Locking in longer term yield

Gene Tannuzzo, Global Head of Fixed Income

COLUMBIA THREADNEEDLE INVESTMENTS

I think fixed income is appealing in 2024, for a variety of reasons, not the least of which is the price.

Yields have risen meaningfully, which means we have an attractive entry point whether you're buying high-quality bonds at yields of five to 6% or riskier bonds like high-yield debt or bank loans at nine to 10% yields, you're being paid for the risk that you're taking. It's very different today than it was perhaps a couple of years ago when yields were sub 2% on investment-grade debt and below 4% on risky debt. That valuation regime has reset dramatically.

I would consider two primary scenarios as we think about planning for 2024. The first is a scenario where the economic resilience that we've seen in 2023 continues, that consumers continue to spend, the unemployment rate remains low and default rates on corporate debt also continue to remain quite manageable. In that scenario, given how much interest rates have reset higher and credit spreads remain at historically approximately average levels, I would look at credit sensitive assets as doing very well, and in particular, high-yield bonds with yields of nine to 9.5% and even bank loans with yield in the 10% area. Even with conservative loss adjustments to those yields, you're still talking about high single-digit return potential in a good economic environment.

The other scenario that's important to plan for is, frankly, the unexpected. It's the one in which, hey, all of the lagged effects of tightening monetary policy and higher interest rates finally start to impact the economy in a more notable way. It's where companies are hesitant to hire and invest because frankly, interest rates are higher and the demand outlook might be a little bit lower. In that environment, we would expect to see inflation and growth pressures both receding, and that's an environment where the Fed could be cutting interest rates. That's an environment where you'd want a higher quality bond portfolio, but one where you'd expect those longer maturity bonds to really be appreciating in price from the discounts that they're at today.

The truth is we don't know with certainty how long the Fed will keep interest rates where they are or how quickly they will reduce them if and when that's necessary. So I think it's important to think about longer term investments as you think about earning that yield and locking that in so to speak, over a longer period of time.

History tells us that the longer end of the yield curve will move first. So by the time the Fed starts cutting, it will already be true that a lot of the price appreciation in long maturity bonds has already occurred. And I think it's important to think about that when planning a portfolio.

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

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