Against a backdrop of slowing economic growth and moderating inflation, CIO remains most preferred on fixed income, with a focus on high-quality bonds. (UBS)

Markets helped by optimism over Fed outlook

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The yield on the 10-year US Treasury fell 15 basis points on Tuesday to 4.65%, the largest single-day decline since March when the collapse of Silicon Valley Bank raised concerns over the stability of the banking system.

The yield fell further on Wednesday to 4.56%. Investor sentiment has been boosted by recent indications from top Federal Reserve officials that an end to the hiking cycle might already have been reached. Atlanta Fed President Raphael Bostic said: "I actually don't think we need to increase rates anymore," adding that monetary policy was likely at a level sufficient to slow the economy without tipping it into recession. Stocks also gained ground, with the S&P 500 rising 0.5% on Tuesday.

The moves come ahead of the release of the minutes of the Fed's September meeting, which showed top officials becoming more cautious about the pace at which they will be able to ease policy in 2024. Over the past week, investors have once again become more upbeat about the speed of potential rate cuts next year.

But, whether such optimism proves justified will hinge on upcoming economic data, including the release on Thursday of the Consumer Price Index for September:

Investors will be hoping that the September data provide reassurance that the inflation threat has receded. The consensus forecast among economists suggests this will be the case, with the core month-over-month rate—excluding volatile food and energy prices—seen holding steady at 0.3%, which is consistent with inflation moving toward the Fed's 2% target. The year-over-year core rate is projected to slow to 4.1% from 4.3%—down from a peak of 6.6% last September. The Fed and investors will also be looking for continued signs that the super-core inflation gauge—which also strips out housing costs—will ease too.

Compensation growth appears to be cooling, reducing the threat that rising wages will keep inflation elevated. While September payroll data pointed to about double the pace of employment growth economists had been expecting at 336,000 for the month, there were some signs that pay settlements are moderating. Annual average hourly earnings rose 4.2%to September, the smallest advance since 2021. While this measure is not adjusted for the mix of jobs created, so it could reflect increased hiring in lower-paid sectors like hospitality, other metrics of compensation growth have been encouraging. The Atlanta Fed's three-month moving average of median wage growth slowed to 5.3% in August, from a peak of 6.7% a year earlier

Fed officials have been acknowledging that rising bond yields are likely doing much of their work for them, helping to slow growth. San Francisco Fed President Mary Daly reiterated that recent tightening in financial conditions "could be equivalent to another rate hike." And similar observations have been made this week about the constraining effect of higher bond yields by Dallas Fed President Lorie Logan and Fed Vice Chair Philip Jefferson. Even after this week's slide, the 10-year yield is still up over 40 basis points in recent weeks, having started September at 4.11%.

So, against a backdrop of slowing economic growth and moderating inflation, we remain most preferred on fixed income, with a focus on high-quality bonds. We like opportunities in the 5–10-year duration segment in high grade (government), investment grade, and sustainable bonds. We think 10-year US Treasuries can deliver 14% total returns in our base case for a "softish" economic landing in the US, 10% in an upside scenario of reaccelerating growth, and 20% in a downside recessionary scenario.

Read the original report : **Markets helped by optimism over Fed outlook, 11 October 2023.**