Feb. 23, 2024

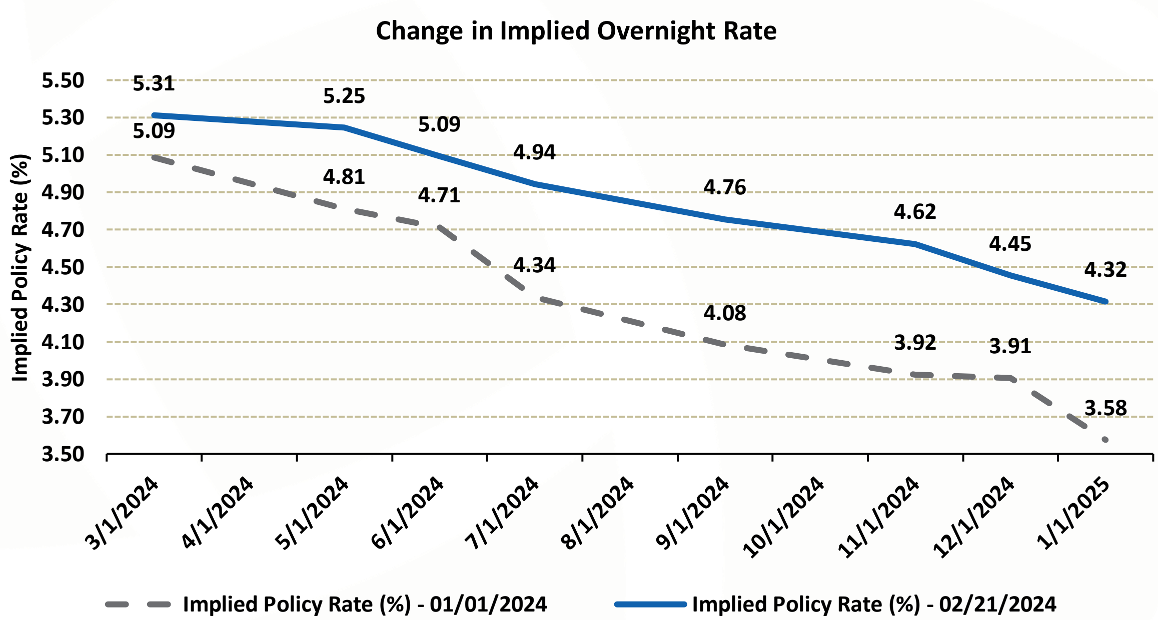
Bond Market Update
Rate Expectations and CPI Surprise – Not a Novel by Charles Dickens

By Bill Smith, Fixed Income Trader and Portfolio Manager

First Cut Remains Elusive

Although rate cuts are still widely anticipated this year, recent data has pushed the expected start date further into 2024. The likelihood of a cut at the next Federal Open Market Committee (FOMC) meeting appears low, following comments from Federal Reserve Chair Jerome Powell that he doesn't "think it's likely that the committee will reach a level of confidence by the time of the March meeting" to adjust rates. Additionally, last week's Bureau of Labor Statistics Consumer Price Index (CPI) report surprised to the upside with a 3.10% year-over-year read compared to the consensus estimate of 2.90%. This raises concern that the Fed's path towards a 2% inflation target could be a bumpy one, and that rates may need to remain elevated for longer.

The odds of a cut in May are now just 35%, as estimated by Bloomberg's interest rate probability model, leaving June's FOMC meeting the more likely candidate, assuming inflation resumes its downward trend. This marks a significant shift in sentiment from the beginning of the year when expectations were high that easing could begin as early as Q1 2024, as illustrated in the "Change in Implied Overnight Rate" chart below.

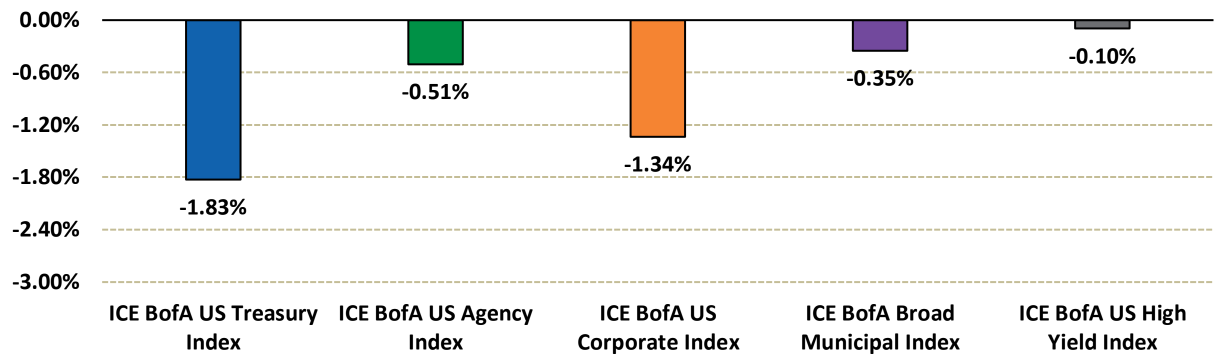


Source: Bloomberg. Past performance is no guarantee of future results.

Bond Prices Have Trended Lower

Bond prices generally declined in February as the fixed income markets digested the prospect of a delayed start to Fed easing. Year-to-date total returns are now negative across major fixed income indices, led by declines in Treasuries and investment grade corporate bonds. While slightly negative on the year, high yield continues to outperform as shown in the "Year-to-Date Total Return" chart below.

Year-to-Date Total Return Feb. 20, 2023

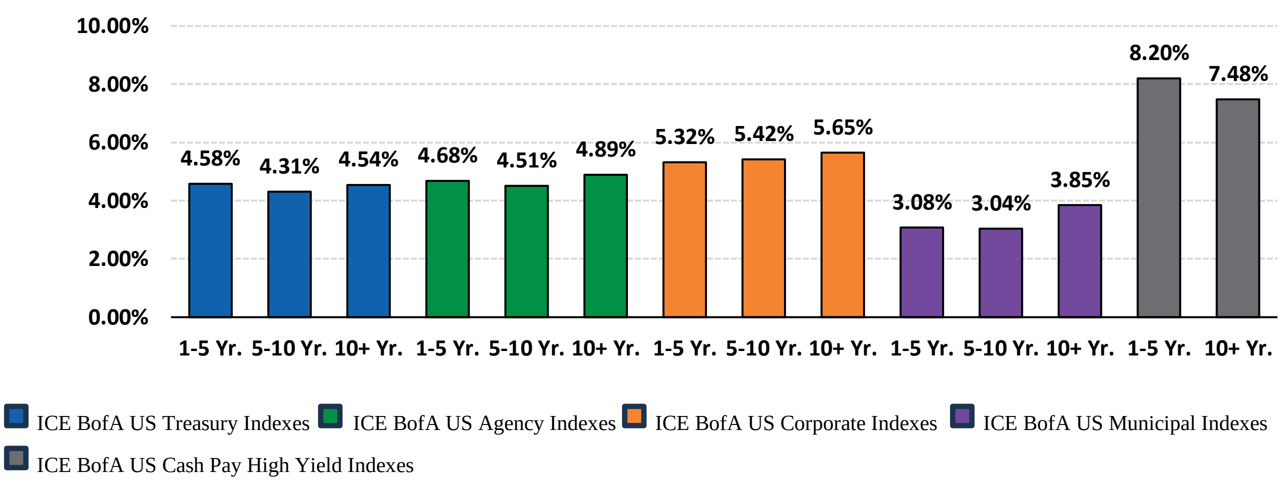


Source: ICE BofA Indexes, Bloomberg. Past performance is no guarantee of future results.

Lower Prices, Higher Yields

Recent price declines have increased yields to levels rarely seen over the last two decades, offering income investors an increasingly attractive entry point into the fixed income markets. The chart below, "Yield to Worst Feb. 21, 2023," summarizes the current yield of select ICE BofA indexes broken out by maturity band.

Yield to Worst Feb. 21, 2023



Source: ICE BofA Indexes, Bloomberg. Past performance is no guarantee of future results.

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Near Term Volatility to Remain High

Although a lower yield environment in 2024 continues to be our base case scenario, shifting rate expectations and February's CPI surprise demonstrate the inherent uncertainty of future monetary policy. With a strong economy, low unemployment and inflation above the Fed's 2% target, we expect volatility will remain elevated in the near term.

A prudent approach to fixed income investing calls for diversification across both credit and duration exposure. As always, Dynamic recommends staying balanced, diversified and invested. Despite short-term market pullbacks, it's more important than ever to focus on the long-term, improving the chances for investors to reach their goals.

Bill Smith serves as president, Portfolio Management & Trading, of Harmont Fixed Income in Phoenix.

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