CIO expects bond yields to fall in 2024, supporting returns for the asset class. (UBS)

More to come from the US bond market rally

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Bonds rallied in November amid rising expectations for the extent of Federal Reserve rate cuts in 2024.

Total returns for the Bloomberg US aggregate index were 4.5% in November, the best month since May 1985, and 5% for the Bloomberg global aggregate index, the strongest month since December 2008.

But despite this strong run, our view is that bonds can rally further next year:

We expect bond yields to fall in 2024, supporting returns for the asset class. Following solid US economic performance during the summer, recent data show that the tightness in the labor market is beginning to ease and inflation is continuing to recede. In 2024, we see growth and inflation continuing to slow as excess savings are run down further. Although inflation will likely remain above the Federal Reserve's 2% target through most, or all, of the year ahead, we believe policymakers will be sufficiently confident by mid year that inflation is falling sustainably toward target to begin cutting rates. Our year-end 2024 forecast for the 10-year US Treasury yield is 3.5%, compared with 4.31% currently.

The decline in yields is unlikely to be smooth. The bond rally has been underpinned by rising hopes that the Fed will cut rates next year, with the latest market pricing suggesting almost five 25-basis-point reductions by December 2024, with a 50% chance that the first cut comes as early as March. We think the market may have run ahead of the likely pace of cuts. Our base case is that the Fed will deliver two to three cuts next year, with the timing data dependent, but most likely starting in July. Fed officials have started to push back against market expectations. On Thursday New York Fed President John Williams said, "it will be appropriate to maintain a restrictive stance for quite some time to fully restore balance and to bring inflation back to our 2% longer-run goal on a sustained basis." His remarks helped push 10-year yields 7bps higher on the day, and we note that Fed Chair Jerome Powell speaks later today.

The risks associated with increased supply appear manageable. In mid-October, the 10-year US yield briefly touched 5% intraday, in part due to a rising term premium—the extra yield investors demand for holding a long dated bond rather than a shorter-dated one. A surprise increase over the summer in the US Treasury's borrowing forecasts, a downgrade to the US sovereign AAA credit rating by Fitch, and the risk of a near-term government shutdown led investors to demand a higher term premium. These concerns have receded, and the term premium on 10-year US Treasuries has fallen back to around zero (from about 50 basis points at the October peak, based on the New York Federal Reserve's ACM model).

Looking ahead, given the increased level of issuance to fund the budget deficit, concerns over the ability of the Treasury market to absorb greater supply may return. The biggest risk for the market is a failed bond auction, where the Treasury receives fewer bids than the face value of securities it wishes to sell. In our view, this is unlikely. US banks remain flush with excess reserves and primary dealers' responsibility is to act as a buyer to prevent this scenario. Our expectation is also that the Fed would intervene to restore stability if required. Regulatory changes could be made to make it economical for banks to hold more Treasuries, and the Fed could quickly reverse quantitative tightening and resume bond purchases.

So, we continue to recommend high-quality (specifically high grade/government and investment grade) bonds with a 1–10-year duration, particularly the five-year segment.

Main contributors - Solita Marcelli, Mark Haefele, Frederick Mellors, Vincent Heaney, Jon Gordon, Jennifer Stahmer

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