COLUMBIA THREADNEEDLE INVESTMENTS

Fixed-income outlook: What higher for longer means for bonds

April 30, 2024

With the Fed standing pat for now, where are the opportunities in fixed income? Here's our take.

A series of volatile inflation reports have cast doubt on the Federal Reserve's ability to begin cutting interest rates this year. Government bond markets reacted violently to the uncertainty, with prices falling after yields rose by 40 to 60 basis points across the U.S. Treasury curve. Returns from duration risk remain elusive, and many investors are reluctant to reenter the bond market without a clear signal that the Fed is ready to take interest rates lower. In contrast, credit assets like high-yield bonds have been largely immune from the volatility. Investors have been rewarded for risk-taking, in part because the economy continues to grow faster than many expected. But the longer the Fed remains on hold, the more likely we are to see this dynamic shift.

A longer pause is not bad news for bonds

It's easy to assume that the bond market needs the Fed to start cutting interest rates in order to kick-start its recovery. With that first cut likely being extended further into the future, investors are now sweating a longer pause. But the Fed has effectively been on pause since July 2023 — the last time it hiked. Since then, the Bloomberg U.S. Aggregate Index has produced a small, but positive, total return. Credit sectors, and especially those that derive the majority of their return from default risk, have done far better than less risky bonds. Several below-investment-grade corporate indices are up over 7%, buoyed by resilient economic growth and strong demand for yield. We expect the margin of credit outperformance over Treasuries to narrow from here. While credit spreads offer limited upside potential, all-in yields remain at levels unseen in well over a decade. This means that investors today have an attractive entry point to lock in yields and elevate future total returns for years to come.

Gene Tannuzzo, CFA
Global Head of Fixed Income

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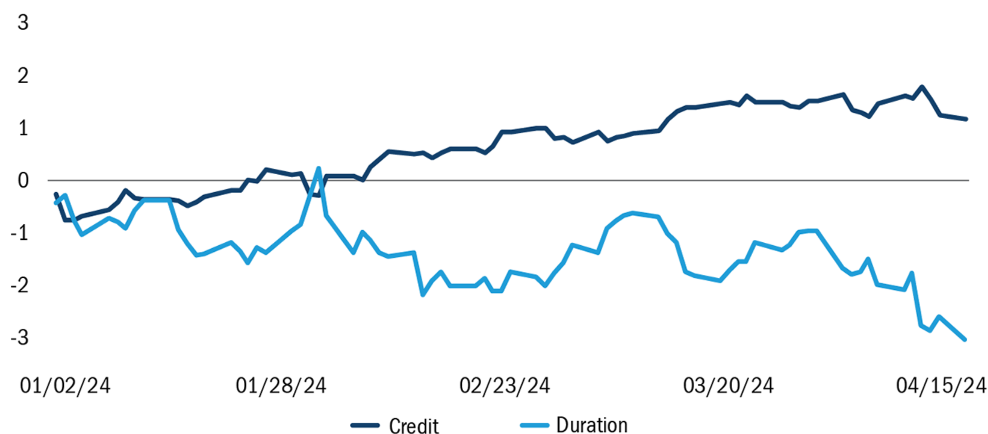
Credit risk has been driving fixed-income returns year-to-date

(Cumulative return, percentage points)



Source: Columbia Threadneedle Investments as of 04/12/24. Credit is represented by the excess return of the Bloomberg U.S. Corporate High Yield Index vs. the Bloomberg U.S. Treasury Index. Duration returns are represented by the return of the Bloomberg U.S. Treasury Index. Past performance is not indicative of future results. It is not possible to invest directly in an index.

Diversification is back

Year to date, prices of risky and safe-haven assets have moved in opposite directions. While this hasn't played out the way many investors anticipated, the differentiation bodes well for the role of bonds as a portfolio diversifier. Investors have generally used fixed-income allocations to hedge riskier exposures, like equities, in pursuit of more stable returns. With equity indices near all-time highs, the diversification and downside protection that bonds can provide increases in importance. And within fixed income, investors may realize a less volatile return stream by striking a more complementary balance of duration and credit risk.

Expect dispersion

While a longer pause does not change our views on the attractiveness of fixed income broadly, it does impact how we want to own it. Credit fundamentals are broadly deteriorating, but from a very strong and stable base. Eventually, more highly levered borrowers will start to feel a bite from higher funding costs. We're already seeing this among consumers, where non-prime borrowers have drawn down excess savings and are experiencing rising delinquencies. In contrast, seasoned mortgage borrowers — those who have been in their homes for several years — have benefited from low fixed-rate financing and home price appreciation. We expect these trends to become even more acute as the business cycle progresses. Winners and losers will emerge, which creates the opportunity for active managers to differentiate performance through credit selection.

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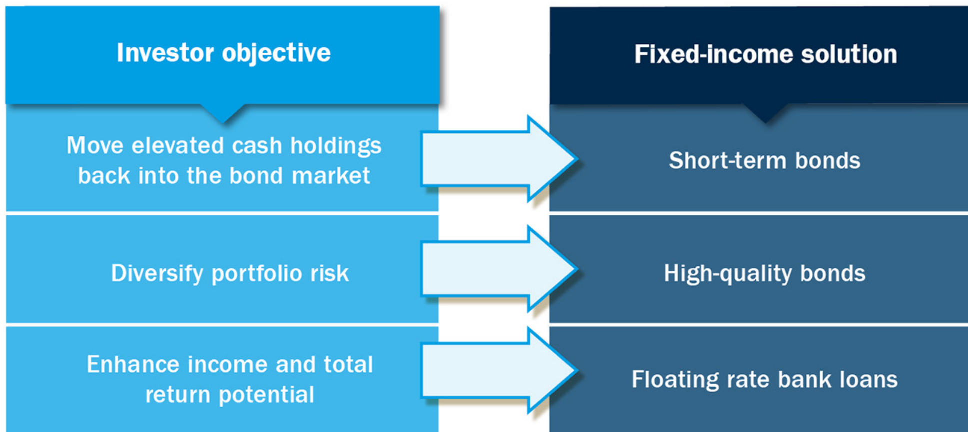
Three ways in

With yields at multi-decade highs and the Fed's next move likely to be a cut, we think it's most important that investors find their way back into the bond market. We also recognize that investors have different objectives and concerns that can influence how to go about doing so. For more conservative investors who are sitting on elevated cash balances, short-term, taxable and municipal bonds offer an attractive way to generate lower volatility sources of income. On the other hand, investors who have had a great run in the equity market might consider diversifying their exposure with high-quality core bonds. Finally, the robust growth backdrop could continue to support yield-seeking in more aggressive sectors like floating rate bank loans, where investors effectively trade exposure to interest rates for lower rated corporate credit.



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. Floating rate loans generally are subject to legal or contractual restrictions on resale, may trade infrequently in the market, and the value of the loan may be impaired in the event the fund needs to liquidate them.

Bottom line

Recent inflation and labor market data have created new questions about the timing of a Fed rate cut and reintroduced volatility into parts of the market. But as is often the case, volatility can create opportunity. This year's volatility has been confined to interest rates, and strong performance from credit has reinforced the value of a diversified approach. We don't expect for credit to remain immune forever, and a longer Fed pause should create more differentiation among sectors and issuers. This should allow security selection to play a more prominent role driving performance.

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Non-investment-grade (high-yield or junk) securities present greater price volatility and more risk to principal and income than higher rated securities.

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CTBPPAY (04/24) CTNA6561337.1