Fixed Income Quarterly: Q4 2023

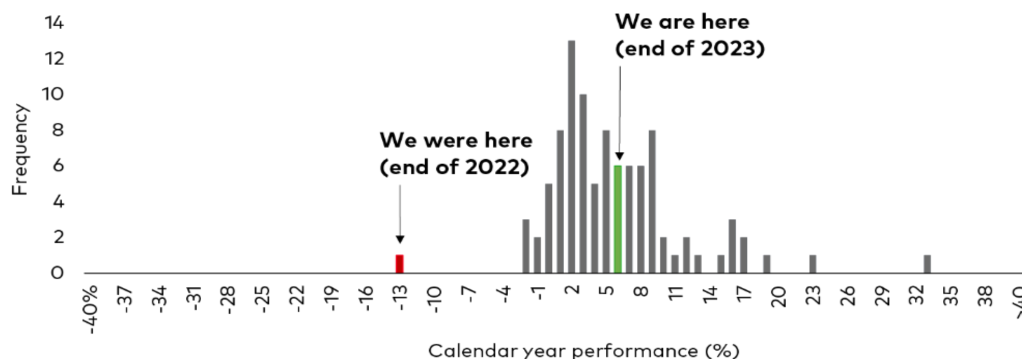
"These poor people have been BS'd by the system into believing that if you change the name of the condition, somehow you'll change the condition."
-George Carlin

Internal Use Only

The Markets:
Now that's the way to end a year! As we've been stating since mid-2022, inflation should continue to work its way down and the Fed will look to lower or discuss lowering rates by Q4. Even discussing the end of hikes often has the same effect since financial markets are forward-looking. Personally, I believe the recent rally in stocks/ bonds is overdone and Q1 of 2024 might not be so great, but it was probably time for the Fed to shelf the hawkish talk given CPI YoY is back down to 3.1%.

All major indices were up during the final quarter: the Dow +13%, finished the year at 15.9%, the S&P up +11.6% to end at 26.0%, the NASDAQ up +13.8% for a total of +44.7% and even the Barclays Bond Aggregate came from negative territory to end the year up +5.5%. Fortunately, our fixed-income portfolio faired much better to make up for last year's worst fixed-income market in four decades. Our Core bond portfolio was up +12% and our Core+ portfolio was up over +15% for the year. Granted equity returns were concentrated in a handful of tech/communication names, but equity concentration is not a new phenomenon. Picking the securities of solid companies in both stock and bonds and staying the course has proven to work in investing. Looking back almost 100 years at the distribution of government and aggregate bond index bond performance, we can see the concentration of returns with very few outlying years with a high frequency.

Figure 4b: Distribution of annual bond performance (1928—2023)

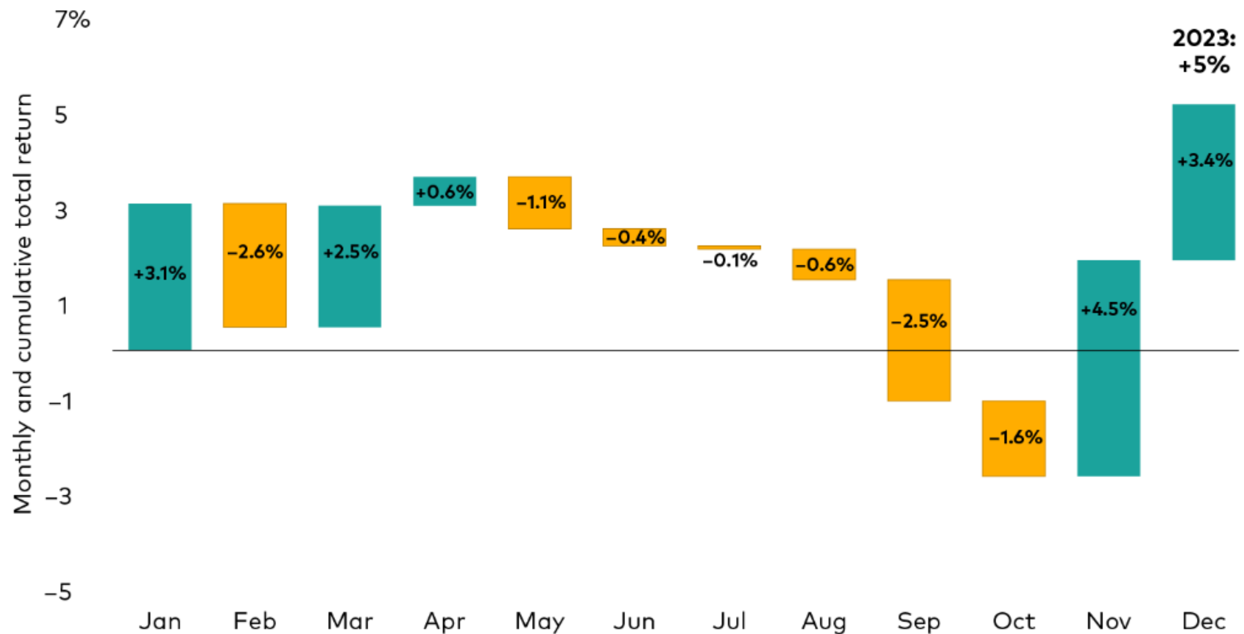


Vanguard: IA SBBI U.S. Intermediate-Term Government Bond Index through 1972; Bloomberg U.S. Government/Credit Intermediate-Term Index from 1973 through 1975; Bloomberg U.S. Aggregate Bond Index thereafter.

Bond World:

Revised data for lower labor and inflation numbers during the quarter helped push the yield curve lower to a bull flattener position or inverted bull flattener to be more precise. Credit spreads came in tighter on top of the US Treasury curve rally with IG and HY spreads tightening during November by -21 bps and another -7 bps in December for IG credit. HY saw -58 and -50 bps worth of spread tightening during November/December, bringing overall spreads on IG bonds to -104 OAS and -334 OAS, (Option Adjusted Spread) for HY bonds. All bond sectors tightened through the quarter with Real Estate, Autos, Leisure, Banking, and Financial Services leading the way with -18 to -12 bps worth of tightening. The High Yield (HY) Index tightened by -50 bps MoM and by -145 bps for the entire 2023. Triple CCC let the way followed by single B and double B credits, with CCC credits tightening/rallying by over -300, (3.0%) bps during the year.

Cumulative monthly Barclays Bond Aggregate returns for 2023



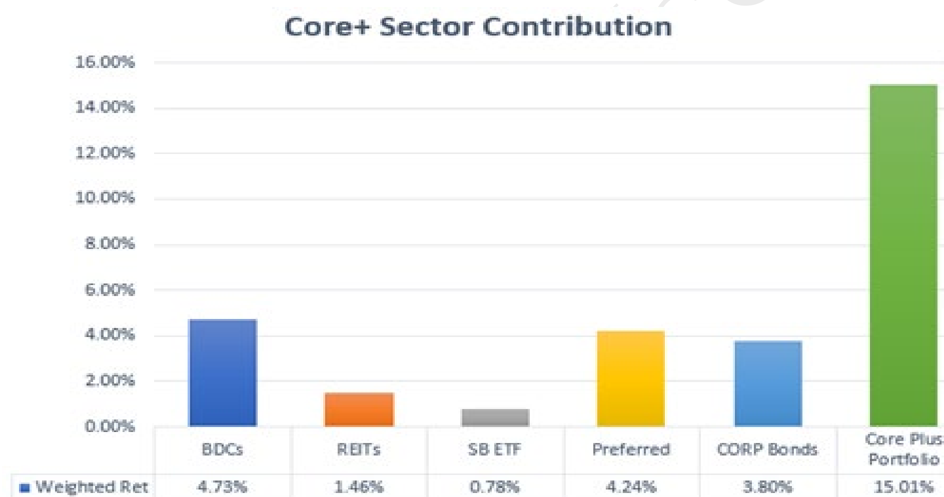
Source: Vanguard

Given the weaker reported labor and inflation numbers and the Fed's pivot to a more dovish speech at the December 13 meeting, we've seen bonds and equities rally to a point where we didn't buy many bonds during the last two months of the year. Fixed income markets are mostly professional/ institutional markets and when professionals anticipate a rally, such as we've just experienced, they tend not to offer their bonds out to the market, unless you want to grotesquely overpay of course. Therefore, trading volumes were light for us during the holiday season. However, earning 5.25% in a "fairly" risk-less money market instrument isn't the end of the world, provided we get a selloff during the first quarter of next year to put additional capital to work at better spread/yield levels than where bond yields finished the year.

Outlook:

The first half of 2023 looked pretty good for both equities and fixed income, but markets were expecting to have weaker inflation and labor market numbers and those expectations were not fully realized. Therefore, the second half of 2023 started with the Fed increasing rates again at their July meeting, due to "sticky" inflation numbers not receding fast enough for their comfort. During the third quarter, returns for fixed income and equities began to unravel given those earlier inflation numbers. However, once the markets, and the Fed, started to see economic revisions and J. Powell's much-anticipated speech turned dovish, markets continued their climb.

The Bloomberg global bond index increased by 5% in December for the largest monthly gain since December of 2008, when the Fed slashed rates to zero and pushed their quantitative easing policy in November of that year. Needless to say, it's probably been overdone and we're looking at a bit of a bond selloff in the coming months. This should present yet another opportunity to purchase bonds on sale, with decent spreads/ yields to lock in the next few months.



While this year produced great returns and increased income for our income-based portfolios, I am cautiously entering into 2024. I state this because financial markets are usually forward-looking, and investors are assuming the Fed will quickly lower rates and therefore bid up bonds back below a 4% yield in the 10-year US Treasury. Given investors have probably priced in a "Goldilocks" scenario for next year, we'll look for continued weakness in inflation before making material adjustments. I'll continue to search for quality companies that pay solid income and interest, but I do expect that returns will revert towards the long-term mean for equity and fixed-income markets in the year ahead, provided a recession can be avoided. Though this would be the first time so many signs were pointing to a recession and yet not have one.

Maybe in an election year we'll continue down the current societal path of not calling a spade a spade. When I hear the term "soft-landing", I often think of Geoge Carlin's stand-up routine about

“soft language” and its warning, but we’ll see how the economy shakes out soon enough. Until then, let’s savor this return for 2023!

Regards,

Eric Lutton, CFA
Chief Investment Officer
Sound Income Strategies LLC

Investment Advisory Services offered through Sound Income Strategies, LLC, an SEC Registered Investment Advisory Firm.

For Internal Use Only