Portfolio Management Outlook

Preparing for Expected Rate Cuts

Higher quality fixed income has outperformed in previous easing cycles.

Our baseline economic outlook, which helps set the roadmap for our long-term investment strategy, is for a gradual slowdown in U.S. growth as fiscal support fades and a cooling labor market pressures incomes and consumer spending. That said, risks to our growth outlook are weighted to the downside. Our views on the labor market were confirmed by the miss in the July jobs report, which went on to spook global markets. Not surprisingly, one of the common themes from our sector teams in this issue is that rate cuts starting in September have already been discounted by the fixed-income market, but views on how much and how many are still evolving. We continue to expect volatility, particularly around data related to the health of the consumer and economy.

In general, our view is that yields across fixed income remain high and attractive, particularly relative to post-global financial crisis (GFC) norms. Credit fundamentals are healthy overall, but more mixed in lower quality, and we expect to see further dispersion as the economy slows.

Our credit and risk position is driven by fundamentals and relative value. We are prioritizing high carry, shorter duration instruments in areas including non-Agency Residential Mortgage-Backed Securities (RMBS), senior Collateralized Loan Obligation (CLO) tranches, commercial Asset-Backed Securities (ABS), and BB-rated corporate bonds. After the July jobs report there has been some spread movement as the Treasury curve resets lower and flatter, but our expectation is that spreads will remain relatively rangebound. Spreads in high grade sectors are tighter than recent wides, but they remain cheap relative to fundamental risk, particularly in structured credit. We have been maintaining some dry powder for taking advantage of opportunities that may arise and targeting an average level of credit beta.

From a duration perspective, the yield curve has bull flattened in July and into August, and is likely on its way to a steepening once rate cuts begin. In this environment, we prefer to express duration using Agency RMBS, given wide spreads and improved convexity profile, with a marginal bias towards the belly of the curve given its historical outperformance during easing cycles.

As the Federal Reserve (Fed) comes to the end of the pause phase of the cycle and starts easing, historical data show that higher quality fixed income has outperformed money markets and riskier assets like stocks. Investors considering when to reallocate into bonds will also want to consider technical factors that could affect the timing of such a move, including getting ahead of possible outflows from money market instruments and taking advantage of low dollar prices available in the market.

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Investing involves risk, including the possible loss of principal. In general, the value of a fixed-income security falls when interest rates rise and rises when interest rates fall. Longer term bonds are more sensitive to interest rate changes and subject to greater volatility than those with shorter maturities. During periods of declining rates, the interest rates on floating rate securities generally reset downward and their value is unlikely to rise to the same extent as comparable fixed rate securities. High yield and unrated debt securities are at a greater risk of default than investment grade bonds and may be less liquid, which may increase volatility. Investors in asset-backed securities, including mortgage-backed securities and collateralized loan obligations ("CLOs"), generally receive payments that are part interest and part return of principal. These payments may vary based on the rate loans are repaid. Some asset-backed securities may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity and valuation risk. CLOs bear similar risks to investing in loans directly, such as credit, interest rate, counterparty, prepayment, liquidity, and valuation risks. Loans are often below investment grade, may be unrated, and typically offer a fixed or floating interest rate.

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