RBC Global Asset Management

Turning market noise into investment harmony

Active management decisions in today's fixed income market

November 2024

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Key takeaways:

- 2024 has been a year of heightened rates volatility in which we saw acute reactions to perceived changes in the future path of interest rates and exaggerated price movements, both positive and negative.
- Adapting to evolving market conditions is key to unlocking alpha; we benefit from flexibility in our process and philosophy, which empowers us to target alpha across various sources.
- Trump's win in November reveals opportunities to add spread duration in sectors benefiting from deregulation and domestic protectionism.
- In the current environment, it is important for investment managers to be flexible while acting with conviction to benefit from opportunities that may arise.

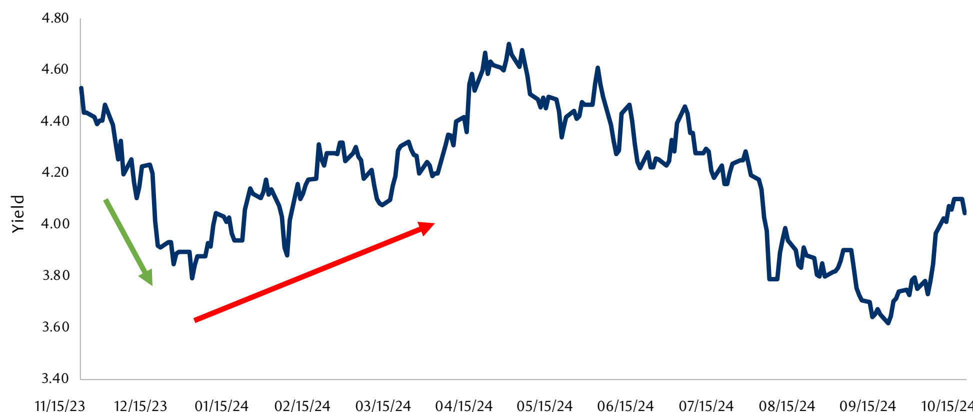
An orchestra is simply noise without a skilled maestro directing the music

The course of 2024 has been beset by what could feel like a cacophony of economic noise. From worries surrounding US elections to market jitters amid rates volatility, inflation projections, and the labor market, there has been no shortage of dissonance with which investors have had to grapple. As unsettling as this may feel for passive observers, these are the types of markets that excite active investors. A skilled maestro can take the unsettling noise of volatility and shape it into harmony. Of particular importance in these environments is an investor's ability to exert flexibility across sectors and subsectors within their strategies when opportunities arise. In this article, we reflect on what has unfolded over the course of 2024 and explain how we have positioned our clients for success. We will also outline our outlook on risks and opportunities for the year ahead and define where active fixed income thrives as an important opus amid the broader catalog that is an asset allocator's investment universe.

A year of heightened rates volatility

Now, let us turn the page back to December 13, 2023, when Federal Reserve (Fed) Chair Jerome Powell's comments regarding the path of rate cuts and inflation ahead were perceived as dovish by the market. This sent US Treasury prices soaring the morning of December 14, as yields on the 10-year bond fell from 4.23% earlier that week down to 3.91% by December 15. This rate volatility is exhibited in Figure 1a.

Figure 1a: Ten Year US Treasury Yield



Source: Bloomberg.

To us, this was a strong signal of how the market would behave for the foreseeable months ahead – acute reactions to perceived changes in the future path of interest rates. This created exaggerated Treasury price movements, both positive and negative. Reactions like these can be triggered by subtle changes in Fed rhetoric, data that indicates a too-hot or too-weak US economy, and any signs the labor market may be cracking. Indeed, by the end of December, many market participants were calling for as many as eight fed funds rate cuts throughout the course of 2024. Many were also calling for recession.

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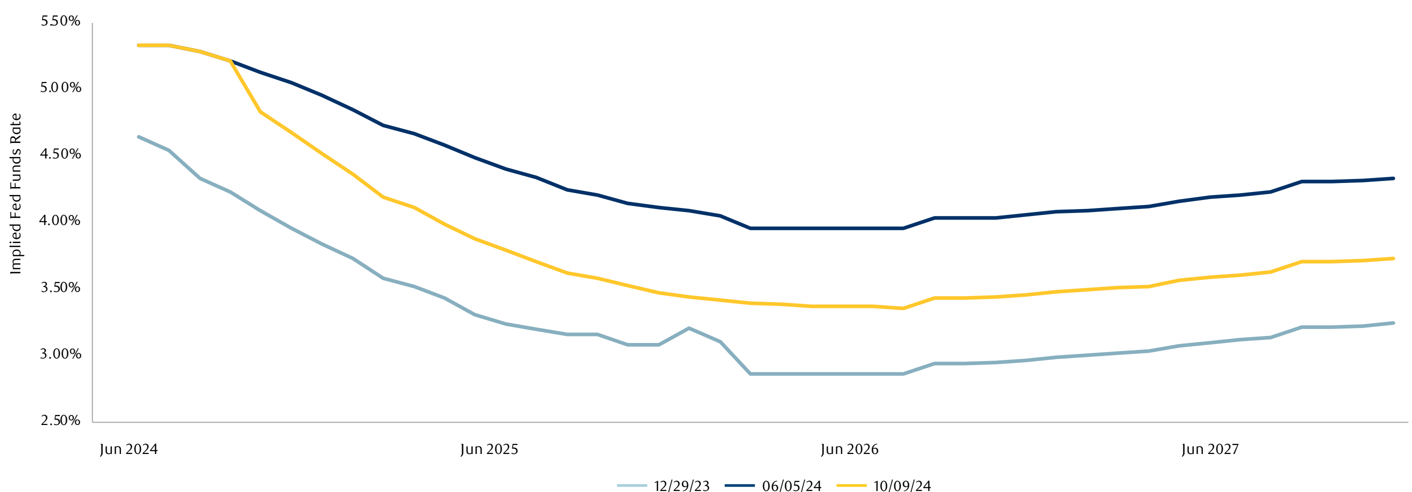
Our view was, and has been, for positive US growth and two-to-three cuts for the entirety of 2024 with questions surrounding how much the Fed will be able to ease monetary policy in 2025 and beyond. This stable view is in stark contrast to fed funds futures over the period, a barometer for market participants' more broadly held views on the fed rate path, which have swung wildly on inbound economic news. In response to signs that the economy is running too hot, expectations for rate cuts plummet, and fixed income total returns suffer. Conversely, on signs that inflation is slowing or the economy is dipping toward recession, expectations for rate cuts skyrocket, and fixed income total returns benefit.

Philosophically, we believe it is important to have a conviction view coupled with flexibility while the polyphony of economic data and Fed rhetoric creates distractions for both economists and other managers alike, and while passive investors are forced to track and stomach the volatility. This market noise is clearly exhibited in Figure 1B, where we can see the expected path of rate cuts through 2024 and 2025 was more exaggerated when priced at year-end 2023 than when priced at both June of 2024 and October of 2024. For the duration of 2024, market participants went from ~200 basis points (bps) of cuts at year-end 2023 all the way back to less than ~100bps by mid-2024, to eventually settle closer to our view of 75-125bps by October of 2024. Our once-contrarian view has remained constant and, in hindsight, proven accurate, as many market participants now seemingly agree with us. This begs the question: How were we positioning our clients in rates and fed funds futures throughout this volatility, and what are we doing to prepare for the end of 2024 and the start of 2025?

Piano, mezzo-piano, forte – shifting dynamics make all the difference in the pursuit of alpha

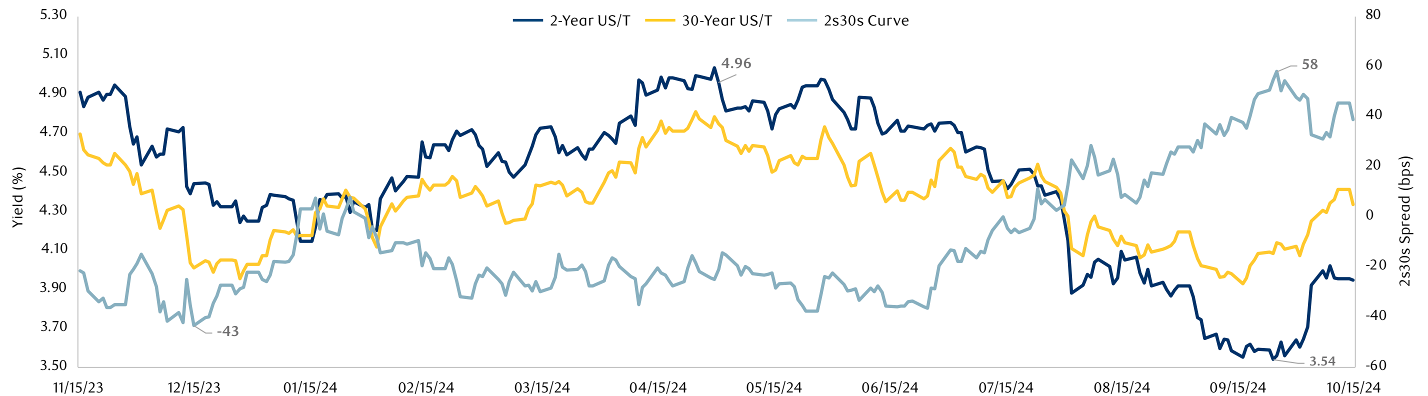
Our process and philosophy empower us to target alpha across various sources with varying degrees of magnitude. The three main sources of alpha for our strategies are credit alpha (the combined effects of security selection and sector allocation), credit beta (overweighting or underweighting risk as defined by beta-adjusted spread duration), and term effects (duration and yield curve positioning). With these, we are thoughtful in how we position portfolios in the pursuit of outperformance given current and expected market dynamics. Just like musical compositions, active asset management can never be performed at one volume and one volume alone.

Figure 1b: Market Expectations of Fed Cuts



Source: Bloomberg.

Figure 2a: 2s30s Yield and Spread



Source: Bloomberg.

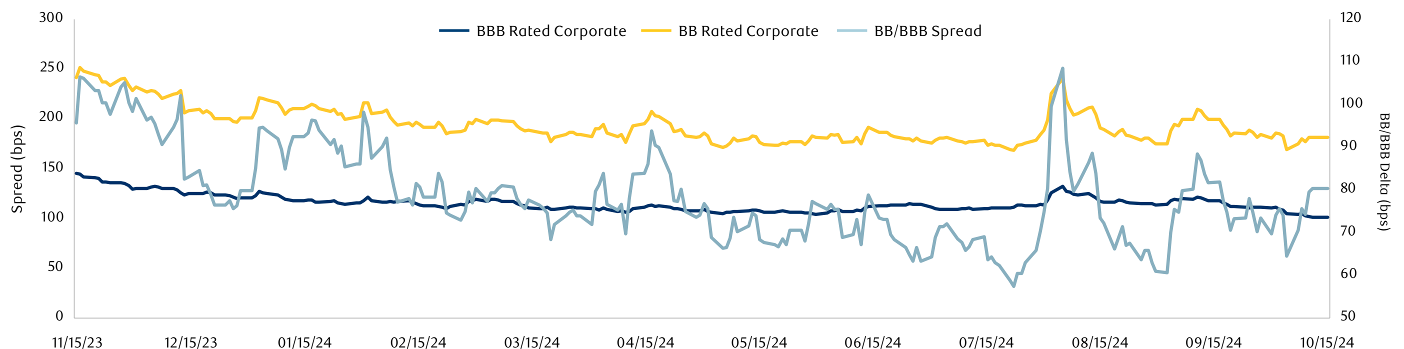
It is fair to say that investment-grade, high-yield, and securitized spreads have largely been trading near or inside of fair value for most of 2024. While we continue to generate most of our alpha via credit alpha, heightened volatility in rates predicated on forward-looking expectations of Fed monetary policy has allowed us to also target a portion of alpha utilizing yield curve positioning throughout the year. In both our core plus and strategic income (unconstrained bond) strategies, we have been able to leverage 2s30s steepener trades while also implementing focused spread compression trades to generate alpha. Indeed, as the two-year yield has rallied down, the 30-year has remained relatively high, and we believe it could remain elevated for a longer period. As such, the yield curve has normalized in shape, allowing 2s30s steepeners to show attractive returns at various periods during the year. This normalization is exhibited in Figure 2a.

Thus, we saw an opportunity to generate reliable, complementary alpha from our term effects' bucket in a more pronounced way than is perhaps normative for us. However, by philosophy, credit alpha is a familiar refrain in our pursuit of outperformance within our multisector fixed income portfolios, such as core plus and strategic income (unconstrained bond).

Even if spreads are relatively tight, credit fundamentals show no imminent signs of deterioration. This is particularly true in the US where the consumer remains strong and the labor market resilient.

We see value in allocating a portion of our credit exposures to various parts of capital structures in large, well-capitalized banks and financial services companies, as well as non-cyclicals, such as health care, utilities, telecommunications, and technology. We seek to generate alpha in these sectors via high-conviction position sizing. Our strategies may hold a couple hundred issues versus thousands in conventional fixed income indices. We size positions for impact. Additionally, these strategies offer us the flexibility to dial up and down exposures across sectors, subsectors, and credit ratings bands as opportunities present themselves. For instance, we remain relatively underweight below-investment-grade exposure relative to peers in our strategic income (unconstrained bond) strategy due to relatively tight spreads between BBB rated credit and BB rated credit. This is illustrated in Figure 2b.

Figure 2b: BB/BBB Credit Spreads



Source: Bloomberg.

Since November of 2023, the average spread between BB and BBB rated corporate credit has been ~79bps. Compare this with a year-end 2022 value of 136bps and a year-end 2020 value of 143bps – times wherein there was more value in leaning more heavily into below-investment-grade issuers. As a result, our ability to generate strong returns utilizing investment-grade sectors has produced a Sharpe ratio that is more attractive than that of many peers in the active core plus bond and strategic income (unconstrained bond) spaces.

A flexible approach to asset allocation is key

This inherent flexibility in our strategies enables us to deftly allocate between investment-grade and high-yield issuers when value is present. Importantly, this is not limited to allocations across different corporate bond ratings classifications. Indeed, we have seen opportunities to dial up allocations to investment-grade broadly syndicated loans at various times this year to help complement our investment-grade bond allocation in strategies such as core plus bond. We have also been able to utilize secondary collateralized loan obligation (CLO) tranches when discount margins screen attractive relative to similarly rated comparables in the more typical bond space. The addition of these two sectors, among others in the securitized space, allows us to pursue returns that seek to be less correlated to the Bloomberg US Aggregate Index when compared to other public fixed income strategies that may seem otherwise similar.

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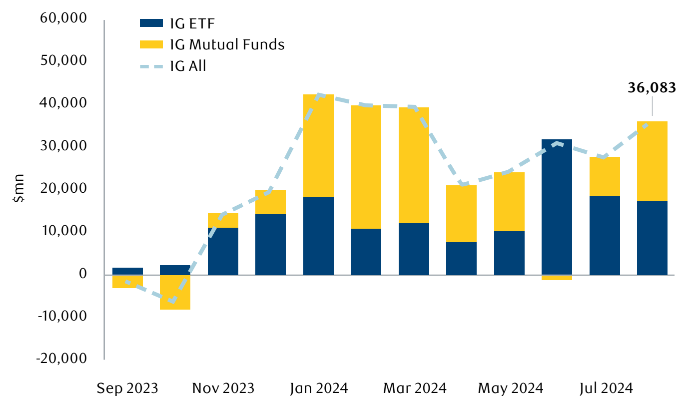
This flexibility is further compounded by our ability to allocate a measured portion of these portfolios to non-US domiciled risk in developed markets while maintaining largely USD-denominated currency exposures. This allows us to leverage our long track record in managing credit risk across geographies of domicile while maintaining a distinct US focus by product design. Importantly, inflationary environments, growth prospects, liquidity, and asset valuations can vary materially from one geography to the next over time. This further renders us uniquely situated to capitalize on times when these dynamics are more acute. In the current environment, inflation remains stickier in the US than in Europe, and European issuers may be in a different stage of their credit cycles than their US counterparts. This is to be weighed against reasonably positive growth and a relatively resilient labor market/consumer in the US.

Figure 3a: Investment Grade ETF and Mutual Fund Flows



Source: JP Morgan.

Taking all of these realities together further articulates the importance of managing changing dynamics in fixed income. In music, adding differentiated pieces to a symphony orchestra can create interest in movements and the ability to further employ the impact of dynamics in sound. This nuance is also critically important in actively managed fixed income portfolios.

Is the music set to crescendo or decrescendo? Our outlook for fixed income returns

We believe one of the primary drivers of potential total returns across the risk and sector spectrum of fixed income is the recent US election. Typically, an election cycle may not have as material an impact on our medium-term outlook for bonds. However, the market remains as reactionary to incoming data stimuli as it has been throughout 2024 regarding the path of potential rate cuts and Fed monetary easing. Clearly, if inflation were to stop showing signs of trending lower, the Fed would have greater difficulty in justifying material rate cuts throughout the course of 2025.

A positive technical for both investment-grade and high-yield total returns for 2024 has been a large amount of flows into the asset class. For example, almost ~$300 billion of flows have poured into investment-grade bonds year to date through the beginning of October. This can be seen in Figure 3a.

These flows are coming from investors who believe the Fed will be able to continue to lower rates, which will bolster bond prices and thus generate positive total returns for the asset class. If the music were to shift and the narrative changes to one wherein the Fed cannot lower rates, these flows would likely be diverted toward money markets and other alternatives at the expense of fixed income. This would stymie our total return outlook for fixed income.

Taken altogether, this highlights the need for flexibility and active management as investors re-engage with the asset class.

Our outlook for fixed income given a second Trump presidency suggests a moderate cap on total returns over the medium term, although a repeat of the atypical 2022 bear market – with simultaneous spread widening and rates sell-off – is not expected. In the short term, we are cautiously optimistic about spreads and risk despite tight historical levels, but less optimistic on interest rates. Concerns over tariffs, inflation, and potential trade conflicts weigh on rates, positioning the market for a steepening curve and potentially higher long-term yields, with the 30-year bond projected to move towards 4.75 to 5% in the near term..

Opportunities remain to selectively add spread duration in sectors posed to benefit from deregulation, domestic protectionism, and energy and industrial independence. However, we are avoiding long duration in interest rates, given the projected bear steepening as fiscal deficits grow.

Floating rate assets (loans, CLOs, corporates, etc.) may find support as the Fed eases less than previously expected, while short duration bonds (such as off-the-run ABS with collateral types that benefit from U.S. energy and industrial independence) may become increasingly attractive for their relative resilience.

This environment underscores the need for adaptability in fixed income allocations, with flexibility across sub-sectors to navigate evolving market conditions. We seek to remain vigilant throughout the transition of Presidential administrations and have several trading strategies ready for execution that utilize the liquidity and flexibility we have built into our core plus and strategic income (unconstrained bond) strategies. As a result, we are ready to act swiftly for our clients regardless of any shift in the music ahead.

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