), and increasing corporate default rates.

Upgrades and downgrades for investment-grade and high-yield bonds, 2023



Source: Standard and Poor's rating actions: Jan. 1 to Dec. 29, 2023

We remain cautious on high-yield bonds. However, if a recession is avoided in 2024, they may still perform well despite low spreads. It is conceivable that high-yield bond prices may remain resilient despite tight spreads, should the economy experience moderation and a recession or hard landing be averted. It is worth noting that the Bloomberg U.S. Corporate High-Yield Bond Index, with an average coupon rate of approximately 6%, offers investors a buffer, whereby prices could decline by roughly 6% over 12 months without incurring losses.

Bloomberg U.S. High-Yield Corporate option-adjusted spread, Jan. 2019 to Feb. 2024

Source: FactSet, as of 2/2/2024

Emerging market debt: Beneficiaries of developed market policy easing

As global central banks turn from inflation concerns to supporting economic growth, we believe emerging market (EM) debt issues offer selective opportunities relative to the U.S., eurozone, and U.K. sovereign debt markets. In an environment where developed central banks are easing interest rates, we expect central banks in emerging market countries to have the ammunition to cut rates and bolster their economies, especially those that quickly adjusted their monetary policies in the face of rising inflation. When central banks are lowering rates, the U.S. dollar historically tends to see outflows as institutions move away from the safety of the dollar and into emerging market currencies to take advantage of the carry opportunity.

We see potential growth in EM that might differentiate from Developed Markets (DM) this year. Structural forces such as near-shoring and improving trade and supply-chain links should act as a tailwind for EM, in conjunction with capital investment flowing into emerging economies. Lastly, lower food and energy prices should help emerging markets, where commodity prices impact economic growth more than services-related activity (such as the U.S.).

Investors should be aware that emerging markets remain linked to sentiment arising from geopolitical risk and macroeconomic headwinds. For example, China's faltering economic growth could dampen EM sentiment. Similar to the U.S., there remains uncertainty around the timing and magnitude of interest rate cuts in emerging market countries.

Emerging market debt in relation to U.S. dollar, Jan. 2022 to Jan. 2024

Source: FactSet, data as of 2/2/2024

Conclusion

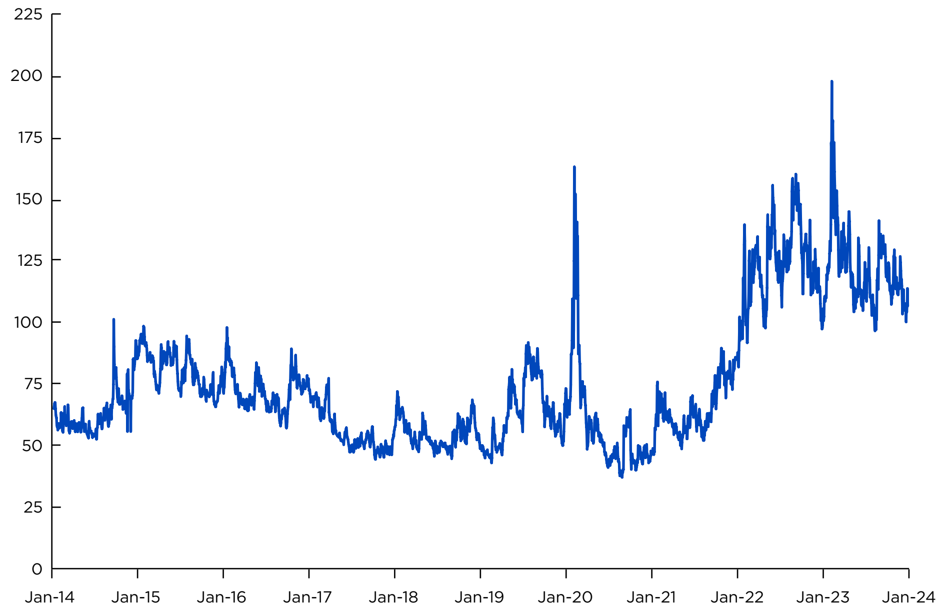
The current backdrop of higher yields allows investors to generate income and diversify their portfolios. Despite the likelihood of continued elevation in market volatility, we remain optimistic about the fixed income landscape. We contend that active managers are well-positioned to capitalize on the changing market, given that market volatility will likely remain as the Federal Reserve assesses the economic landscape.

As such, the fixed income market will likely experience volatility in 2024. The current economic cycle has been markedly distinct from previous ones, and the path from high to low and stable inflation may not be straightforward. Any economic data report, Federal Reserve meeting, or comment could trigger market volatility. For example, consistent with our theme of volatility, over the first couple of months of 2024, investors have seen expectations for Federal Reserve rate cuts moderate, from 5 to 6 rate cuts priced earlier in the year to about 3 rate cuts expected by investors, beginning in the June FOMC meeting. This shift in market expectations comes as inflation data surprised to the upside and as Fed officials have talked about remaining patient before starting rate cuts, particularly given that economic growth has held up better than expected.

In our view, this shift to 3 rate cuts starting in June is more aligned with the Fed's view as well as our base-case scenario for 2024, underscoring how changes in economic data and monetary policy can usher in bouts of volatility. Therefore, when considering the backdrop for bonds, we encourage investors not to play the timing of interest rate reductions; rather, we think it is more prudent to maintain a long-term perspective on the natural destination of rates and work with a financial professional to adapt an appropriate fixed-income strategy.

ICE BofAML MOVE Index, Jan. 2014 to Jan. 2024

ICE BofAML MOVE Index measures U.S. interest rate volatility—a key theme as investors debate the magnitude and timing of potential Fed rate cuts.



Source: FactSet, as of 2/2/2024

About the author: Mark Hackett

Mark Hackett serves as Chief of Investment Research. As a leader for Nationwide's capital markets analysis, Mark develops content to educate financial advisors and their clients on financial markets and implications for investors. In this role he is responsible for asset class research, market commentary, white papers and topical market pieces.

Mark brings more than 20 years of experience in the asset management industry, including roles in research for both Nuveen and Vanguard Group and as a portfolio manager for Nuveen. He began his investment career at the Vanguard Group as a research associate in the fixed income group.

Mark has been interviewed by and quoted in numerous media outlets, including The Wall Street Journal, CNBC.com, CNN Money, The Associated Press, and several others. He also contributes weekly market commentary to the Nationwide Advisor Advocate Blog.

He earned his Bachelor of Science in Business Administration with concentrations in Finance and Economics at the University of Richmond, holds Chartered Financial Analyst (CFA) and Chartered Market Technician (CMT) designations and is a member of the CFA Institute.

About the author: Waldo Torres

Waldo Torres is a Senior Investment Analyst for Nationwide's Manager Strategies team, which he joined in 2021. He is the lead covering the fixed income portfolios for the Nationwide Mutual Funds and the Nationwide Variable Insurance Trust. He also plans, leads, and coordinates portfolio reviews and strategy selections.

Torres has been with Nationwide for eight years. Prior to joining the financial administration team, he worked for the Nationwide Institutional Investments Distribution team for two years. As a Data Analyst, he was responsible for data analysis concerning performance, sales, and database management for the Nationwide Mutual Fund product lineup.

Torres was recently recognized by Citywire as part of their 2023 Rising Stars of Manager Research list.

Torres earned a Bachelor of Science degree from the University of Houston. He is a Chartered Mutual Fund Counselor (CMFC®).

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Bloomberg US Aggregate Bond Index: An unmanaged, market value-weighted index of U.S. dollar-denominated, investment-grade, fixed-rate, taxable debt issues, which includes Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities and commercial mortgage-backed securities (agency and non-agency).

Bloomberg US Corporate Bond Index: An index that measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

Bloomberg US Corporate High Yield Index: The index measures the performance of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds.

Bloomberg US Corporate Investment Grade Bond Index: An index that represents primarily investment-grade corporate bonds within the Bloomberg US Aggregate Bond Index.

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ICE BofAML MOVE Index: A well-recognized measure of U.S. interest rate volatility that tracks the movement in U.S. Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries.

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