FIXED INCOME

Bonds fell during the second quarter as the Fed signaled further rate increases to come. This contrasted with stocks, which continued to resist the gravitational forces of higher interest rates. The market's expectations for rates at year end increased by 100 bps – from 4.5% to 5.5% – and market pricing no longer incorporated a projected a 'pivot' (i.e., interest rate cuts) in 2023. The bond market continues to play from behind though as the FOMC increased its own expectations for year-end fed funds from 5.1% to 5.6% as part of its June economic projections – an outcome the market only gives a quarter chance.

Figure 8. Decoupling of stocks and real yields

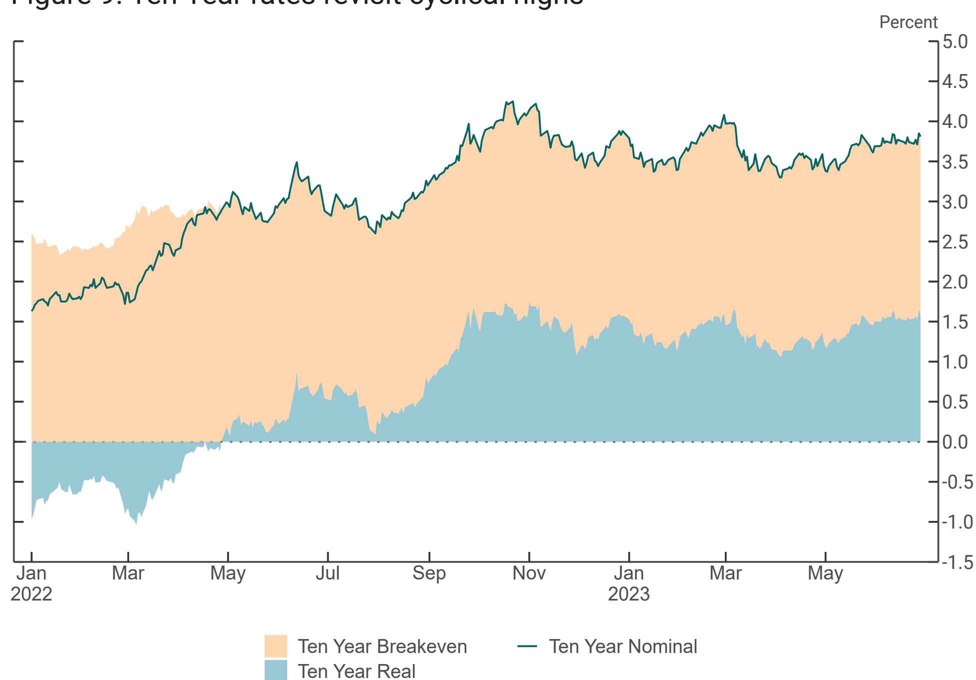
Source: Bloomberg Finance LP.

The Bloomberg US Aggregate Bond Index declined -0.8% as the headline 10-year Treasury yield climbed 33 basis points to 3.81%. The move was driven entirely by higher real rates as the 10-year TIP yield rose 43 basis points to 1.59%, while breakeven inflation rates declined -10 basis points to 2.22%. The level of real yields is notable as they revisit the cyclical highs seen over the last nine months, periods that preceded strong bond rallies. This has been overlooked as nominal yields remain well off last year's highs as implied inflation expectations have softened.

Credit outperformed during the second quarter as the spread on the ICE BofA US Corporate Index tightened to Treasuries by -15 basis points to 1.30%. While tighter quarter-over-quarter, spreads remain nearly 50 basis points over the 2022 tights. Investors remain hesitant of investment grade credit though, pointing towards the inverted yield curve as a harbinger of recession. But it's not the inversion of the curve, but the reversion that historically has spelled trouble. With the spread between the 2-year and 10-year Treasury ('2s10s spread') still more than 100 basis points negative after falling -48 basis points during the second quarter, the alarm bells aren't yet ringing. Furthermore, investment grade credit has a yield-to-maturity of 5.5% as compared to the S&P 500's forward earnings yield of 5.2%.

With real yields near cycle highs, credit spreads well off their recent tights, and a very low or negative equity risk premium, there is a bullish setup for spread products as we head into the second half of the year. With high quality bonds priced to potentially offer equity-like returns with risk mitigating benefits to a portfolio, investors can be paid well to wait as downside risks accumulate due to higher interest rates.

Figure 9. Ten Year rates revisit cyclical highs



Source: Bloomberg Finance LP.