Bond Market

Consultant Commentary

September 30, 2023

U.S. Treasury yields rose significantly in the third quarter leading to sharp declines in bond market returns. Longer maturity returns fell more substantially as a result of the yield curve steepening. The 2yr/10yr and 2yr/30yr spreads began the quarter at inverted differentials of negative 106 and negative 104 basis points, respectively. At present, they stand at negative 47 and negative 35 basis points.

Rising rates appear to be less focused on the continued fear of rising inflation and now seem geared toward fiscal behavior surrounding the increasing level of our nation's debt and deficits. This coupled with rising oil prices, the UAW strike, student loan repayments, slowing consumer spending, tightening consumer credit, and rising delinquencies all create the potential for further market volatility into year end.

In our opinion, a soft landing is not the most likely outcome. At a minimum, an economic slowdown is highly probable. The risks of a mild to moderate recession are rising. Just as the Fed held tight in their "Inflation is Transitory" statements, we view the "Higher for Longer" talk in the same regard. The Fed talks tough, but it is until it isn't. Structurally, we want to make sure portfolios are market participating, but are positioned to be ready for a directional market shift.

Credit spreads have largely held steady as a function of persistent demand and limited supply. Higher overall interest rates have increased corporate credit attractiveness. Cyclically, where we are within the Federal Reserve Policy cycle, credit spreads should be widening. Seasonally, we also tend to see some credit weakness in the coming months. Credit markets appear overdone in their enthusiasm, and we believe will widen into the year end. We are not materially overweight in our corporate allocation, and our overall credit exposure is neutral to underweight. We have a tilt up in the quality spectrum with single A credits overweight versus an underweight in BBB rated securities. The overall duration of our credit allocation is short to neutral. We would rather have some dry powder to capitalize opportunistically on future potential volatility in the sector than chase a minimal pickup in carry over the short term. We do not feel investors are overly compensated for the underlying risk in corporate credit in the near term.

The MBS index trailed other investment grade sectors this quarter. Interest rate volatility is not usually beneficial to MBS performance relative to other sectors. Our mortgage allocation is neutral to slightly overweight as MBS Option Adjusted Spreads, although not overly attractive, are attractive. MBS are more compelling versus corporate credit cyclically. The positive convexity of deep discounted coupon spec pools make them a reasonable alternative to U.S. Treasury and, in some instances, an alternative to corporate credit. There is likely more room for spreads to widen in this sector but spread volatility may be more muted relative to corporates. Selection along the coupon stack will make a difference in the contribution of this sector. Any further increasing relative value will cause us to move to overweight in both allocation and duration of this sector.

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