

January 2024

2024 Fixed Income Outlook in One Word: Batman!

At a recent conference, we were asked to summarize the state of the U.S. bond market in a single word. We contemplated the anodyne “Fixed income is *attractive*” or “Fixed income is *back*.” Instead, we landed on:

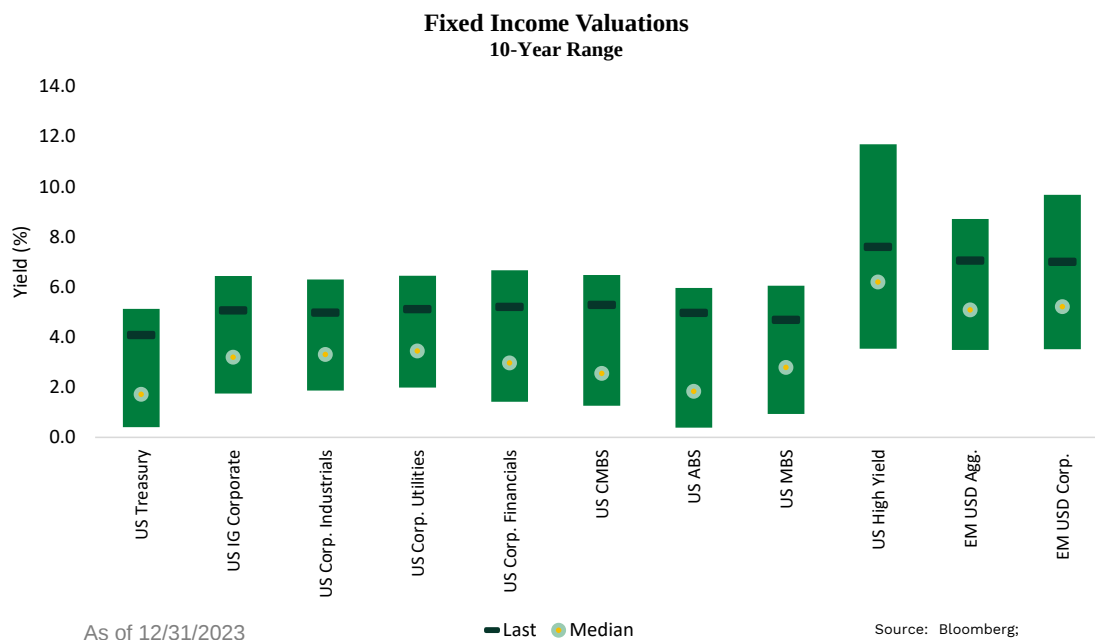
‘Fixed income is Batman.’

After listening to industry peers describing their respective asset classes with attributes that sound like superpowers, our explanation of fixed income in today’s market is that there is no magic. Unlike asset classes promising higher returns and lower volatility, bonds do not have superpowers. But like Batman, they have a lot of income and the hard work of using that income creatively gets the job done.

There are a lot of unknowns on the horizon for the upcoming year. Will the economy slow as the cumulative impacts of tightening monetary policy take effect? Or will the Fed thread the needle and pull off the elusive ‘soft landing’? Will the worsening U.S. fiscal situation begin to have real world effects? Will the U.S. navigate the turmoil of geopolitical conflict and slowing global economies and emerge relatively unscathed? And of course, there is a U.S. presidential election, which is likely to be contentious.

All of these issues will matter. But the rising interest rates of the past few years mean that these issues will matter less than in recent years. Income is the single most predictable factor in total returns and with rates significantly elevated from their decade long morass, the outlook for fixed income returns is attractive.

The factors that may drive markets in 2024 may feel as dark and uncertain as Gotham at night, but bonds are Batman.



The Dark Knight Rises

The 40-year downward trend in rates culminated in sub-1% 10-year Treasuries in the wake of the Fed's COVID-19 response. During that prolonged period, fixed income remained a necessary component of asset allocations, but in the last phase had become a 'hold your nose' asset class. Fixed income was still needed, but because it was painful for return assumptions, allocations were often made begrudgingly.

Ultimately rates ended effectively unchanged for the bellwether 10-year in 2023, despite markets vacillating between moderate rallies and severe selloffs in Treasuries. However, given the significant rise in interest rates in 2021 and 2022, the outcome has been significantly higher yields. As a result, unlike the past decade, fixed income is now a compelling offering from a total return perspective. Across most fixed income sectors, yields are at or near their highest levels in a decade.

With significant compression of spreads in non-governmental sectors since the mini banking crisis was contained in the second quarter of 2023, we observe spreads generally fair to tight across fixed income sectors. Despite being less attractive within their own historical relative valuations, fixed income sectors remain attractive on all-in yield perspectives on a cross-asset class basis.

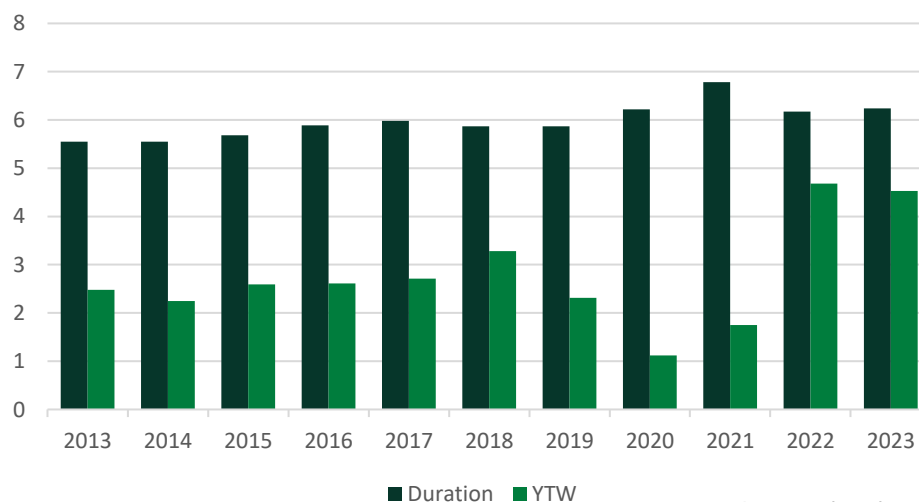
Most significantly, because income is the most predictable form of return, it is not just that prospective total returns are better, but the certainty of achieving those returns is higher.

Batman Begins

Delving into bond math and holding everything else constant, as coupons rise, duration falls. Adding in the higher cost to issue after years of low costs, corporate issuance has declined since records were broken in 2020. The combination of the natural rolldown toward maturity of existing bonds and bond math has led to a pronounced shortening of duration in bond indexes. After the Bloomberg US Aggregate Bond Index's duration peaked in 2021 at nearly 7 years, it has declined by almost a full year, ending 2023 at 6.2 years.

This means that the index is not only offering its highest yield in a decade, but doing so with a lower sensitivity to future changes in interest rates.

Bloomberg US Aggregate Bond Index
Duration vs. Yield by Year



Source: Bloomberg

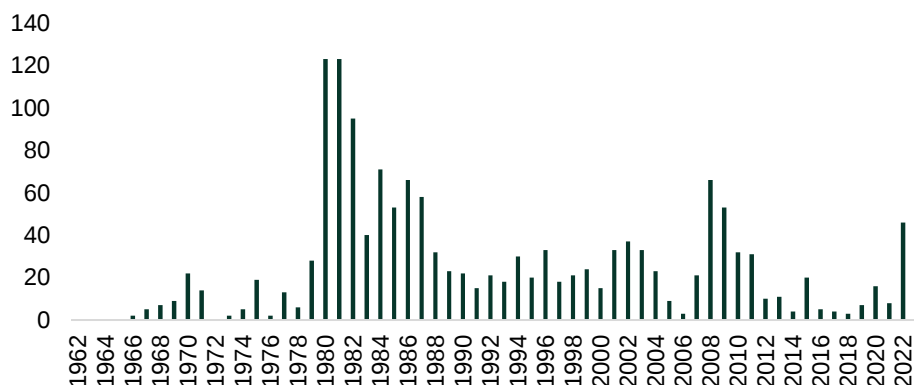
You Must First Master Your Own Fear

The lower sensitivity to changes in interest rates is significant in light of the increased volatility of interest rates. The volatility can be seen in the wide range for 10-year rates in the year, from a low of 3.31% right after the regional banking mini-crisis to a peak of 4.99% in the middle of the fourth quarter. It was not only large macro catalysts that pushed rates higher and lower, but daily movement that we have not seen in some time.

The number of 10 basis point moves in rates of these past two years is reflective of several factors, including the return of inflation and the monetary policy transition initiated to combat it. The number of days with a significant move in rates has exceeded the long run average of 25 days. This volatility is likely to persist as markets weigh a wide array of potential risk factors, including: the ending of the monetary policy tightening and anticipated Fed cuts, concerns around U.S. debt levels, lagged impacts of the recent tightening and the potential for an economic slowdown, ongoing geopolitical concerns and of course, a U.S. presidential election.

Notably, despite the higher yields and proliferation of tools to access the asset class, flows have yet to materialize to the degree anticipated. Volatility may have played a role in the level of flows to the asset class, but it has also created opportunities for nimble capital.

of daily rate moves in excess of 10 bps on 10 year
Treasury



Source: Bloomberg, LCAM

The Bruce Wayne Paradox

When Batman is visible, it deters crime, making Batman less necessary and increases his time spent as Bruce Wayne. But when he returns to the role of billionaire, crime reappears creating the need for Batman again.

The Fed has a similar challenge today. In its November meeting, the Fed noted that the market had tightened independently, lessening the need for the Fed to tighten. However, in not tightening, the Fed gave a greenlight to positive sentiment resulting in equities rallying and rates declining. Thus, the Fed's need to tighten after the meeting (holding all other factors constant) was greater than before.

Since that time, the market has begun to price in rate cuts for 2024. This creates an unusual expectation for 2024 of rate cuts and moderate economic outcomes. Typically, rate cuts are seen as a response to economic deterioration, which would suggest a paradox for 2024. However, in this case, the argument for cutting is not an economic deterioration, but rather progress in the Fed's battle with inflation. The Fed (though not all market participants) thinks in terms of real rates and with inflation having declined as much as it has, from this perspective the Fed ought to cut nominal rates to retain consistent (and not overly tight) real rates.

Interestingly, popular discourse seems to be overlooking the other side of the coin from November. Since the market has loosened significantly on the expectations of Fed cuts (rates closed the year down over a full 100 bps since the mid-October high, credit spreads tightened 30 basis points since their October high), financial conditions are doing the work for the Fed – possibly lessening or obviating the need for rate cuts.

Perhaps the Fed's ideal path is to tease rate cuts to keep market conditions loose, while not being forced to actually deliver them. Using moral suasion as the Fed has increasingly done to supplement or replace changes in policy can be a highly leverageable and effective tool but in some cases may also over-signal the market.

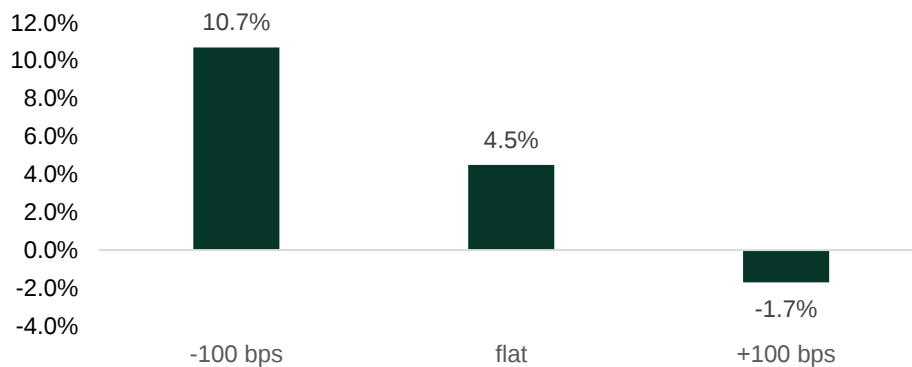
The Bat Signal

If only macroeconomics were projected as clearly as the Bat Signal onto the night sky. We expect a noisy and turbulent election. We expected risk sentiment to vary as markets digest the end of the Fed tightening cycle and try to balance the delayed impacts from recent hikes with the sentiment boost from projected cuts. We see the U.S. economy, though weakening, as a relative strength among global economies. While inflation is subsiding, the bite of higher prices from the past two years is continuing to weigh on consumers, and concerns regarding the historical pattern of additional waves of inflation cannot yet be dismissed. The promise of AI, a topic we addressed earlier in the year, could mitigate some concerns if productivity gains begin to materialize – though as we noted, it is yet to be determined how the balance of productivity gains with employment losses will be seen over any discrete period of time.

There are reasons, both positive and negative for risk sentiment, which could drive rates higher and lower in the coming year. A few are listed below, but importantly, the higher yield and lower duration profile of fixed income today versus recent history demonstrate the skew to be much more in investors' favor today. This suggests that even with uncertainty on the horizon – or perhaps especially given the uncertainty on the horizon – fixed income has become an increasingly compelling addition to asset allocations.

	Rates Down	Rates Up
Positive for risk sentiment:	- Fed cuts rates consistent with decline in real rates - Financial conditions ease	- Growth exceeds expectations - Productivity gains accelerate
Negative for risk sentiment:	- Economic slowdown / fears of recession - Geopolitical risk increases	- Inflation returns - Concerns around U.S. fiscal situation / debt levels

Bloomberg US Aggregate Bond Index One Year Returns Given the Following Rate Environments



As of 12/31/2023

Source: LCAM, Bloomberg

These returns are simple projections based on Treasury rate moves and neither account for the presumptive additions from the positive carry of actively managed portfolios, the tactical moves that could be made during the period, nor any market moves with regards to spread or convexity changes. A credit spread widening is certainly a possibility, one that would likely be tethered to other more painful risk-off moves, such as an equity market sell-off. Historically, spread widenings have tended to correlate with rates declining, though this is by no means a certainty. A decline in yields could help to insulate the overall asset class from the impacts of a spread widening event.

Conclusion: Do me a Favor. Tell your friends. I'm Batman

In the reintroduction of Batman to the big screen in 1989's 'Batman', Batman encounters several criminals early in his emergence as a superhero. Using Bruce Wayne's income and creativity, he has fashioned a bulletproof Batsuit and a suite of tools to combat crime. These criminals fire several shots at Batman and he falls, with them thinking he has been killed. They turn to see him stand up, having withstood their attack. He holds one of the criminals over a ledge as the criminal pleads for his life. Batman responds "I won't kill you. I want you to do me a favor. Tell all your friends about me."

Fixed income is the asset class that has been shot at for a decade and a half. It appeared to be fatally wounded but has now stood up and reminded us that a lot of income and a little creativity can protect you and maybe even make you a superhero. Do us a favor. Tell your friends.

This is not intended to serve as a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. Information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. This publication is prepared for general information only. This presentation may contain targeted returns and forward-looking statements. "Forward-looking statements," can be identified by the use of forward-looking terminology such as "may", "should", "expect", "anticipate", "outlook", "project", "estimate", "intend", "continue" or "believe" or the negatives thereof, or variations thereon, or other comparable terminology. Investors are cautioned not to place undue reliance on such returns and statements, as actual returns and results could differ materially due to various risks and uncertainties. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. It does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investment involves risk. Market conditions and trends will fluctuate. The value of an investment as well as income associated with investments may rise or fall. Accordingly, investors may receive back less than originally invested. Investments cannot be made in an index. **Past performance is not necessarily a guide to future performance.**

Loop Capital Asset Management – TCH, LLC is a registered investment adviser and a wholly owned subsidiary of Loop Capital Asset Management, which is a subsidiary of Loop Capital LLC. Loop Capital is the brand name for various affiliated entities of Loop Capital LLC that provide investment banking, and investment management services. Products and services are only offered to such investors in those countries and regions in accordance with applicable laws and regulations. Loop Capital is a trademark of Loop Capital Holdings LLC.

Loop Capital Asset Management LLC, and Loop Capital Markets LLC are affiliated companies.

Investment products are: **Not A Deposit | Not FDIC Insured | No Bank Guarantee | May Lose Value**

©2024 Loop Capital LLC