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Conversations with Commerce Trust podcast
April Episode: 2024 Opportunities in Fixed Income
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David Hagee: Hello and welcome to *Conversations with Commerce Trust*, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today we're discussing the fixed income markets with Scott Colbert, our Chief Economist and Director of Fixed Income. Welcome to the podcast, Scott.

Scott: Colbert: Hello, David. How are you?

David: Here we are with fixed income. I'm struck by, one, the opportunity set that we're seeing today that we haven't seen for 15 years. Maybe you could talk a little bit about what we're seeing inside the fixed income markets right now in terms of rates and what yield curves look like.

Scott: You alluded to the fact in general why we like fixed income, because we haven't seen yields like we have today in a number of years. To have cash yields as high as they are today, you have to go all the way back to basically before the internet bubble popped, 2000, 2001. Even the five-year (U.S.) Treasury, you have to go back to 2007 to find yields as high as they are today.

The first thing we like is we like the interest rate level that we haven't seen for, as you said, 15-plus years or so. The overall yield of the investment-grade market has a yield today of almost exactly 5%. When you can lock in 5% with an average AA or better credit quality, you pretty much hone in on what your returns are going to be for nearly a decade. It's 5% today compared to the twos and threes that we've been used to for the last 15 or 16 years.

David: The other thing of note inside the fixed income markets is we've had an inverted yield curve since July of 2022. With that inverted yield curve, meaning that shorter-term rates are higher than longer-term rates that has been inverted because the Fed (Federal Reserve) has raised rates to be able to fight inflation. Inside 2024, there's been a lot of consideration for a Fed rate cut. What are your thoughts around Fed positioning and the likelihood of interest rate cuts for 2024?

Scott: A lot of this depends, of course, on the direction of the overall economy and then, most importantly, the direction of inflation. We do see that even though there's a slight re-acceleration in real growth, that nominal growth is still continuing to cool a little bit. In other words, basically year-over-year aggregate growth, and with it, we're likely to see a continued slowdown in inflation. The core PCE (Personal Consumption Expenditures Price Index), with Fed's favorite measure of inflation, over the last 12 months has been 2.8%.

They've been able to halve essentially what inflation was at its peak based upon this similar measure. We think they're likely to make continued progress going forward, which will afford them the chance to modestly lower rates over the back half of the year. Of course, the bond market tends to do well when they're lowering rates and it tends to do poorly, as it has done for the last four years, when they're in the process of raising rates.

David: As we look at the opportunities inside fixed income, let's talk about the location of bond assets. There's a taxable market, a tax-exempt market. How are we looking at both of those?

Scott: As retail clients know, they like to have tax-exempt securities, and for our institutional clients, they want taxable securities because most of that are tied up in pensions or non-profits or where you don't have to pay tax. In terms of the taxable market, that's the yields we talked about that have backed up to five, even five and a half percent. The tax-exempt market, of course, is higher today, too, but on a relative basis, when you compare the two markets, the tax-exempt market is awfully rich, or I will say, less attractive on a dollar-for-dollar basis. That would be the first point we want to make, is that for those that want to play both sides of it, both the taxable and the tax-exempt market, the taxable market appears to offer a bit more value. Secondly, both markets, though, are unique and different, and so to find value within those markets is a different operating set.

On the taxable side, we're finding value really in three pockets. Number one would be in certain parts of the corporate market, particularly the banks and financials and the energy sector, and that would be say, compared to the consumer non-durable sectors, which are trading at very, very tight levels. Secondly, we like the mortgage-backed area, which has been really pushed down as interest rates have risen and prepayments in mortgages have slowed, and they've largely underperformed the markets. We like the mortgage sector. Then we like the asset-backed sector for marginal incremental trade, which is niche to the taxable market.

On the tax-exempt side, it's more of yield-curve positioning, as you talked about this inverted yield curve. We really like short-term municipal securities because they're still yielding above 3%, and then we like longer-term municipal securities because they're trading above 3%, but all the securities in the intermediate part, the three to, say, nine-year part of the curve, are trading exceptionally rich. It's yield curve positioning on the tax-exempt side and basically credit positioning on the taxable side.

David: With that, and given this Goldilocks scenario that we're seeing inside a strong U.S. economy, potentially falling rates or Fed rate cuts over the course of 2024; do we want to start to consider any of the plus sectors? Thinking about emerging market debt, high-yield debt, how are we approaching those right now?

Scott: As long as the economy stays good and the world stays healthy, higher-yield spaces always tend to outperform over time, but you're also taking on a lot more risk. As the market has moved, they have moved towards positioning these securities to offer very little incremental return going forward. One pocket that we do like though, because it hasn't held up as well, is the emerging market debt side, where they have yields that basically are about 3.5% more than treasuries, but higher overall credit quality than the domestic high-yield space that only has those yields of about an extra 3%. Finally, I would add that they also have slightly longer durations, which means we can lock in those higher yields for a longer period of time than we can in a high-yield market.

David: In what sort of environment does emerging market debt start to outperform?

Scott: Interestingly enough, it's very correlated to the U.S. dollar. Our economy has done so well, and our interest rates are so much higher in general than most global interest rates that we have attracted a lot of money, which has put the dollar in a better position relative to the euro, relative to the pound, relative to the yen. As the dollar is likely to decline as the Federal Reserve lowers interest rates and monies flow more globally, this is when the emerging market bond sector tends to do its best.

Basically, a benign economy where the U.S. interest rates are falling, and the dollar is largely less valuable relative to the rest of the world is when emerging markets shine. We think this is why it's been held up, why the emerging market debt has not held up as well as say these other riskier sectors and why we think it's an attractive opportunity now, today, not so much a year or two ago.

David: You mentioned falling interest rates here. Some research that we've done would say that the time to extend duration or to start buying longer bonds to get more durable yield inside of a portfolio is roughly three months before the Fed starts to cut interest rates. Any thoughts on how we're positioning portfolios given the Fed impact out there?

Scott: If you have a three-year time frame, the ideal time to be adding bonds and/or maturity to a portfolio is exactly about three months prior to cutting rates. Now the hard part of that is knowing when they're going to cut rates. The market was expecting to see interest rates cut as early as March this year. It's April already and, of course, they haven't cut. We're still not sure they're going to cut this year at all, although it's quite likely, we think, that they will. We would see this as an ideal time to add bonds and then, secondly, an ideal time to add maturity because what you're really saying is you'd like to capture the highest yields for the longest period of time when you can and, of course, that is before the Fed starts to cut rates.

If we're wrong about the Fed not cutting rates, I don't really see a materially higher interest rate environment coming anyway, which isn't necessarily bad, then you just "clip your coupon" (collect the interest payment from a bond) as time goes on.

David: As we start talking about the opportunities here, I'm struck by how big deficits have grown inside the U.S., what their longer-term impacts are going to be. What's the long-term impact of all this deficit spending that we're seeing right now, and how does that impact the markets?

Scott: You certainly think that to clear the supply of U.S. debt, since it's grown so much over time, the U.S. has to offer a higher interest rate and, by the way, the U.S. does offer a higher interest rate relative to developed markets. Our 10-year Treasury yield is about 2% higher than the German 10-year treasury yield. We do offer higher interest rates and I think that's due to the technicals of having a larger supply. To the extent that the supply continues to grow relative to the world supply, this also puts pressure on our interest rates (and) 30% of our debt is held by foreign investors.

Now, that's not an all-time high, by the way. It used to be about 40% back during the early 80s (1980s) when inflation was running high and interest rates were so high. The marginal investor in our debt is a foreign investor and so we have to keep rates attractive enough, or high enough relative to their own interest rates, to attract that. The deficit has gotten so big too now that it begins to crowd out domestic spending, but that's probably the biggest albatross around the U.S.'s economic growth prospects' neck is this rising deficit. It's become to the point now where debt service will be next year or this year that we're in, 2024, will be the second highest line item in the U.S. budget behind the defense spending.

David: You mentioned the debt service out there, and as we talk about that, the Fed did start raising rates on this and that's increased the amount of debt service that you have for the U.S. government, but they started raising rates because of inflation. They think that they can lower rates because inflation is somewhat subdued. What are our thoughts around inflation at this point and where are you seeing weakness at, where are you seeing strength at in terms of inflation?

Scott: There's no doubt we've seen inflation cool from its highs. We've seen a slight re-acceleration this year basically for the first three months of the year relative to where it was rolling for the last say nine months at the end of last year. That re-acceleration has been driven, it's been broad-based, it's been driven by some goods prices increases, it's been driven by ongoing home prices that continue to meet high levels, even a rebound in auto prices, insurance prices, you name it. We still think that in general inflation is probably around three and heading slightly lower which will afford the Federal Reserve the ability to lower rates.

The big driver at the margin, the big swing, is housing. Housing is still clocking in at about a 6% pace on a year-over-year basis in terms of its contribution to inflation, and of course, in the CPI (Consumer Price Index) housing is 33% of the CPI or about a third. Housing alone is contributing 2% of the overall 3% inflation rate that we have today. To the extent that housing prices can continue to slow their increase, we've already seen this in rents, I think we'll likely see inflation begin to tail off as the year progresses and afford the Fed the chance to lower rates, certainly not raise them.

David: As we look at things today, I'm looking at the positioning that we have inside fixed income, it's been a great market for us that we have rate back with us, we have a little bit of yield that we're able to obtain, looks like the Fed might be in a good position to cut rates. As you say, inflation is somewhat subdued. Economic growth in the U.S. surprisingly was better in '23 (2023) than it was in 2022. We've had real economic strength. At this point, it seems that bonds are very attractive. In addition, as you mentioned, emerging market debt out there represents an opportunity for us as well, as you've seen strength inside those markets as well.

Then finally, in the jokingly called the ABC portfolio — "anything but cash" — now might be the time to start extending duration in portfolios to move away from what should be a declining yield in cash assets as the Fed starts to cut rates.

Thanks for the interesting discussion today, Scott. For more information on today's topic, please visit our website, www.commercetrustcompany.com and download our latest commentary. Also, if you've enjoyed what you've heard, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts from.

Thanks for joining us on *Conversations with Commerce Trust*. I'm David Hagee. We'll talk again soon.

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