



While the economy is poised to slow from its torrid pace, a soft landing remains our view. (UBS)

# Fixed income 2Q outlook: The slow turn

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**The UBS Chief Investment Office (CIO) shares their expectations for the fixed income market in 2Q24. They also reaffirm their preference for higher-quality segments, along with their view that interest rates will decline later this year as the Fed begins its rate cut cycle.**

## A slow turn: 2Q Outlook

With the Federal Reserve's monetary policy on hold for five consecutive meetings, financial markets are anxiously awaiting the next turn of the wheel—from pause to pivot. The economic backdrop remains on solid footing, with the Atlanta Fed GDPNow pointing to 2.8% growth in 1Q24. Although lagging the 3.4% and 4.9% growth rates of the previous two quarters, it would still be the seventh straight quarter above 2%, downplaying recession fears that dominated the market heading into 2023 and 2024. While inflation remains stickier and oil prices are up 17% on the quarter, we expect inflation to slow this year, albeit not linearly. While the job market remains strong, there are pockets of weakness showing in the lower quit rates, a two-year high in the unemployment rate of 3.9%, and continuing claims being up 8% year-over-year. Households have relied more on savings to support spending, as the personal savings rate declined to 3.6%—the lowest since December 2022—from 4.1% in January. While the economy is poised to slow from its torrid pace, a soft landing remains our view. While consumer wallets are likely to be challenged by rising credit card balances, falling savings rates, and less robust employment growth, the record household net worth should prevent a collapse in spending. Additionally, government-induced corporate investment through the CHIPS and Science Act, Inflation Reduction Act, and Bipartisan Infrastructure Law are likely to offset any consumer weakness. In our view, data dependence will define the Fed's near-term policy considerations, but the data will not define the eventual trend of interest rates, which we believe will be lower.

## 2Q24 outlook

With financial conditions loosening at such magnitude, and with higher credit embedded sectors outperforming, we caution against overallocating to sectors that have a high correlation to the equity market. While we remain positive on above-trend economic growth and expect the Fed to cut rates starting mid-year, we do anticipate short-term corrections in 2Q24 given the outperformance since late December, when the Fed officially hit the pause button. We show the current yield and spread percentile over the past 10 years across various fixed income sectors. The spread component across the board is low compared to history for most risk assets, except for securitized product such as MBS and CMBS. However, income earned (yield) is on the higher end across most fixed income product. Given our view that it is yield, not spread, that is the material driver of total returns, we prefer to take the higher yield offered in higher-quality sectors such as agency MBS, IG corporates, CMBS, and TIPS. We think maintaining a preference for higher quality and ample liquidity, while locking in carry, will be a key driver of performance over the next six months as the market digests high-for-longer fed funds rates while anticipating slower but above-trend growth.

We examined historical performance in the period after the peak in Fed rates and during easing cycles. We find that from peak rate to first cut, lower-quality sectors tend to outperform higher quality, and this cycle it is not different. Historically, recessions have been the driver of Fed rate cuts; in today's environment, however, we view 2024 cuts as "maintenance cuts"—meant to keep the fed funds rate at restrictive levels for a longer period while preempting a shock to the labor market that impedes future growth. We show the total return and average spread levels today versus the past cutting cycles. Today's spread levels are historically tight versus previous policy shifts, except for loans, CMBS, and agency MBS. While lower-quality sectors outperform during the transition from peak to cut, higher-quality sectors outperform 12 months following the first cut and throughout the cutting cycle. While we do not foresee a hard landing, we continue to look for the Fed to start cutting rates in 2024, for QT to start tapering, and for growth to slow in 2Q24, leading to lower rates and outperformance of higher-quality sectors.

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For more, read the full report [Fixed Income Strategist: The Slow Turn: Q2 Outlook](#) 5 April 2024.

See the report [Corporate bonds: Best ideas in HY, IG, and preferreds](#) 28 March 2024.

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