RBC Global Asset Management

Is it Springtime for US Fixed Income?

April 2024

Andrzej Skiba
Managing Director and
Head of U.S. Fixed Income

BlueBay Fixed Income Team

In this paper, we will be discussing the following points:

- **What is the Fed's weather forecast for rate cuts?**
- **Are fixed income investors seeing their shadows waiting for the Fed to move? Is the market full of groundhogs?**
- **Will the CRE storm rain on the party?**
- **Could higher-for-longer yields impact the relatively temperate current climate in credit fundamentals?**
- **What do the changing seasons look like ahead?**

> **"We believe that market participants could potentially accept the idea that rate cuts may be pushed back, just as long as they continue to maintain confidence that a substantive easing cycle is on the horizon."**

What is the Fed's weather forecast for rate cuts?

Many market participants and policymakers held high expectations for warmer weather at the end of 2023 by way of projected rate cuts and slowing CPI. In the March FOMC meeting, however, the Fed revised its forecast for growth and inflation slightly higher for the year ahead. Regardless of this projection for persistently stubborn US GDP growth, the FOMC continued to signal their intentions to cut rates three times for the balance of the year. This was perceived as a decidedly dovish stance for Chairman Powell and the committee to take. The fact remains though that economic data is not showing many signs of slowing, and the most recent core CPI print has disappointed to the upside.

Core CPI in the second week of April proved to be another consecutive disappointment and came in at a month-over-month level of 0.36%, against market hopes of 0.3% or less. Despite the shelter component of the index coming roughly in line with expectations at 0.4%, other service inflation components remain stubbornly high with the super-core inflation measure at 0.65%. We maintain that the first cut is likely to come in the second half of 2024 or even early 2025 as this data, coupled with persistently strong US economic and jobs numbers, will continue to make it difficult for the Fed to justify an earlier cut.

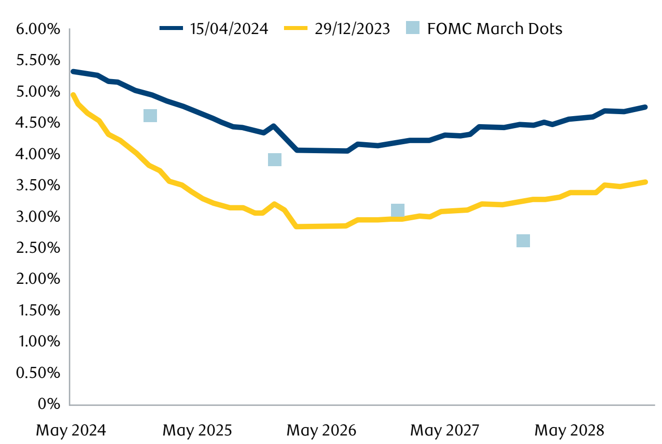
To this end, we have maintained a more conservative view on rate cuts since 2023 versus the broader market. We had projected our first cut to occur as early as June or July of this year, but recent data may suggest it could occur deeper into the calendar year. Market participants had quite bullishly projected initial cuts for March of 2024. Given data printed since year-end, US Treasurys have steadily repriced wider after posting massive rallies late in 2023. Interest rates have now sold off to their widest levels on the year in April.

"The stock market continued to hit new records before selling off after the CPI report in early April."

Many investors that had stubbornly held bullish views on 150bps+ of rate cuts for 2024 have had to reset their views down toward 2-3 cuts in total. We also sense that Chairman Powell would like to have an opportunity to cut rates, if only data would allow for this. Moreover, there is an underlying desire to start cutting rates before the election cycle gets into full swing. On this basis, we still believe the FOMC may cut rates this summer, but we maintain that we are likely to see only one or two cuts this year unless the pace of economic activity cools materially.

Meanwhile, risk assets continue to push higher, although some cracks of volatility are starting to show. The stock market continued to hit new records before selling off after the CPI report in early April. Stocks have since rallied back some of these losses but continue to prove choppy. Credit spreads remain relatively tight. Interestingly, with Chairman Powell sounding like he wants to be the market's friend, it is understandable that investor psychology continues to remain altogether resilient, despite clear risks to further volatility on the back of incoming economic data.

Chart 1: Market Expectations of Fed Cuts



Source: Bloomberg as of 15 April, 2024.

US rates are starting to screen cheap-to-fair-value after a series of rates sell-offs as bond traders rethink their rate cut expectations. This is particularly true in the shorter parts of the yield curve, although normalization of curve shape has indeed persisted over the first half of April. As of April 16th the 2s10s spread is -28bps and the 2s30s spread is -17bps. This inversion has improved from -37bps and -22bps at the end of 2023 respectively. This indicator further stresses a decreased probability of a US economic slowdown in 2024 relative to the end of 2023; although we are not quite on spring break yet.

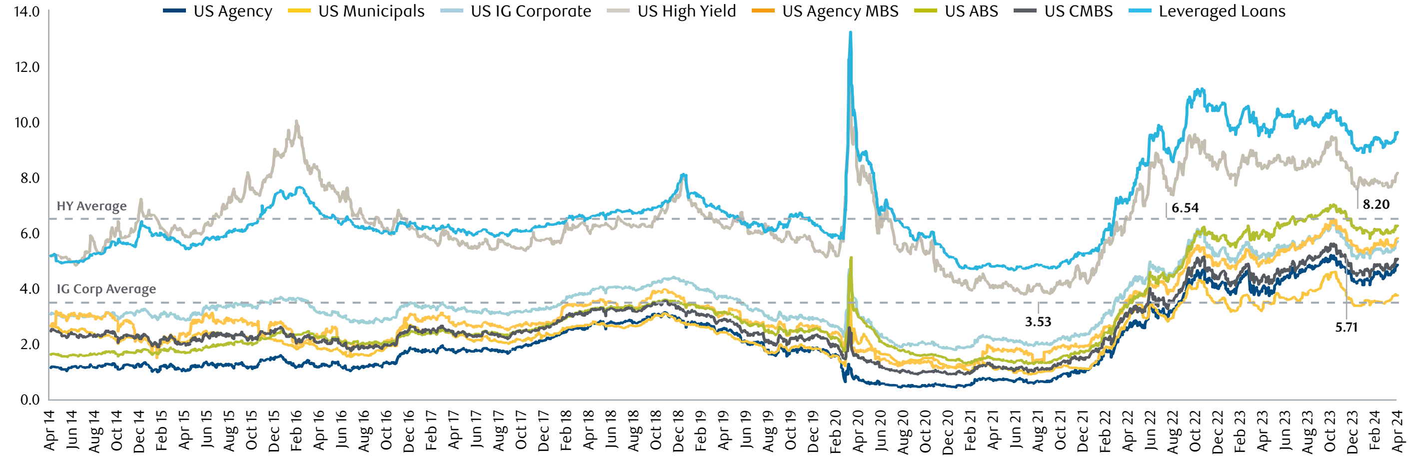
We believe that market participants could potentially accept the idea that rate cuts may be pushed back, just as long as they continue to maintain confidence that a substantive easing cycle is on the horizon. This latter point is something we remain more inclined to question. Certainly, we think that it remains incongruous to simultaneously look for the Fed to cut rates more than 150bps in conjunction with a resilient US economy. The only way this seems plausible would be if inflation makes material progress toward the Fed's stated target of 2% while also maintaining a tight labor market. The former of which, has simply not been the case to date.

Are fixed income investors seeing their shadows waiting for the Fed to move? Is the market full of groundhogs?

Early in the year, market valuations were projecting a Goldilocks economic scenario of slowing inflation and resilient growth supported by easier monetary policy. To us, it appeared clear that investors would be stuck disappointingly watching their shadows and waiting for winter to come to an end by way of promised rate cuts in 2024. This disappointment to the market has indeed largely played out. While a recession is not our base case, there are signs that markets had been overly optimistic about the path of cuts. Even if one has a baseline expectation for a soft landing, the margin of error reflected in current risk asset pricing remains very thin with spreads at their tightest levels in years across the spectrum of fixed income.

However, interest rate levels suggest to us that it may be prudent to consider maintaining key-rate-duration positioning at points from across the short end of the curve to as far out as the middle of the curve. Additionally, we believe in employing an active approach toward credit risk within the contqaxt of locking in these high all-in yields in this environment. There is tremendous opportunity for strong total rates of return in US fixed income given these levels. All-in yields are largely hovering around their 10-year highs. As of mid-April, investment grade bond yields were hovering around 5.71% on average, 218bps in yield wider than their 10-year average. High yield bond yields were hovering around 8.2% on average, 166bps in yield wider than their 10-year average.

Chart 2: US F1 Market Review



Source: Bloomberg as of 15 April, 2024.

Additionally, potential upcoming adjustments to fiscal policy could see a return of term premium to the fixed income market. As such, it could make sense to target the shorter parts of the yield curve where most of your yield is realized, given the still-inverted shape of the yield curve. This positioning is slated to potentially outperform as the yield curve resets itself into a more normal shape and the Fed finally starts cutting rates – opening an opportunity to potentially add duration down the line should the shorter end eventually rally relative to longer-dated maturities while the broader bond market continues to watch their own shadows and winter drags on.

Will the CRE storm rain on the party?

Credit fundamentals in the investment grade corporate bond market remain strong. However, there are pockets of concern. Ratings migration down has outpaced ratings migration to the positive year-to-date for the index. Given highly publicized levels of stress in pockets of the commercial real estate (CRE) market and the large preponderance of banks in the investment grade index, could this subset of the universe potentially rain on fixed income's party? CRE fears and US regional banks' exposure to the space has come back into focus following 4Q earnings from New York Community Bank (NYCB) where the bank reported a quarterly loss due to CRE related asset quality issues. This has led to questions about the extent of exposure within the broader US Regional bank space.

Thus far, the biggest focus within CRE has been on office properties and tenants' needs for space in a post-pandemic world. While the number of corporations offering full time work from home arrangementsis declining, hybrid arrangements remain popular. Work from home arrangements vary by vocation and geographic location, but even the transition to hybrid arrangements has challenged corporations to rethink their workspace needs.

Although headlines would suggest that office real estate is doomed, the reality is much more nuanced. The challenges within the office space are impossible to generalize by geographic region, city or even by neighborhood. Instead, the difference between in-demand and out-of-demand office space often comes down to specific location, floor plan, and amenities that a particular office offers. A natural extension of these concerns around office real estate is to question who provides the financing for these buildings. Like our assertion that not all office properties can be characterized in the same way, the same goes for banks' exposure to the broader office sector and real estate in general. Recent actions from NYCB to boost their loan loss reserves held against their office portfolio has thrust regional banks back into the spotlight given their role as a capital provider to the sector.

The challenges in office real estate are likely to exist for several years. This represents a positive tailwind for the large banks we follow as it allows them an extended period to generate earnings and capital to offset any potential losses. Additionally, the extended timeline of this dynamic also allows banks and the underlying properties to benefit from any cuts in interest rates that the FOMC may enact. Decreasing interest rates would help alleviate some of the stress for borrowers that are being challenged by diminished debt service capacity.

In the meantime, we believe the large US banks, including Regional Banks, are well prepared to deal with these challenges due to limited office exposure, prudent underwriting, well established loss reserves, and ample capital positions. Pockets of harsh weather in CRE should remain idiosyncratic in nature. This dynamic emphasizes the need to be highly selective in execution while remaining in constant communication with the financial institutions investors choose to lend to.

Could higher-for-longer yields impact the relatively temperate current climate in credit fundamentals?

We have noted that since the end of 2023 many investors were expecting rate cuts to have already commenced by March of 2024. We reiterate here that robust US economic data and stickier-than-expected inflation may well stand in the way of cuts in the short term and result in an environment where yields remain elevated for longer. So how does this affect our view of the fundamental credit quality across credit markets?

We believe this environment lends itself to a higher degree of dispersion in outcomes across the credit quality spectrum. In other words, we believe relative performance within names across the investment grade sector can vary wildly under current market conditions and selection will be key. Indeed, we have seen ratings downgrades outpace upgrades within investment grade year to date. We also believe defaults will continue to tick up within leveraged finance – both bonds and loans.

> **"We believe the Fed is at peak rates for this cycle and that the yield curve may continue normalizing in shape as rate cuts start to take hold in the second half of 2024."**

Stickier and higher levels of current yields tend to benefit companies that have already been able to refinance their debt into fixed rate notes at previously lower levels. Indeed, leveraged loans priced off the SOFR curve may come under pressure from eroding debt-service-coverage-ratios (DSCRs) given high interest rates on the ultra-short end of the curve – where their borrowings happen to price. Comparing this fundamental story to high yield corporate bonds that have had the benefit of refinancing their debt at historically low risk-free-rates leads us to believe this environment favors bonds versus loans. However, higher quality tranches in the CLO market with historically low default rates and a diversification of underlying collateral can prove to be a prudent way to play the loan market.

All this advocates for an active approach in investing in fixed income assets, whether investment grade or below. Actively managed, focused portfolios should outperform their underlying benchmarks if managers can avoid bad players in the space visa vis forensic credit research and a focus on liquidity.

What do the changing seasons look like ahead?

Our markets have shifted away from the jubilation story surrounding market projections for rate cuts that prevailed into the end of 2023. Economic data remain favorable but should eventually show signs of slowing. As such, a great deal of uncertainty remains as we progress through the earlier days of Q2 2024.

Incoming data will be closely watched for signs of whether the economy is further losing steam. Our baseline assumption is sub-2% US GDP growth for the calendar year of 2024. We believe the Fed is at peak rates for this cycle and that the yield curve may continue normalizing in shape as rate cuts start to take hold in the second half of 2024.

Given the recent dramatic moves in credit spreads and interest rates, and the potential for short rates to eventually fall - we view the shorter-to-middle points of the yield curve as showing more value than longer dated maturities in terms of nominal interest rate positioning. Strong technical supply and demand dynamics, however, can lend themselves toward seeing some aspects of longer duration issues become in demand and contribute meaningfully to portfolio total returns.

Additionally, the outcome of the US election cycle could further normalize the shape of the yield curve on the heels of fiscal stimulus promised by both presidential candidates. This could potentially cause term premium to return to the fixed income market, which may impact our view on relative value in US rates.

With volatility and uncertainty elevated, caution and careful investment selection is of key importance. After the fourth quarter's dramatic rally, we believed there will be some short-term choppiness in asset prices that will create attractive entry points into risk. This is exactly what happened in the first quarter, and we have seen more of this theme continuing through the beginning of the second quarter. In this environment, we think risk assets can offer positive excess returns, but security selection will be paramount as potentially weakening fundamentals will offer caution. At the end of the day, April showers tend to precede May flowers. We believe volatility in weather outcomes throughout the course of spring can be reasonably analogous to both the volatility and potential upside we see in the current US fixed income market.

This document was prepared by RBC Global Asset Management (UK) Limited (RBC GAM UK), authorised and regulated by the UK Financial Conduct Authority (FCA), registered with the US Securities and Exchange Commission (SEC) and a member of the National Futures Association (NFA) as authorised by the US Commodity Futures Trading Commission (CFTC).

In the United States, this document may also be provided by RBC Global Asset Management (U.S.) Inc. ("RBC GAM-US"), a SEC registered investment adviser. The entities noted above are collectively referred to as "RBC BlueBay" within this document. The registrations and memberships noted should not be interpreted as an endorsement or approval of RBC BlueBay by the respective licensing or registering authorities.

With respect to the investment performance presented, past performance is not indicative of future performance. Actual account performance may or will vary from the performance shown because of differences in market conditions; client-imposed investment restrictions; the time of client investments and withdrawals; tax considerations; economies of scale; portfolio turnover; the number, type, availability, and diversity of securities that can be purchased at a given time; differences in the underlying currency of the assets in the account, and other factors. Client assets managed using these strategies in separate accounts or different vehicles may be subject to restrictions, fees or expenses that are materially different than those found in the non-US funds.

This document is confidential and, without RBC BlueBay's consent, may not be (i) copied, photocopied or duplicated in any form by any means or (ii) distributed to any person that is not an employee, officer, director or authorized agent of the recipient.

Information herein is believed to be reliable but RBC BlueBay does not warrant its completeness or accuracy. This document contains information collected from independent third-party sources. For purposes of providing these materials to you, neither RBC BlueBay nor any of its affiliates, subsidiaries, directors, officers, or employees, has independently verified the accuracy or completeness of the third-party information contained herein.

The information contained herein does not constitute investment, tax, accounting or legal advice. Recipients are strongly advised to make an independent review with their own advisors and reach their own conclusions regarding the investment merits and risks, legal, credit, tax and accounting aspects of all transactions. Any risk management processes discussed refer to efforts to monitor and manage risk but should not be confused with and do not imply no or low risk. No chart, graph, or other figure provided should be used to determine which strategies to implement or which securities to buy or sell.

RBC Global Asset Management (U.S.) Inc.
Minneapolis | Boston | Chicago
800.553.2143 | **rbcgam.com**