Fixed Income Outlook

2024 Year Forecast

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The Next Normal

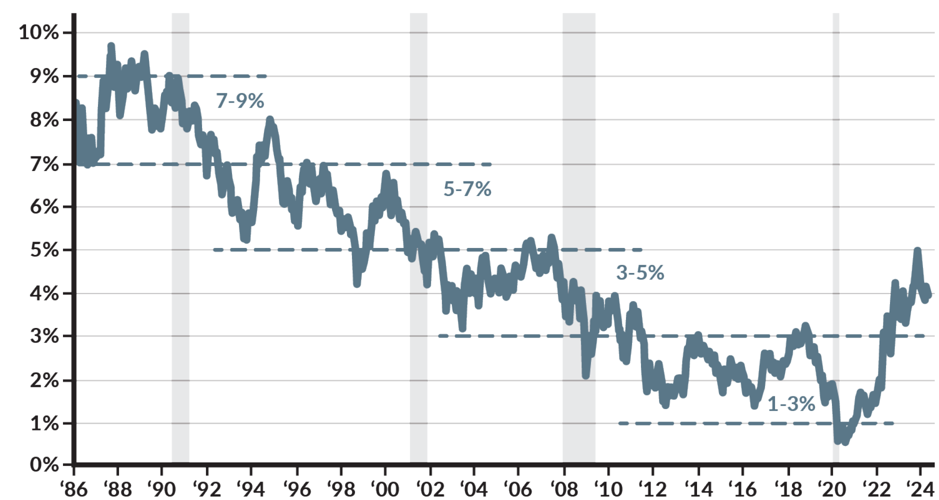
For investors, the defining characteristic of the post-Great Financial Crisis period from 2009 to 2019 was low interest rates—some would say artificially low interest rates. The Federal Reserve kept short-term rates near zero to support the economy during a long period of slow but stable economic growth while inflation remained stubbornly below central banks' targets. This low growth, low-rate period was dubbed by some the "New Normal."

The path to policy normalization that began with modest rate hikes from 2017-2019 was famously interrupted by the 2020 Covid pandemic, when central bank action and unprecedented fiscal policy support combined with supply chain disruptions to unleash the highest inflation since the 1980s. The 10-year Treasury yield, which had fallen below 1% during the depths of the crisis, began a rapid ascent as the Fed began the fastest interest-rate hiking cycle since the 1970s. The 10-year peaked at 5% in October of last year, just below the Fed Funds rate, which now sits in a range between 5.25%-5.50%.

We begin 2024 by shifting our focus to the future and navigating the Next Normal, which we believe will look more like the pre-GFC period. We believe intermediate interest rates will settle into the 3-5% range seen pre-crisis *[Figure 1]*, providing an attractive yield for fixed income investors. While the recent surge in rates will take time for the economy to absorb, we think the Fed Funds rate and inflation have both peaked for this cycle. Rates will likely decline further as the Fed meets its inflation targets, but we don't expect a return to the ultra-low interest rates that dominated the last 15 years. We think the Fed will be mindful of reigniting inflation and repeating the mistakes of the 1970s. In short, the Next Normal will look a lot like the Old Normal.

Figure 1

10 Year U.S. Treasury Yield



Source: Bloomberg

Slowing Inflation and Anticipated Rate Cuts Support Bond Prices

Central to our thesis of a return to the Old Normal is that the Fed is winning the war on inflation. Both the widely followed Consumer Price Index and the personal-consumption expenditure (PCE) price index, the Fed's preferred inflation measure, showed steady declines in 2023. Core PCE, which excludes volatile food and energy costs, rose 2.9% in 2023, the smallest year-over-year increase since March 2021 and down from 4.9% in 2022. The three-month annualized rate is already at the Fed's 2% Target *[Figure 2]*.

In response to the benign inflation prints, the Fed in November signaled it had likely made its last rate hike for the cycle. This ignited a furious fourth quarter rally in bond prices as 2-10-year yields fell back to where they began the year *[Figure 3]*. Bond fund flows turned positive in Q4 as investors scrambled to lock in yields, further supporting the rally.

The bond market is now pricing in a decline of about 1.50%, or six quarter-point cuts, to the Fed Funds rate in 2024. While we don't think the Fed will be overly aggressive in cutting rates without seeing further weakness in the labor market, we continue to encourage investors to consider moving out of cash in anticipation of slowly declining money market yields and intermediate-term yields that are well above the anticipated rate of future inflation.

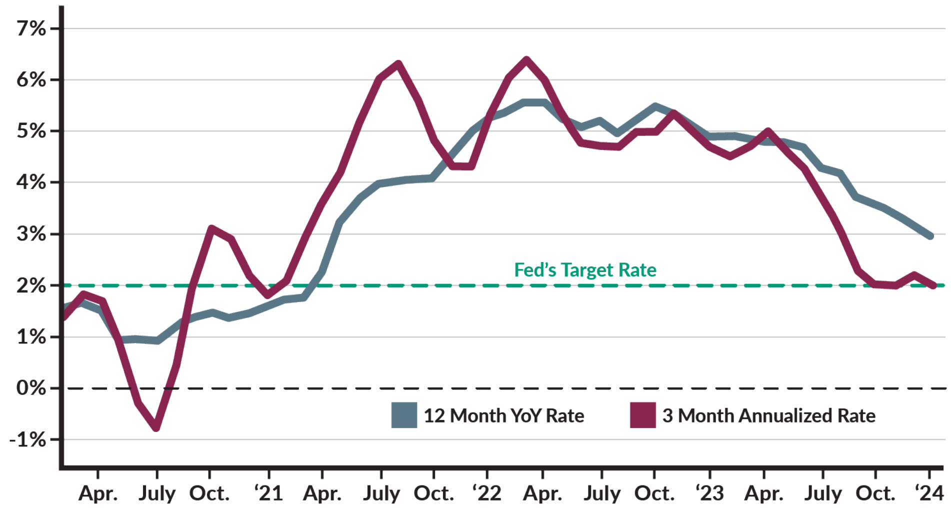
Rich Credit Valuations, Pockets of Opportunity

Just as Treasury yields were volatile in 2023, so were credit spreads. The regional bank failures in early 2023 caused credit concerns in the corporate bond market, while the usually staid Agency Mortgage-Backed Security market suffered from a rough combination of interest rate volatility, the FDIC's $100 billion liquidation of Silicon Valley Banks's mortgage portfolio, reduced Fed purchases, and weak bank demand.

Despite the volatility, corporate credit spreads ended 2023 near all-time lows, leaving little margin of safety as investors increasingly priced in a more accommodative Fed and an economic soft landing. The Bloomberg U.S. Corporate Index's average option-adjusted spread (OAS) was 99 basis points at quarter-end. Brown Brothers Harriman

Figure 2

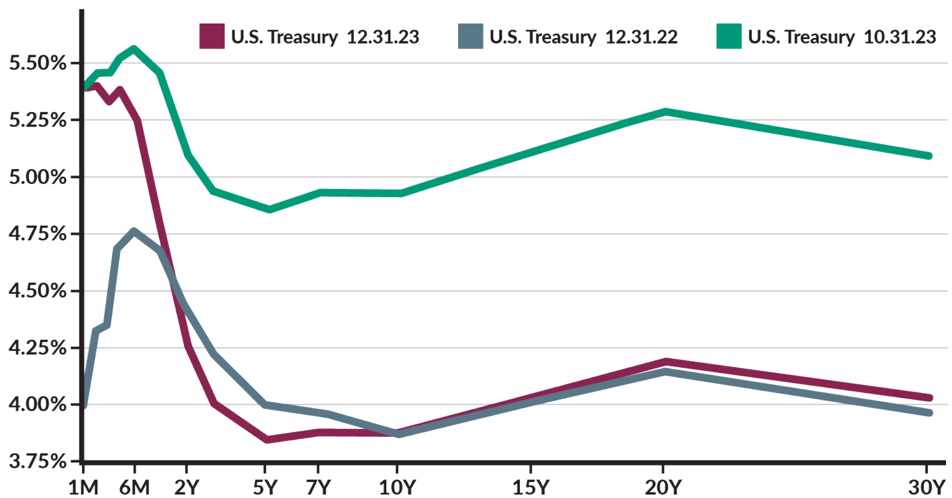
U.S. Core PCE 3 Month vs YoY Rate



Source: Bloomberg

Figure 3

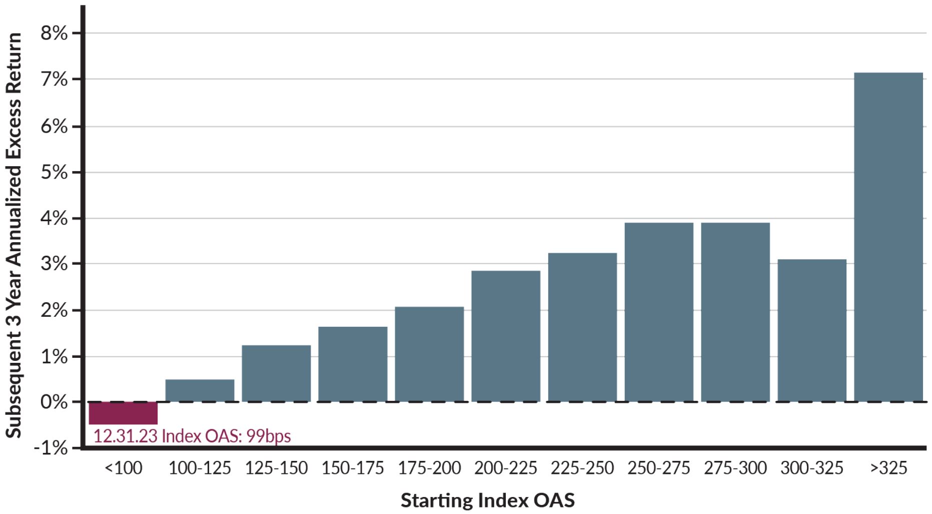
U.S. Treasury Yields from 2023



Source: Bloomberg

Figure 4

Corporate Credit Spreads



Source: Brown Brothers Harriman

recently noted that the corporate bond index tends to generate negative excess returns when spreads start at levels below 100 basis points *[Figure 4]*. This means that corporate bonds may underperform risk-free Treasuries if spreads return to their long-term average.

Outside of corporate credit, we see pockets of value in the securitized market, which includes both agency and non-agency residential mortgage-backed securities, commercial mortgage-backed securities, and asset-backed securities. These bonds require deep credit analysis of their underlying collateral and often fly under the radar of retail investors. Spreads here remain wide with the potential for price appreciation. We are largely avoiding office-related credits as they continue to suffer from high vacancies.

High tax-bracket investors should review allocations to tax-exempt municipal bonds. State and local governments continue to demonstrate strong reserves as a result of economic resilience and unspent pandemic stimulus and there may be opportunities for tax-adjusted yields over 5%.

Yields Keep Bonds Interesting

Despite the fourth quarter rally that saw yields decline by 1%, both nominal and real (inflation-adjusted) yields remain attractive. The yield on the 10-year Treasury at year-end (3.88%) is over 3% above the lows of 2020 and above the average yield over the last 25 years. We expect another year of gains in 2024, reflecting investment grade yields currently in the 4%-5% range, with the potential for additional price appreciation if the Federal Reserve is more aggressive with rate cuts than currently expected.

Consistent with our outlook for a range of 3%-5% on the 10-year Treasury and following a Q4 decline in rates to near the middle of the anticipated range, we are seeking to modestly reduce the average maturity of our bond portfolios. We continue to focus on intermediate-term maturities which we expect to benefit as the yield curve normalizes and cash rates fall. We sought to add to securitized credit, where appropriate, opportunistically to begin the year, and will look to add to corporate credit again when valuations are more favorable.

After more than a decade in which investors earned very little holding bonds, today's yields have fixed-income investors excited once again. Improved returns from fixed-income portfolios represent a significant transition for investors, enabling investors to achieve higher returns with less risk compared to the New Normal era of ultralow rates. The era of no income is over, and we expect it to stay that way as we navigate the Next Normal for our clients.

Let's Start a Conversation

Your Johnson Financial Group team is here to help you understand this complex and ever-changing economic landscape. Over the coming weeks, we'll share more specific outlooks for stocks, bonds and alternative investments. We aim to position your portfolio with the flexibility to navigate this volatility while also meeting your financial goals. **Thank you for your partnership and trust in Johnson Financial Group.**