With inflation coming in greater than anticipated for most of the year, breakevens have stayed higher while nominals have begun to fall, creating a tailwind for outperformance. (UBS)

In the fixed income space, our message has not changed: Buy quality

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One of the key stories of 2024 has been the continued volatility of interest rates.

Clearly, the path to the Fed pivot has not been as straightforward as initially expected. And this year, expectations regarding the timing of the first Fed cut have shifted from March, to June, to July, to sometime between 3Q24 and 4Q24 as markets have continued to recalibrate for every piece of growth and inflation data.

Fixed income is a "show me" market. And while we remain within our near-term range for interest rates, we have been once again reminded of the market's data dependence, as expectations quickly shift with each data point. So what happens next? We break down our outlook for rates and how to position.

What will drive interest rates?

Interest rates are always hard to predict, but especially so when inflection points in monetary policy are approaching, incoming data is noisy, technical factors like liquidity are also causing yields to bounce around, and policy shifts outside the US, such as in Japan, are also complicating the picture.

But to make it simple for you, while all of these factors will play a role, we believe the fundamental driver of rates over the remainder of the year will still come down to two factors: growth and inflation, and where the pendulum around the Fed's dual mandate swings next as a result.

On the economic activity front, we are confident that the macro dynamism that has been the story for the past few years is slowing down—at least a bit. While the payrolls report was hotter than expected, beneath the surface, we are seeing signs of a cooling labor market, with the unemployment rate ticking up to 4%, its highest level since early 2022, and job openings falling. From the Fed's perspective, these could be warning signs that the tightness in monetary policy is pinching and that recession risks might be building.

How to position?

In the fixed income space, our message has not changed: Buy quality. While higher-credit-embedded sectors have outperformed year to date, and even cash has beat many areas in high-quality fixed income, we expect these trends to reverse. We see high-quality bonds delivering solid total returns for the remainder of 2024.

More specifically, we see good value in US TIPS, investment grade corporate bonds, Agency Mortgage-Backed Securities, Commercial Mortgage-Backed Securities, and municipal bonds—all of which should benefit as the Fed pivot starts to get priced in later this year.

In the IG corporate space, spreads are very tight, but corporate balance sheets are sound while foreign and domestic demand remains strong. While drivers of return will not be material spread compression, compounding income and price appreciation from lower Treasury yields in 2H24 should provide strong tailwinds to total return.

In the case of Agency Mortgage-Backed Securities, heightened interest rate volatility had been a headwind to performance. However, spreads have compressed since the Fed 1 May meeting, while remaining a standard deviation cheap vs. their longer-term average. Besides their relative value, the high credit quality and ample liquidity will provide support as the cycle continues to mature and growth begins to slow through the rest of the year.

We view 7-10 year TIPS as our preferred position to extend duration—given our view that real yields will also fall throughout the year. With inflation coming in greater than anticipated for most of the year, breakevens have stayed higher while nominals have begun to fall, creating a tailwind for outperformance.

Finally, we continue to see municipal bonds as a core holding in portfolios for taxable investors. Tax-equivalent yields for long-end munis in the highest states can currently exceed 8%.

Original report - **The rate roller coaster: Where yields could go next and how to position, 11 June 2024.**

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