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Strategy Update: US Core and Core Plus

Despite the rate volatility last year, we see many reasons for optimism in 2024. Inflation concerns have eased recently, shifting the market's focus to expectations of slower growth. The Fed's pivot toward potential rate cuts has made yields attractive, suggesting a strong case for the fixed-income asset class. We anticipate continued disinflation and moderate growth in the US, avoiding a recession. The Fed is likely to cut rates mid-year, providing a further tailwind for fixed-income. We see opportunities in structured credit, agency mortgages and EM. As a result, we're using a balanced portfolio approach to manage geopolitical risks and interest-rate volatility. Here are some key takeaways.

Market Review

- Despite volatility, yields ended 2023 unchanged, with views shifting from recession fears to strong growth.
- A late-2023 rally in fixed-income occurred as disinflation continued and Federal Reserve (Fed) policy pivoted.
- Negative correlations between rates and risk assets returned in 2023, providing diversification benefits and contributing to portfolio performance.

Federal Reserve Policy

- As acute inflation concerns dissipated in 2023, expectations shifted from furthering Fed tightening to Fed rate cuts, at some point.
- As inflation declines from peak levels and economic growth is expected to moderate, the Fed's next policy move, likely rate cuts, will potentially begin in mid-2024, setting up a possible tailwind for fixed-income returns.

Inflation

- Recent Consumer Price Index (CPI) and Producer Price Index (PPI) reports came in slightly above expectations, but the overall trend shows a reduction in inflation rates compared to the same period a year ago.
- Various measures of rents, a significant component of inflation, show a clear downward trajectory, although some lag behind real-time changes.
- The jobs print was higher than expected in January, but the trend is moving in the right direction. Combine this with a downward trajectory of wages as well as labor demand and quit rates being down indicate a softening of the labor market ahead.
- We expect the disinflationary trend to continue although not without some bumpiness along the way.

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Investment Themes

- Our view is that the current macroeconomic environment of good growth, declining inflation and a Fed that's biased to cut rates is supportive of spread products. Our bias is on structured credit, particularly commercial mortgage-backed securities (MBS).
- We continue to hold investment-grade and high-yield credit but at reduced levels compared to a year ago.
- We view the widening of agency MBS spreads as an opportunity and think that it's poised to do well as the Fed starts cutting rates.
- Valuations of emerging market (EM) valuations are at extremely low levels. We believe EM is tied strongly to the overall health of the global economy and we're constructive on that.
- We think interest-rate volatility should decline as growth subsides to more sustainable levels and inflation continues its downward trajectory. In this environment, investors should feel more comfortable having duration in their portfolios.

Outlook

- Fixed-income valuations are attractive today relative to the median.
- Given the substantial progress in reducing inflation over the last year, the disinflationary trend is expected to continue through 2024, barring any significant surprises.
- The pivotal shift in Fed policy from aggressive tightening toward ending hikes and introducing potential rate cuts set up supportive tailwinds for financial markets overall.
- Now that historical negative correlations between asset classes have largely resumed, bonds are anticipated to provide improved diversification benefits in portfolios going forward.
- As we approach Fed rate cuts, we believe that the attractive cash rates should dissipate and locking in longer-term securities with more duration will be beneficial.

Q & A

- Interest-rate volatility has been a significant driver in the bond market, but the expectation is that it will decrease as growth moderates, inflation continues to decline and the Fed moves toward cuts.
- The US dollar has shown some strength at the start of the year, though we believe this should level off as the Fed begins to cut rates and global growth continues, leading to a more sideways trading environment for the dollar.
- Developments in China, including deflation and property market concerns, are being monitored, but the country has resources to address imbalances, and EM regions are less reliant on China than in the past, offering investment opportunities in select countries.

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