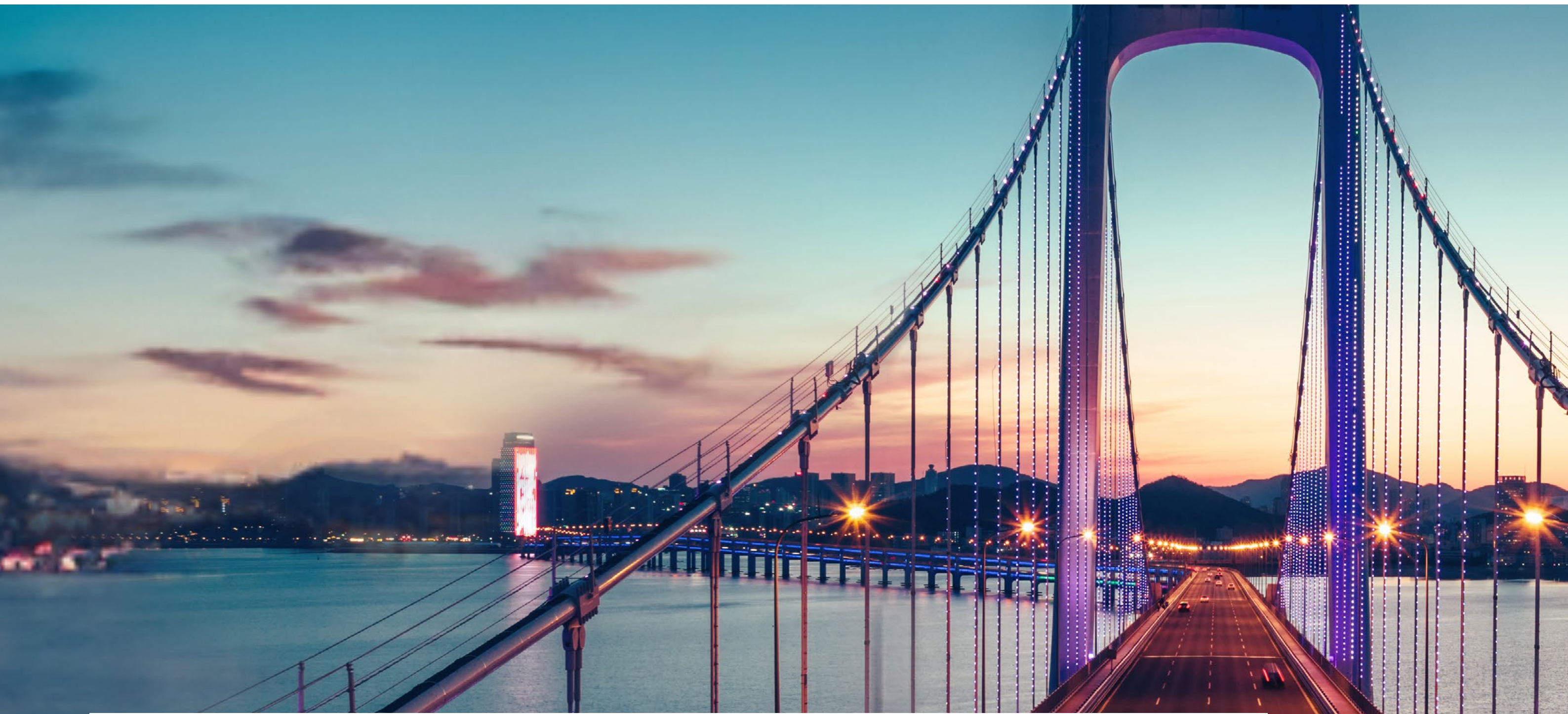

**2024** FIXED INCOME OUTLOOK

# The peak in rate hikes is an inflection point for bonds

**Gene Tannuzzo**
Global Head of
Fixed Income

## You don't have to be bearish on the economy to be optimistic on the bond market. Here's why

As we head into 2024 we think that the next phase for the US Federal Reserve is likely a pause while the central bank assesses the impact of the tighter lending and financial conditions it has established. Investors should expect a lot of talk about whether the Fed will achieve a soft landing, but bond investors have a unique opportunity to generate attractive returns either way. Here's our rationale:

### Bonds have performed well around Fed pauses

Typically, Fed pauses like this last less than a year, and it doesn't take a cut in rates for bonds to rally. History suggests that when the Fed reaches the

peak of its rate hike cycle, overall bond performance in the period afterwards is exceptional (Figure 1).

**Figure 1: bond returns after Fed rate hike peaks[1]**
(Average forward return after a pause, %)

| | 3 months | 6 months | 12 months |
|---|---|---|---|
| 3-month T-bills | 1.5 | 3.1 | 5.6 |
| 10-year Treasuries | 5.9 | 8.9 | 11.6 |
| Investment grade | 5.1 | 9.4 | 14.3 |
| High yield | 5.3 | 8.7 | 12.9 |
| Mortgage-backed securities | 4.7 | 7.4 | 12.4 |
| Munis | 3.8 | 6 | 10.4 |

Source: Columbia Threadneedle Investments.

We're not in the hard landing camp, but given the unknown magnitude of an economic slowdown and the level of inflation, we think that where investors are on the quality spectrum will make a difference. While lower-rated bonds have been strong performers in 2023, we think the market is going to be more discerning as we head into 2024. We expect higher quality bonds will be the best bond performers over the next year.

We also think performance will be more dispersed than it has been. As we enter a higher-for-longer rate environment we should see more separation between the winners and the losers – especially in lower-quality segments of the market. This will make credit selection more important, which is one of our core strengths.

## Investors can lock in higher rates for the long term

Bond yields have risen to levels we haven't seen in decades. We think investors shouldn't miss the opportunity to lock in higher yields for the long term – not to mention the total return potential as prices on those bonds rise. It is also a great incentive to move out of cash. There has been a money market renaissance as investors

[1] Represents data from 1984 to 2023. Three-month bills are represented by the Bloomberg US Treasury Bellwethers 3 Month Index, which is an unmanaged index representing the on-the-run (most recently auctioned) US Treasury bill with 3 months' maturity; 10-Year Treasuries bonds are represented by The Bloomberg US Treasury Bellwethers 10 Yr. Index, an unmanaged index representing the on-the-run (most recently auctioned) US Treasury bond with 10 years' maturity; Investment Grade is represented by the Bloomberg US Corporate Investment Grade Index, which measures the investment-grade, taxable corporate bond market; High Yield is represented by the Bloomberg US High Yield Corporate Bond Index, which represents the universe of fixed-rate, non-investment grade debt; Mortgage-backed securities are represented by the Bloomberg US Mortgage-Backed Securities Index, which tracks agency mortgage-backed pass-through securities. Municipals are represented by the Bloomberg Municipal Bond Index, which represents the broad municipal market. Past performance is not a guarantee of future results. It is not possible to invest directly in an index.

There are risks associated with fixed-income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

realised they can own cash and get a competitive yield. The attractiveness of cash will start to fade when short-term interest rates move lower and the diversification benefits of owning high-quality, long-term bonds at higher yields start to make more sense.

Looking outside the US, opportunities may be even more striking in Europe, despite lower absolute yields. Unlike the US, Europe is coming off not just near-zero interest rates, but negative rates. Now, we're not only seeing positive real interest rates but also wider credit spreads. That means you're going to get more risk premium for a similarly rated bond in Europe than you would in the US.

## There's more than one way to take advantage

There are two ways to invest in the bond market in 2024 that we think are equally valid, depending on how you feel about the economy:

1

**Get paid with higher-yielding credit**

If you feel growth will remain resilient (Stable growth in Figure 2) and are comfortable with the risk, the income from high yield bonds and bank loans can be a good addition to a diversified portfolio.

**Figure 2: economic and inflationary outcomes**

| 12 months from now ... | | Economy | |
|---|---|---|---|
| | | Stable growth | Recession |
| Inflation | Lower | ■ Fed pauses and then begins gradually cutting rates to neutral<br>■ Credit outperforms duration | ■ Fed responds by cutting rates quickly and aggressively<br>■ Duration outperforms credit |
| | | Credit-orientated assets (eg high-yield, corporate bonds, non-Agency mortgage-backed securities) | High quality duration-sensitive assets (eg Treasuries, Munis, Agency mortgage-backed securities) |
| | Higher | ■ Fed resumes tightening to address persistent inflation<br>■ Credit and duration both underperforms | ■ Fed's ability to ease is limited by high inflation<br>■ High quality credit outperforms duration |
| | | Minimise duration (eg Bank loans) | Credit-sensitive assets/moderate duration (eg short-term bonds) |

2 **Seek income and protection with high-quality bonds**.

If you're not as confident about the economic outlook (Recession in Figure 2), you can take advantage of high-quality, duration-sensitive assets like Treasuries or municipals. These can be higher-quality assets that may help to protect from loss if we do have a harder landing.

## We believe the peak in rates is near and a Fed pause will be a significant market event

### The bottom line

Our optimism for bonds is balanced by a realistic view of a still uncertain economy, but we think a hard landing is unlikely. More importantly, we believe the peak in rates is near and a Fed pause will be a significant market event. It's an inflection point that has historically delivered outsized returns for bond holders. Combined with the opportunity to lock in attractive yields, we think now is an opportune time for investors to participate in the bond market.

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