Fixed Income

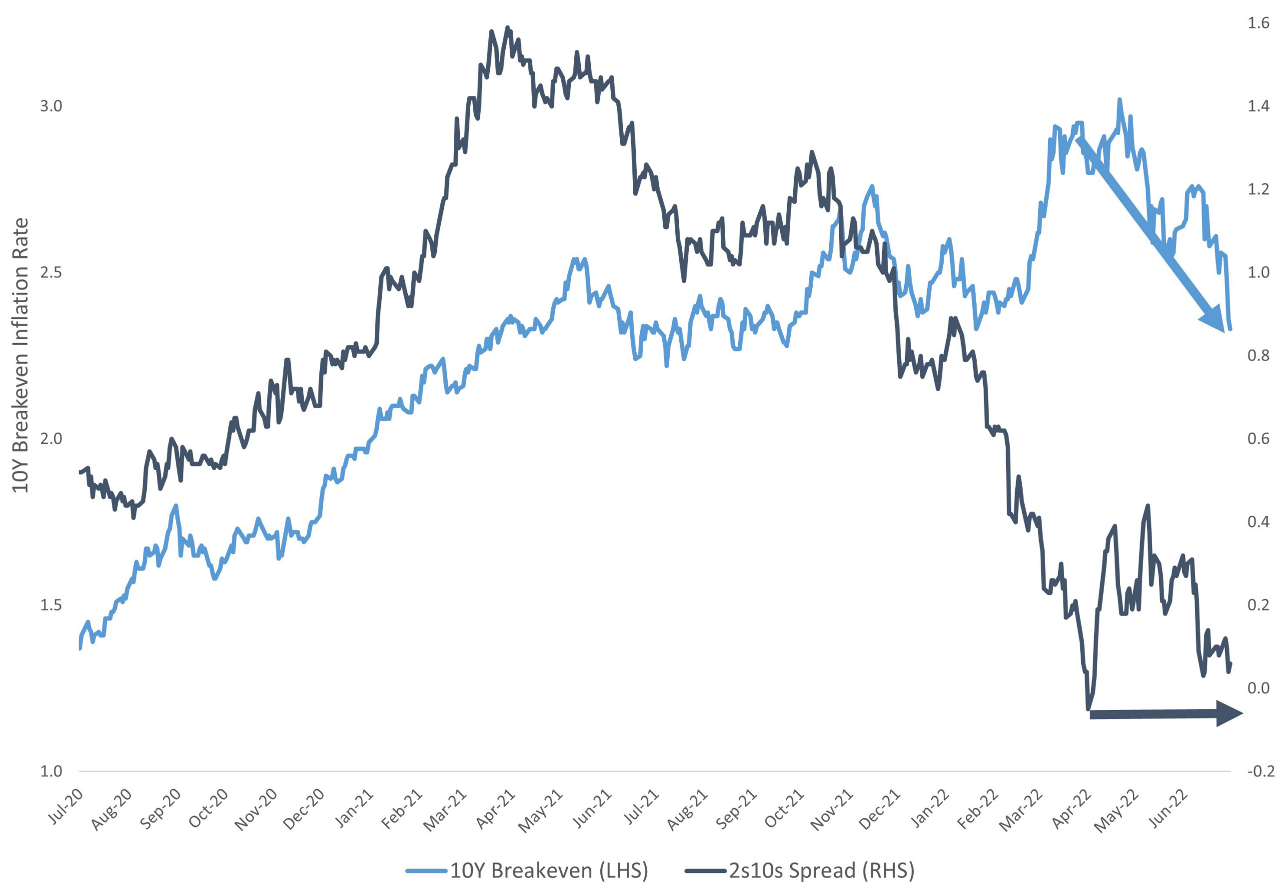
For most of the two years prior to 2022, we experienced a benign environment for nearly all financial assets. Real interest rates fell into negative territory and remained rangebound through the end of 2021.

This year has been far more eventful — only halfway through and we may be on the verge of entering the bond market's third regime change as real rates and inflation expectations, the two driving forces of bond prices, remain volatile.

The US bond market followed Q1 2022, its worst quarter in more than 40 years, with nearly an equal loss in Q2. The Bloomberg US Aggregate Bond Index declined -4.7% during the quarter to bring the year-to-date decline to -10.4%.

Despite the similarly poor performance of bonds over Q1 and Q2, there were notable differences in the composition of the move as breakeven inflation rates declined and the yield curve bear flattening came to a halt.

Inflation Expectations Rolled Over and Curve Flattening



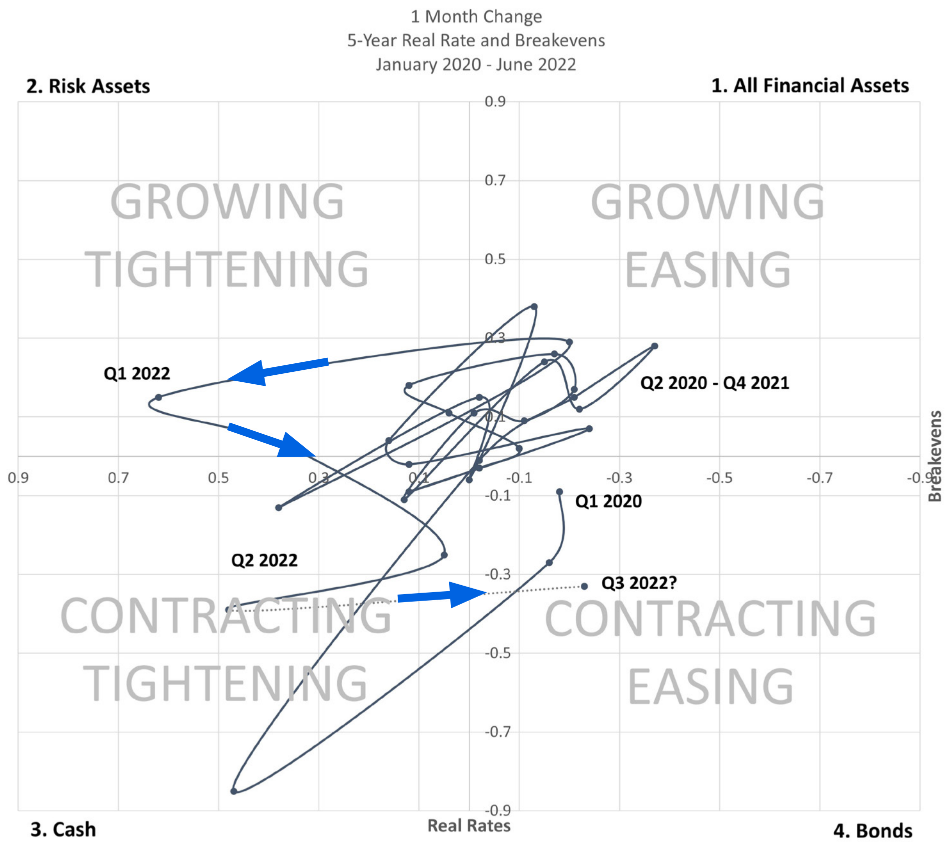
Source: RockCreek, US Treasury Department

10-year breakeven inflation rates came in by 51 basis points to 2.3%, returning long-run inflation expectations to levels previously seen in Q1 2021, when CPI was printing below 3%.

These changes in real rates and breakeven inflation rates can be used to define the economic regimes signaled by the bond market. The regimes not only have implications for the performance of bonds but asset allocation within a multi-asset portfolio.

As seen below, there are four regimes that can be presented as four quadrants representing the bond market's assessment of go forward economic and policy conditions:

The Four Regimes of the Bond Market



Source: RockCreek, US Treasury Department

Quadrant 1 (top-right) is defined by declining real rates and rising breakevens representing a positive economic growth trajectory – fueled by easier financial conditions – which tends to be supportive of all asset prices.

Quadrant 2 (top-left) is defined by rising real rates and rising breakevens representing a positive economic growth trajectory despite tighter financial conditions, which tends to favor risk assets (e.g., commodities, stocks, cyclicals).

Quadrant 3 (bottom-left) is defined by rising real rates and declining breakevens, representing slowing economic growth due to tighter financial conditions; this tends to be an environment where cash is king.

Quadrant 4 (bottom-right) is defined by declining real rates and declining breakevens representing slowing economic growth that is being combated by easier financial conditions, which tends to favor fixed income.

What we've seen so far in 2022 was a shift in expectations from Quadrant 1 to Quadrant 2 during Q1, as the economic tailwinds from the reopening were expected to offset central banker's policy tightening. During Q2, we saw a shift from Quadrant 2 to Quadrant 3, as it became apparent that more persistent inflation would require significant tightening that would take a bite out of economic activity.

Based on the price action of the bond market since mid-June – falling real yields and breakeven rates – we may be transitioning to Quadrant 4, the disinflationary slowdown (i.e., recession). Consistent with this environment, bonds – and on a relative basis, other long duration assets – are the primary beneficiaries, while risk assets – notably commodities – are likely to underperform.

In this scenario, the bond market is telling us that the Fed won't be able to follow through on its planned path of rate hikes through 2023 due to an economic slowdown. And as we've noted at prior inflection points, the bond market is often the "tail wagging the dog."