



While interest rate volatility can be expected in the near term, several recent indicators have continued to point to a macro backdrop that is favorable for quality bonds. (UBS)

Fed commentary and data still point to rate cuts

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The ascent in US equities to all-time highs has grabbed headlines recently, but US Treasuries have also rallied over the past two weeks. The 10-year yield has fallen around 20 basis points to 4.1% as of the close of Wednesday, the lowest level in a month. This came as Federal Reserve Chair Jerome Powell reiterated a rate cut is likely appropriate “at some point this year” during his semiannual monetary policy testimony before Congress.

The path toward US rate cuts this year remains uncertain. Both nonfarm payrolls and the consumer price index for January surpassed expectations, and investors are hoping the numbers for February, to be released in the coming days, will show that the downward trend in inflation is resuming and that labor markets are cooling.

But while interest rate volatility can be expected in the near term, several recent indicators have continued to point to a macro backdrop that is favorable for quality bonds.

The Fed is biased toward easing as inflation should recede. Powell’s remarks echoed a consistent message from other Fed officials in recent weeks that policymakers are in no rush to cut rates until they have greater confidence that inflation is moving sustainably toward 2%. Fed officials have pointed out that the path down to the central bank’s inflation goal could be bumpy. We believe the strength of the January consumer price index largely reflected start-of-year price increases for labor-reliant categories such as medical services, car insurance and repairs, and daycare. We expect inflation in these categories to be lower in February and March. The Fed has also stated its preference for personal consumption expenditure data in its rate decisions.

Business activity survey readings over the past week have been consistent with a soft landing for the US economy. The US ISM manufacturing and services purchasing managers' index readings were both mixed, with weaker-than-expected headline readings on activity contrasting with elements of resilience in the sub-components. In the manufacturing sector, production, new orders, and employment all fell from January, suggesting a slowdown in economic activity. However, comments from the survey respondents were better than the numbers imply. In the services sector, prices paid retreated after a jump higher in January, and employment dropped below 50, while orders were strong. Additionally, the Fed Beige Book, in which the regional Fed banks take the pulse of corporate executives and economists in their area, indicated businesses provided an economic outlook that is generally positive thanks to healthy demand and easing financial conditions. Overall, we think this is consistent with our expectations that the slightly softening US economy remains solid.

Recent labor market data should provide some evidence that conditions are cooling. Recent indications have been mixed. The ADP report pointed to an increase of 140,000 in private payrolls for February, slightly below expectations though higher than in January. The January Job Openings and Labor Turnover Survey (JOLTS) also did little to change perceptions among investors. The report revealed a marginal decline in job openings and a slight reduction in the hiring rate. While there was also a reduction in the quits rate, which suggests strong demand for workers is making it possible to find better positions, this gauge remains near the lowest levels since August 2020. However, the key reading this week will be the nonfarm payroll release on Friday, which is expected to point to a modest slowdown in job creation along with weaker average earnings growth. Signs of cooling in this release could bolster market confidence that the Fed will feel able to cut rates at its June meeting.

So, with Fed rate cuts remaining on the horizon this year, we maintain our preference for quality bonds, which offer an attractive risk-reward proposition in our view. We expect the 10-year yield to fall to 3.5% by December in our base case scenario, and especially like medium-duration bonds. We also think investors should consider taking advantage of actively managed fixed income strategies.

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