FRANKLIN TEMPLETON | Institute

Navigator Series—
Fixed Income 4Q24

Navigating fixed income through Fed policy shifts

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Christy Tan
Investment Strategist
Franklin Templeton Institute

Lukasz Labedzki, CFA
Senior Analyst
Franklin Templeton Institute

This report leverages the Franklin Templeton Institute's US Fixed Income Navigator (FIN) to analyze historical data and provide insights on managing fixed income portfolios amidst Federal Reserve policy changes. European fixed income trends are also explored.

Investment implications

For investors looking to diversify their portfolios from equities and cash-like instruments, as well as those already exposed to fixed income, we believe the following strategy is warranted.

Short-to-intermediate-duration US Treasuries: Historically, short-to-intermediate-duration bonds have outperformed following interest-rate cuts that were not accompanied by recessions. Given the significant gains already realized on the longer end of the yield curve, we believe this strategy appears prudent in the current environment. While the economy is clearly slowing, the data remains mixed and a recession is not a given.

US investment-grade bonds: Higher-quality corporates have historically outperformed high-yield bonds following interest rate cuts, and we believe this pattern is still applicable today. Compressed credit spreads do not offer enough incentive to justify the additional risk of high-yield exposure. Meanwhile, fundamentals remain solid in the investment-grade space.

European investment-grade bonds: We see a strong case for including high-quality European bonds in a portfolio. Historically, they have performed well following European Central Bank (ECB) rate cuts, and if the slowdown in Europe continues, there's a chance the ECB could turn even more dovish than the markets currently expect.

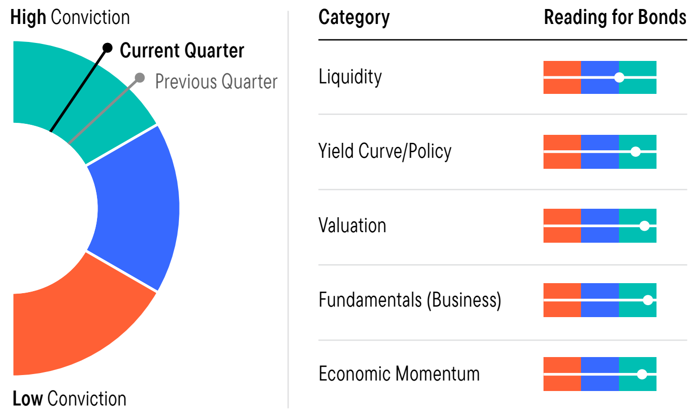
We are currently **neutral on emerging market (EM) local currency debt.** While we observe growing tailwinds for EM debt, many emerging economies are increasingly reliant on financing conditions in developed markets. This is largely due to rising external debt levels, and the yield advantage in many EMs is lower than medium-term averages. As a result, we believe a clearer positive trend is more likely to emerge only when central banks in developed markets—particularly the Federal Reserve (Fed)—enter a more advanced phase of monetary easing and global slowdown fears subside. While EM spreads are historically tight, real yields are at attractive levels, particularly in Latin American countries, indicating select opportunities.

Fourth quarter (Q4) 2024 highlights

In Q4 2024, our model-based conviction has further strengthened, highlighting a more constructive balance of risks and opportunities for bonds.

Exhibit 1: US Fixed Income Navigator Dashboard (LYVFE signals)

August 2024 Update



Source: Franklin Templeton Institute.

Yields in the fixed income space remain historically attractive across the board, especially in real terms, as inflation expectations have eased and are anchored around 2%. Additionally, progress on inflation and slowing global economic momentum have led markets to widely expect the interest rate cut that the Fed implemented in September, driving a bull steepening of the yield curve—a favorable environment for high-quality bonds.

A key short-term risk is that much is already priced in, meaning more pronounced surprises are needed for markets to outperform historical averages. Longer-term risks include rising geopolitical tensions, which could complicate inflation control and growing fiscal deficits that may demand higher premiums for US government bonds.

In this piece, we explore the impact of past interest-rate-cutting cycles on fixed income portfolios and share key historical lessons that we believe remain relevant today.

Lesson #1: Short-to-intermediate-duration bonds have performed the best following "soft landing" interest-rate cuts

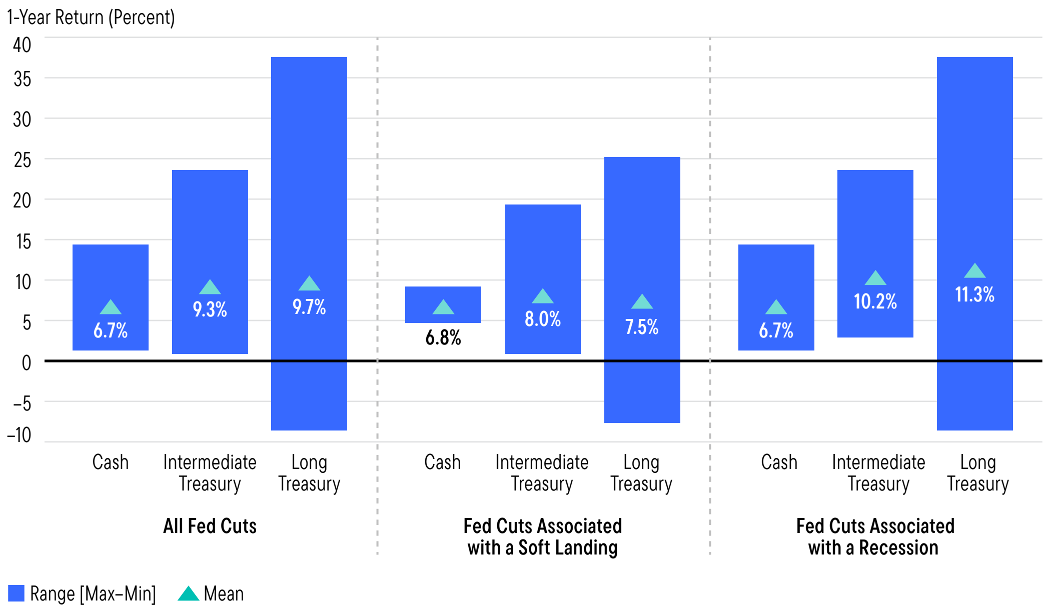
Initial Fed rate cuts have historically been favorable for high-quality bonds. However, the economic environment surrounding these rate cuts plays a significant role in determining whether to favor short-, intermediate- or long-term bonds.

Historical performance studies show that short-to-intermediate-duration bonds have, on average, outperformed in the year following rate cuts associated with a soft landing[1] (middle pane of Exhibit 2), exhibiting significantly less dispersion than long-duration bonds. For investors not expecting major economic or financial shocks, history strongly suggests avoiding extending duration too much. Even for those anticipating higher recession risks, intermediate bonds offer a solid risk-reward profile, providing slightly lower average returns than long bonds but with reduced downside risk (right-hand pane of Exhibit 2).

Intermediate Duration Treasury: Top Performer After Soft Landing Rate Cuts

Exhibit 2: Returns One Year After First Fed Cut

Fed Cuts Since 1974*
Are Considered
As of August 26, 2024



Source: Bloomberg. Analysis by Franklin Templeton Institute.

*Cash, represented by the Bloomberg US Treasury Bellwethers: 3 Month index, has a shorter history, dating back to 1981. Intermediate Treasury is represented by the Bloomberg US Intermediate Treasury Index (avg. maturity: 4.1 years as of 7/31/2024) and Long Treasury by the Bloomberg Long Treasury Index (avg. maturity: 22.5 years as of 7/31/2024).

Notes: The analysis includes all first cuts following a series of rate hikes since 1974. A series of rate hikes (a hiking cycle) is defined as at least three hikes (or fewer if their magnitude exceeds 100 basis points). The September 1998 cut is also considered, even though it was not technically preceded by a series of rate hikes. Single cuts that occurred within longer hiking cycles are excluded (September 1973, November 1979, January 1981, July 1987). Recession cuts are all initial interest rate cuts that occurred within the recession or were followed by a recession within a maximum of 12 months. Soft landing cuts are all the remaining cuts. Recessionary periods are defined by the National Bureau of Economic Research (NBER). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
Past performance is not an indicator or a guarantee of future results.

Cash, while the least volatile, has offered relatively low returns and limited upside potential in an environment of falling short-term rates. This is particularly interesting given the more than US$6 trillion in money market fund assets,[2] which include cash and cash equivalents, currently on the sidelines. Part of this could rotate into high-quality fixed income.

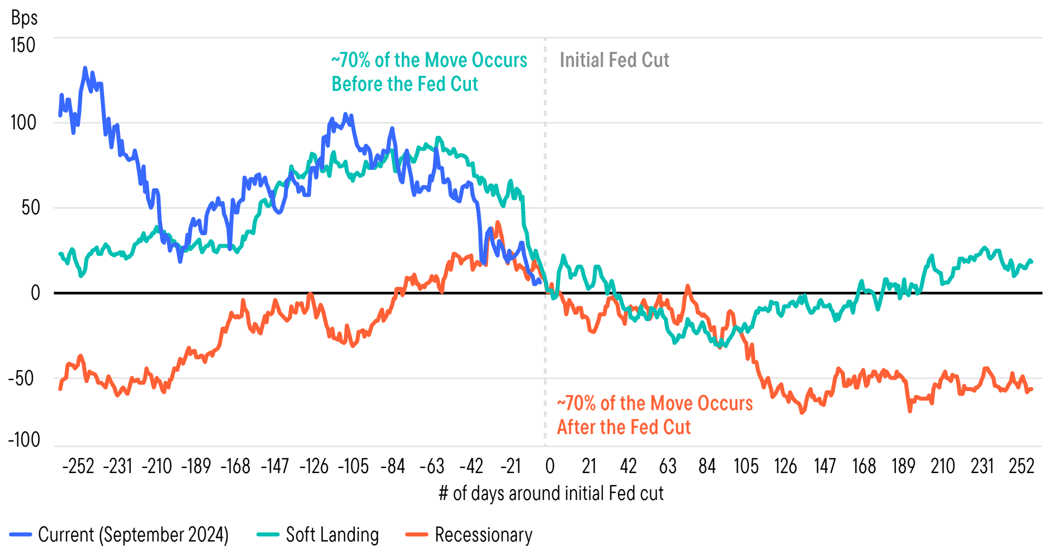
Lesson #2: In soft landings, most of the gains on the long end of the yield curve typically materialize before the Fed cut

Why do long bonds typically not outperform shorter maturities following interest rate cuts? One explanation is that they tend to experience most of their gains before the initial Fed cut. This is the case in soft landings. Historically, around 70% of the drop in 10-year yields (typically considered long-term) occurs before the Fed cut when a recession is not present (see Exhibit 3). While opportunities may not be fully exhausted yet, and the Treasury rally can continue across the yield curve, it does make sense for us that the upside potential is now lower.

Most of the Drop in 10-year Yields Happens Before the Fed Cut in Soft Landings

Exhibit 3: Average Move in 10-Year Yields

Recessionary vs. Soft Landing Fed Cuts: Comparing Recent Moves As of September 13, 2024



Source: Bloomberg. Analysis by Franklin Templeton Institute.

Notes: The analysis includes all first cuts following a series of rate hikes since 1974. A series of rate hikes (a hiking cycle) is defined as at least three hikes (or fewer if their magnitude exceeds 100 basis points). The September 1998 cut is also considered, even though it was not technically preceded by a series of rate hikes. Single cuts that occurred within longer hiking cycles are excluded (September 1973, November 1979, January 1981, July 1987). In the line chart, values are rebased to a base value of 0 on the day of the first cut. Recessionary periods are defined by the National Bureau of Economic Research (NBER).

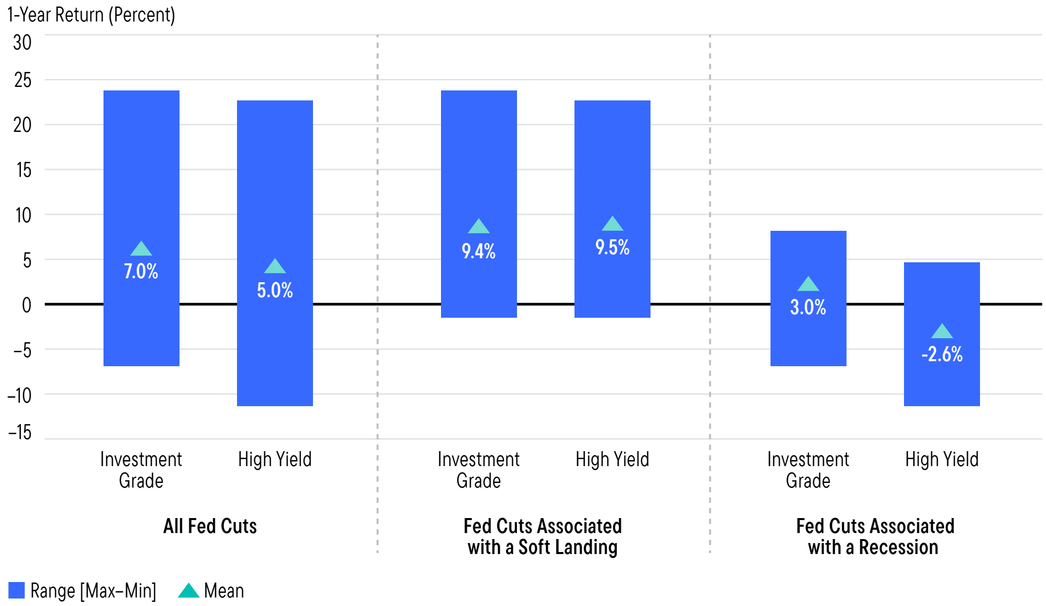
Lesson #3: In the credit space, investment-grade corporates are typically preferred following interest-rate cuts

Historical analysis suggests that corporate bond investors focusing on higher-quality bonds have, on average, fared better following interest rate cuts (Exhibit 4). This is particularly evident during recessions, where high-yield bonds have significantly under-performed, reducing their effectiveness in providing diversification benefits for multi-asset portfolios. During soft landings, investment-grade bonds have delivered nearly identical returns to high-yield bonds but with slightly lower downside risk and greater upside potential.

Investment Grade Corporates Preferred Following Interest Rate Cuts

Exhibit 4: Bond Returns One Year After First Fed Rate Cut

Fed Cuts Since 1984 Are Considered
As of August 26, 2024



Source: Bloomberg. Analysis by Franklin Templeton Institute. Intermediate-grade bonds are represented by the Bloomberg US Corporate Index while high-yield bonds by the Bloomberg US Corporate High Yield Index.

Notes: The analysis includes all first cuts following a series of rate hikes since 1984. A series of rate hikes (a hiking cycle) is defined as at least three hikes (or fewer if their magnitude exceeds 100 basis points). The September 1998 cut is also considered, even though it was not technically preceded by a series of rate hikes. Single cuts that occurred within longer hiking cycles are excluded (July 1987). Recession cuts are all initial interest rate cuts that occurred within the recession or were followed by a recession within a maximum of 12 months. Soft landing cuts are all the remaining cuts. Recessionary periods are defined by the National Bureau of Economic Research (NBER). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

The current environment underpins a continued focus on quality, as compressed credit spread levels do not justify assuming additional risk. Fundamentally, there are significant differences between credit qualities. Median investment-grade issuers appear well-prepared to handle higher interest expenses, while median triple-C (lowest credit quality) issuers are already struggling to generate sufficient net income to cover debt-servicing costs, which may increase in the future.[3]

Lesson #4: Interest-rate cuts benefit bonds internationally, but to varying degrees

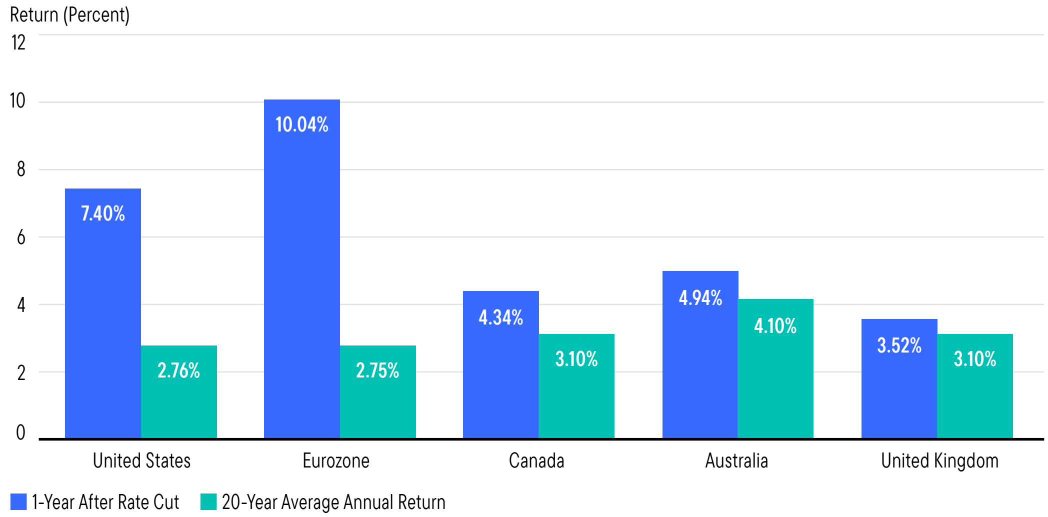
Eurozone government bonds have been doing particularly well following local central-bank cuts, a trend not as evident in all developed markets (Exhibit 5). It might relate to the fact that ECB policy rates have been falling to relatively low levels where they have been staying for longer, especially in the aftermath of the European debt crisis.

While much of the future path of policy rates in the Eurozone appears to be priced in, structural issues, such as depressed productivity growth, continue to keep the neutral rate in the Eurozone lower than many other developed countries, particularly the United States. Additionally, multiple leading indicators suggest that economic momentum in Europe is slowing and may continue to weaken. This could prompt the ECB to prioritize growth, increasing the likelihood of a more dovish ECB than markets currently expect. Such a shift would support our bullish view on a diversified portfolio of European bonds.

Interest Rate Cuts Internationally Also Benefit Bonds, But to Varying Degrees

Exhibit 5: Sovereign Bond Returns Post-Rate Cuts

Selected Developed Markets Since 1999 (the Euro's launch)



Source: Bloomberg. Analysis by Franklin Templeton Institute.

The chart presents total returns of local market bond indexes in local currencies following initial interest rate cuts (since 1999) made by the respective central banks. Initial cuts are defined as the first reduction in main policy rates following a series of at least two interest rate hikes. Indexes used: Bloomberg US Treasury Index, Bloomberg EuroAgg Treasury Index, FTSE Australia Government Bond Index, FTSE UK Government Bond Index, FTSE Canada Government Bond Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

Conclusion

Reviewing recent developments in the fixed income market and relevant historical lessons from past cutting cycles, we find the outlook constructive for high-quality bonds in both the United States and Eurozone. While much is already priced in, there remain attractive opportunities, and we believe that proper strategic duration management and geographical diversification can further capitalize on these conditions.

Endnotes

1. A soft landing is a period following interest rate cuts that hasn't been associated with a recession.
2. Investment Company Institute, as of September 5, 2024.
3. Based on the interest coverage ratio (EBIT to interest expense) for the Bloomberg US High Yield (CAA) and Bloomberg US Corporate Investment Grade indexes, using Q2 2024 financial reports (as of September 12, 2024).

Appendix: Methodology

The 'LYVFE' framework is a systematic analysis of over 20 indicators that are categorized into five groups: Liquidity, Yield Curve, Valuation, Financials and Economic Momentum. Each indicator is assessed individually to determine whether its reading is positive, negative, or neutral for the broad US investment-grade bond market. The signals from all individual indicators are then consolidated into a single final reading. This approach employs a diffusion index, treating each indicator as equally relevant.

List of indicators

Category	Indicator	Description
Liquidity	**MOVE Index**	The MOVE Index measures US interest rate volatility. The index tracks the movement in US Treasury yield volatility implied by current prices of 3-month options. Higher volatility suggests greater uncertainty and potential price swings, prompting investors to consider adjustments to their interest rate risk exposure.
	Price Action of Safe-Haven Assets	Safe haven assets are investments known for their ability to maintain or appreciate in value when markets become volatile or economic uncertainties arise. Keeping a watchful eye on their performance can offer valuable insights into the emergence of 'risk-off' conditions, typically indicating periods when bonds are more likely to exhibit strong performance.
	Financial Conditions	Financial conditions are vital for bond investors as they offer insights into economic health, risk appetite, and central bank policies, shaping investment choices and risk management. Monitoring tightening standards, often associated with economic contraction, aids in identifying opportune moments to increase allocation to high-quality bonds.
	Currency Volatility	Currency volatility serves as a gauge for risk-off periods since heightened uncertainty prompts investors to reevaluate risk exposure and shift towards safer options, evident in currency movements. Monitoring currency volatility offers insights into shifts in overall investor risk appetite. Periods with heightened yet easing currency volatility often signal constructive conditions for bonds.
	USD Liquidity	We consistently monitor net liquidity, which we define as the Fed's balance sheet minus reverse repos and the treasury general account. The concept behind net liquidity is to illustrate the portion of the Fed's balance sheet available for use by financial institutions, often utilized to absorb high-quality bonds and influence the overall appetite for risk-taking.
	Credit Impulse (G3)	We monitor credit impulses in the world's three largest economies (US, Eurozone, China) to understand how credit influences the real economy. A credit impulse reflects changes in credit growth rate, with positive impulses accelerating economic growth and negative impulses potentially slowing it. This serves as a leading indicator for economic activity, making it crucial for bond positioning.
Yield Curve/ Policy	**Yield Curve Shape**	The intricacies of the yield curve stem from various factors. Bond investors gain a comprehensive edge by deeply grasping yield levels and curve slope—essential not just to assess bond viability, but also to strategically navigate duration exposure. Our consistent analysis of 2-year and 10-year yields sheds light on the curve's dynamics, allowing informed decisions.
	Fed Funds Rate	The Fed's interest rate policy affects interest rates throughout the economy and holds significant implications for future economic performance. Generally, rate hiking cycles have a negative impact on bond performance, while rate cutting cycles have a positive effect. However, bond prices often react before official decisions as investors anticipate the future. Hence, monitoring both the current Fed Funds Rate level and factors guiding the Fed's decisions becomes crucial.
	Fed Securities Holdings	The Fed's securities holdings, tracked via the System Open Market Account, directly affect demand for high-quality bonds. Its importance has grown since the Global Financial Crisis, serving as a vital policy tool. Whether the Fed's balance sheet expands or normalizes is crucial for assessing the bond investment landscape, typically yielding positive results for the former and negative for the latter.
	Economic Policy Uncertainty	To assess policy-related economic uncertainty, we use the Economic Policy Uncertainty Index that combines newspaper coverage, the number of federal tax code provisions set to expire, and disagreement among economic forecasters. When the uncertainty rises, investors lean towards bonds over stocks due to increased risk.
Valuation	**Fair Value of 10-Year Yield**	Bond prices and yields share an inverse relationship, underscoring the significance of monitoring yields and anticipating their future direction. We assess current 10-year Treasury yields against their estimated 'fair' value, determined using macroeconomic indicators like real GDP output gap, inflation, and foreign yields. This helps us ascertain whether yields are relatively 'too high' or 'too low' compared to underlying fundamentals.
	Yields Relative to History	Understanding the historical context of yields is crucial for two main reasons. Firstly, starting yields serve as predictors of future bond performance since a significant portion of long-term returns comes from coupon income. Secondly, bond valuations (indicated by yields) tend to revert to the mean, making it important to assess whether yields are currently elevated (more likely to decrease) or vice versa.

	Trend Analysis	Trend analysis plays a key role in identifying and comprehending the prevailing market direction, often being a favorable ally for investors until reaching an extremum. We discern both short-term and long-term trends in the broad US investment-grade market. The former is based on the Guppy Multiple Moving Average (GMMA) strategy, employing multiple moving averages to pinpoint market trends. Meanwhile, the latter employs an internal model that identifies long-term trends by analyzing the 50-day and 200-day moving averages, along with their slopes across various time frames.
	HY Spreads	The high-yield spread denotes the yield difference between high-yield (junk) bonds and benchmark Treasury bonds, representing the additional risk associated with the former. An expanding spread signals heightened credit risk, indicative of economic uncertainty or apprehensions about the financial well-being of high-yield bond issuers. This environment can adversely impact speculative corporate bonds but potentially favor high-quality bonds.
	IG Spreads	Investment-grade spreads indicate the yield differential between high-quality corporate bonds (rated BBB- and above) and government yields. They provide insights into the market's appetite for corporate debt with relatively low default risk. Monitoring these spreads, along with their potential drivers, is crucial to assessing whether valuations favor or hinder investment-grade credit.
	Relative Valuation	Valuation of bonds relative to other asset classes can be estimated by comparing US Treasury yields with S&P 500 index earnings yields. Despite their distinct qualities, bonds and stocks are considered competing assets to some extent by investors and government yield level is relevant to set equity valuation metrics. Thus, a widening yield gap between Treasuries and equities strengthens the case for bonds, while a narrowing gap is less supportive.
Fundamentals (Business)	**Interest Coverage**	Monitoring fundamental health is essential. The impact of interest rate hikes or cuts on the economy and bond prices varies based on issuers' maturity profiles and readiness to handle higher interest expenses. The interest coverage ratio, derived by dividing a company's earnings before interest and taxes (EBIT) by its interest expense over a specific period, holds significance. We monitor this for major US companies. An improving indicator usually enhances the appeal of corporate bonds, and the opposite tends to hold true.
	Net Leverage Ratio	Net debt leverage ratio is calculated by dividing a company's net debt by its earnings before interest, taxes, depreciation, and amortization (EBITDA). It offers insights into a company's debt management and financial stability. We monitor the ratio for major US companies. In general, a lower or declining ratio indicates a healthier financial position, lower default risk, and better capacity to service debt obligations, making corporate bonds more attractive to investors. And the opposite tends to hold true.
Economic Momentum	**US Leading Nowcast Index**	The proprietary US Leading Economic Nowcast Index is a daily measure of growth in the US economic activity. The Index is constructed based on 150 indicators from 37 different data sources. Slower economic growth typically favors bond prices due to flight to quality and lower opportunity costs of holding fixed income assets, among others.
	Recession Probability Model	The Proprietary US Recession Probability Model estimates the probability of a US Recession within the next 12 months. This is a multi-variate probit model that is based on multiple indicators like unemployment rate, consumer confidence, treasury spreads, or survey-based leading economic activity indices. Considering that demand for high-quality bonds tends to rise during recessions, thereby enhancing bonds' performance, early assessment of recessionary risks becomes crucial.
	Economic Surprises	Market expectations are often factored into asset prices, and markets respond to surprises in economic data. It's valuable to monitor whether economic data releases exceed or fall below these expectations. When economic data consistently falls short of expectations, resulting in negative surprises, market sentiment tends to favor safer assets, potentially prompting a shift towards reallocating to bonds.
	Expected Inflation	Bond prices react to shifts in inflation. This is since bonds' fixed coupons become less attractive in the presence of rising inflation, and the inflation trajectory also influences central banks' interest rate decisions. Bonds generally underperform in times of elevated inflation and perform well during disinflationary periods. Given the forward-looking nature of markets, we place emphasis on inflation expectations, as indicated by 1-year zero-coupon inflation swaps.

Note: Safe haven assets are represented by the Japanese yen (to US dollars) exchange rate; financial conditions by the Chicago Fed's National Financial Conditions Index (NFCI); currency volatility by implied volatility of 3-month at the money options of currencies included in the US Dollar Index (DXY); HY spreads by average option-adjusted spread of the Bloomberg US Corporate High Yield Index; IG spreads by average option-adjusted spread of the Bloomberg US Aggregate Corporate Index; economic surprises by the Citi US Economic Surprise Index.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal.

Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. **Low-rated, high-yield bonds** are subject to greater price volatility, illiquidity and possibility of default.

International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility.

IMPORTANT LEGAL INFORMATION

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