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What Goes Up … May Actually Come Back Down

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U.S. fixed income had its best year since 2020. The next 12 months should prove no less dynamic as the Federal Reserve pivots away from its rate hike campaign.

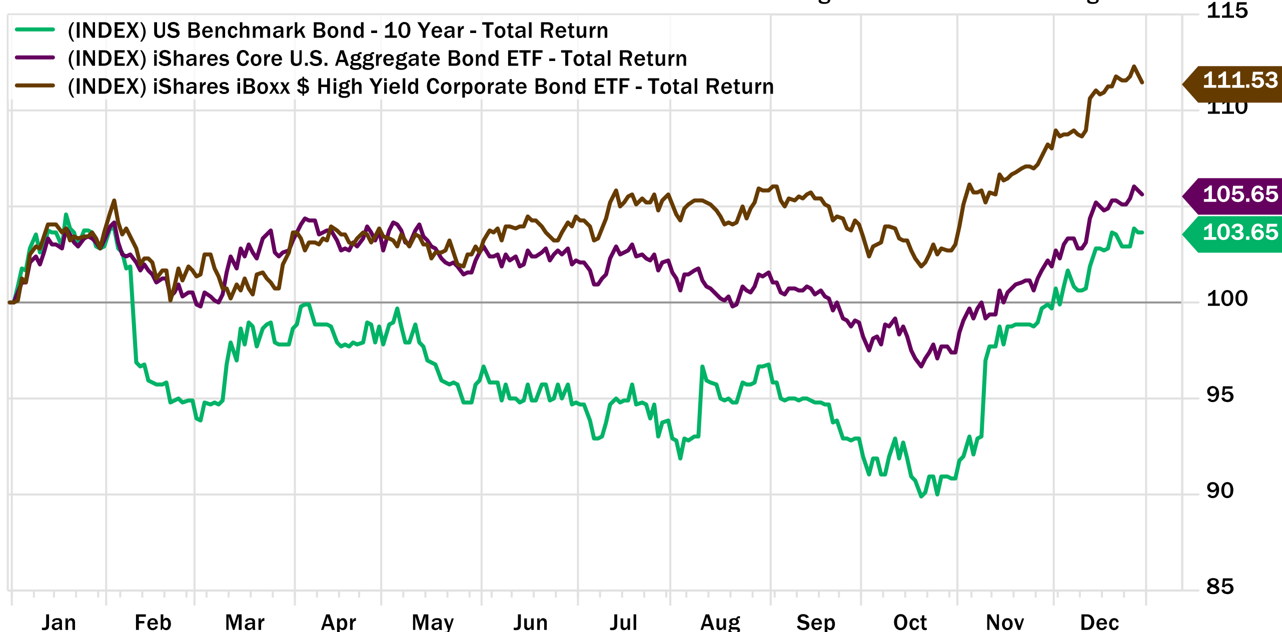
The year 2023 was quite a rollercoaster for U.S. fixed income markets. Rates across the yield curve saw considerable volatility throughout the year as the Federal Reserve's campaign against inflation reached its zenith. The Federal Funds rate, the primary policy lever of the Federal Reserve, saw four hikes of 0.25% in 2023, bringing the rate to a cycle-high of 5.50% in July. The benchmark 10-year Treasury yield began the year at 3.80% and zig-zagged its way to a 16-year high of about 5.00% in October, before ending the year nearly where it started at 3.88%. After enduring nearly two years of unrelenting rate hikes, the Fed managed to successfully pivot into a period of 'wait and see' in the second half of the year. As Jerome Powell and the Fed waited, inflation data cooperated nicely by moderating toward the Fed's target of 2.00%, albeit not quite there just yet.

2023 ended on a high note thanks to the final 70 days of the year.

The U.S. Aggregate Bond Index, a broad measure of the investment grade debt market, had its best year since 2020 with the lion's share of returns experienced in the fourth quarter. High Yield debt performed even better as credit spreads declined further, ending the year at the lowest level in 18 months.

Total Return Performance, 2023

US Benchmark Bond - 10 Year
Daily
3.94 0.06 1.61% 1:58:10 PM VWAP:
High: 104.67 Low: 89.96 Chg: 3.65%



Source: FactSet Research

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This time was different, but now it looks the same.

In some ways, the strong performance in the last ~70 days of the year came out of nowhere. After the Fed's last hike in July, rates continued to climb like during no other pause period going back to the 1970s. The market was bracing for at least one more hike, if not two, by year end. Such was the rhetoric coming from the cautious Jerome Powell and other Regional Fed Presidents.

Why then the rapid reversal? Cooperative economic and inflation data certainly helped. Over the past six months, Core CPI has run at an annualized pace of just 1.90%. Furthermore, Services ex-energy and housing (a metric closely watched by the Fed) has been below 2.00% annualized in two of the last three months[1]. As inflation continued to moderate through the fall months, the market simply took notice.

The historical record is clear that during the last eight 'pause' periods interest rates fell almost immediately. This time, however, rates rose another 1.00% before reversing course. While this time was different, initially, the last 70 days of the year look an awful lot like prior pause periods. Referencing the chart below, the average decline in 10-year Treasury yields five months after the last rate hike is 0.89%. As of December 31st, 10-year yields were down 1.12% from the high watermark in *October* – slightly above the average of the last eight pause periods.

US10Y bond yield move around last Fed hike

	US 10Y bond yield move (bps)									
	Aug 84	Sep 87	Feb 89	Feb 95	Mar 97	May 00	Jun 06	Dec 18	Average	Median
-12m	100	214	118	192	52	80	122	29	113	109
-11m	97	200	87	138	23	50	92	10	87	89
-10m	100	201	61	72	11	76	103	-12	76	74
-9m	97	232	17	62	-13	46	90	-10	65	54
-8m	79	216	49	54	-8	53	63	-16	61	53
-7m	96	207	28	34	1	36	72	-30	55	35
-6m	69	218	4	55	7	47	84	-14	59	51
-5m	7	175	42	49	23	12	68	-8	46	32
-4m	-14	82	57	6	63	-26	64	-11	28	31
-3m	-86	76	30	-24	42	-12	39	-31	4	9
-2m	-113	100	34	-27	14	18	14	-44	0	14
-1m	-76	51	44	-16	37	57	15	-31	10	26
Fed last hike										
1m	-13	29	4	-44	18	-45	-20	3	-9	-5
2m	-66	-41	-23	-46	-2	-33	-42	-12	-33	-37
3m	-125	-33	-76	-60	-32	-59	-57	-14	-57	-58
4m	-127	-50	-114	-146	-58	-58	-52	-20	-78	-58
5m	-116	-102	-135	-146	-38	-69	-67	-36	-89	-86
6m	-100	-101	-120	-119	-64	-76	-49	-73	-88	-88
7m	-81	-63	-117	-143	-78	-124	-30	-70	-88	-80
8m	-144	-37	-151	-148	-91	-119	-63	-115	-108	-117
9m	-200	-22	-159	-168	-102	-132	-55	-97	-117	-117
10m	-224	-52	-156	-195	-108	-165	-50	-100	-131	-132
11m	-229	-31	-101	-209	-115	-117	-31	-97	-116	-108
12m	-246	-29	-84	-206	-112	-98	-17	-83	-109	-91

Source: JP Morgan

[1]Renaissance Macro Research.

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Source: FactSet Research

The [rate] cuts are coming.

Yes, you read that right. If inflation continues its path of moderation, which the Fed does expect to occur in 2024, there is little doubt we will see the first rate cut of this new cycle. This is all the more true if the economy weakens noticeably, specifically if unemployment rises much past the 4.1% year-end forecast the Fed published in December. Looking at expectations, the Fed's December Dot Plot sees a median of three cuts penciled in for 2024. The market, always the more exuberant, sees as many as six cuts in 2024 with the earliest occurring in the first quarter. The prospect of multiple rate cuts in the next 12 months bodes well for fixed income returns, no matter the pace or timing of the cuts. Given this backdrop, Osborne Partners believes medium-term bonds remain an attractive opportunity for clients to achieve solid performance in their fixed income portfolios, especially on a total return basis. Perhaps 2024 will mark the return to the boring bond portfolios of old.

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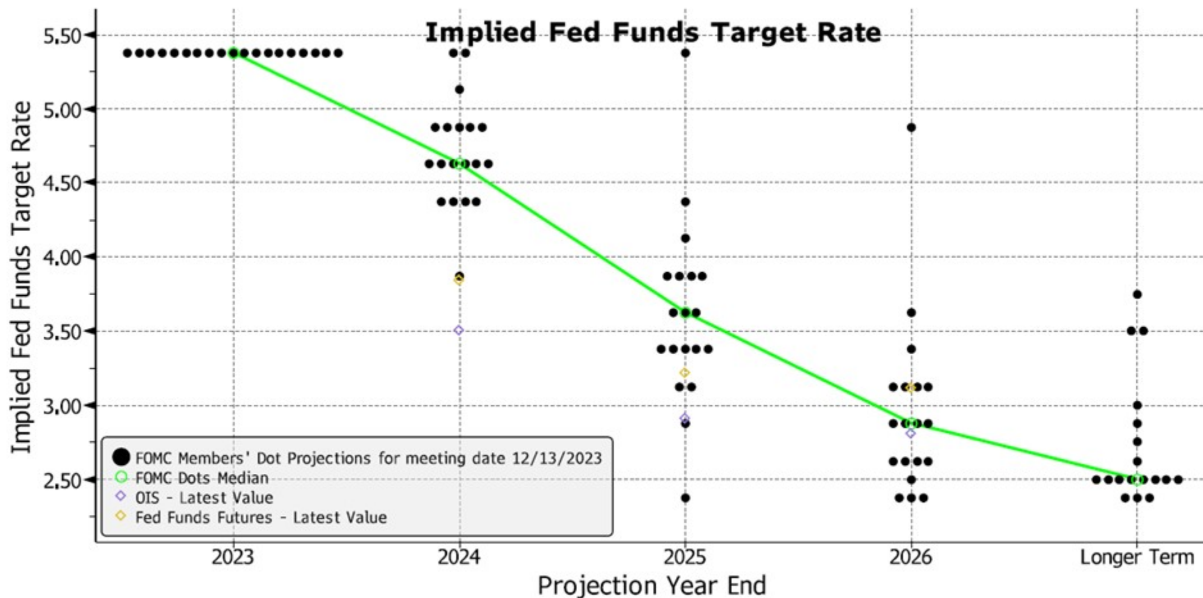
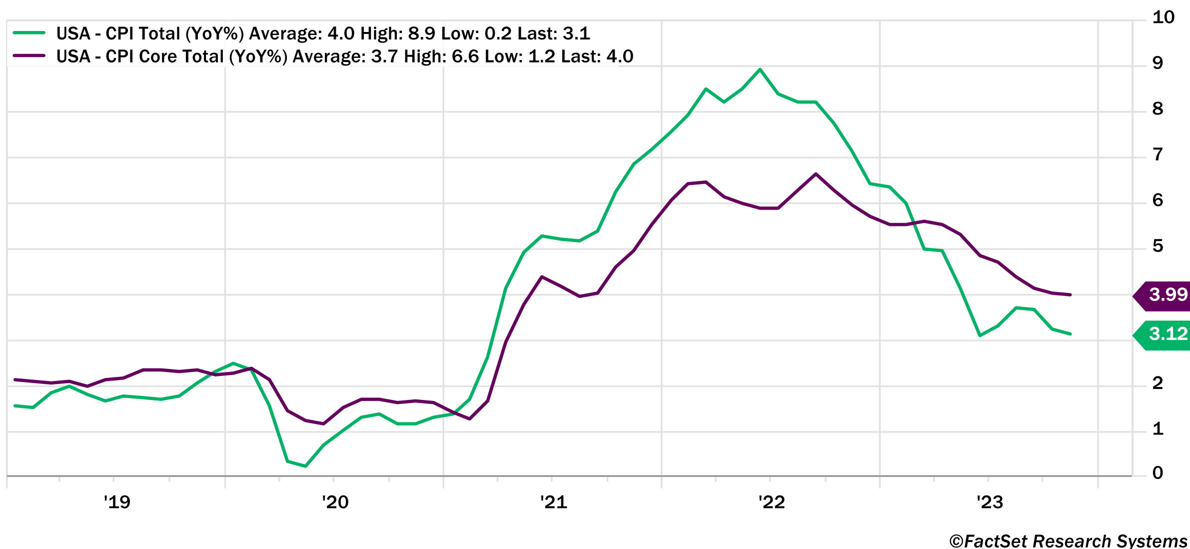
December Dot Plot



Source: Bloomberg, Federal Reserve

U.S. CPI Data – Last Five Years (through November)



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