Sticky inflation and Treasury supply likely to push yields higher

*We believe markets are adjusting to an economic outlook of sticky inflation rather than a soft landing with declining inflation.*

*Rates are likely to rise across the yield curve, but risk assets may show greater tolerance for higher rates.*

**U.S. growth is surprisingly strong, Europe is stagnating, and China is beginning to improve.**

Recent economic data, we believe, suggests sticky inflation with positive GDP growth is more likely in 2024 than a soft landing. We expect that interest rates will stay higher for longer on the back of increased Treasury supply and hawkish Federal Reserve rhetoric. As fixed income markets are forced to consider this prospect, rates are likely to move higher across the yield curve.

At the same time, the markets’ confidence that the economy can tolerate higher rates appears to have risen, and risk assets have continued to show resilience. Risk assets may also draw fundamental support from large fiscal deficits, we believe. Higher rates and higher asset values can exist together. Weak data could change this trend. Housing might be the sector that shows weakness and could influence markets and the Fed.

The Fed does not appear to think that inflation is sticky. Given recent moves higher at the long end of the yield curve, we believe the Fed’s willingness to raise policy rates is much lower. Even hawkish members of the Federal Open Market Committee have signaled a preference for a pause. In our view, the Fed is unlikely to hike in November and will signal a hawkish pause in December.
In the near term, we expect the U.S. inflation rate will fall to the 3.0%–3.5% range, interest rates will remain elevated, and spreads will be flat to slightly tighter. We believe a U.S. recession is possible in the second half of 2024. If the U.S. avoids a recession in 2024, we believe the Fed may not cut rates at all. As liquidity continues to be withdrawn, financial market risks will increase, in our view.

**U.S. growth surprises**

The Atlanta Fed’s Q3 GDP growth forecast has been fluctuating around 5%, indicating acceleration from previous quarters. Consumer spending is strong, as households have been spending more than they could if they only relied on their incomes. The gap between GDP and GDI (gross domestic income) indicates the difference between income and consumption. Real disposable income declined, at the pace of –0.2% M/M, two months in a row while households continued to spend. The saving rate dropped to 3.9% in August.

**Figure 1. Treasury yields rose in Q3, with a bigger rise for long-maturity bonds**

Source: U.S. Treasury Department. Past performance is not indicative of future results.
Manufacturing PMIs improved in September while services PMIs slowed. The labor market has remained strong. Total nonfarm employment increased by 336,000 in September, and the previous two months' employment was revised up by 119,000. Housing activity is losing momentum after stabilizing early in the year. NAHB's builder confidence index has dropped as mortgage rates — now above 7% — were observed to be slowing demand.

**With Europe stagnant, the ECB pauses**

The euro area continues to struggle with weak external demand and the energy transition, which is keeping manufacturing structurally constrained. Domestic activity has been losing momentum for the last couple of months. September PMIs remained in contractionary territory. The ECB hiked the key policy rates by 25 basis points (bps) and signaled the likely end of its tightening cycle in September. It raised inflation projections for 2023 and 2024 while reducing the 2025 projection to 2.1%, slightly above target. With the meeting statement, along with the 2025 inflation projection, the Governing Council of the ECB signaled its intention to pause rate hikes for a sufficiently long period.

**China is beginning to improve**

Chinese policymakers have announced a large number of "small" stimulus measures, as the property market and the overall economy looked likely to lose momentum early in the third quarter. In September, activity data started to surprise to the upside, showing early signs of stabilization. The policy announcements could likely put a floor to deteriorating sentiment and economic growth, although the durability of China's recovery could become questionable.

China's exports and imports ticked up in August, surprising to the upside. While the increase in exports was marginal, global demand might be showing signs of stabilization after a steady decline from the highs. Exports to many regions ticked up, but European demand continued to weaken. China's commodity demand stayed stable in volume terms. Inflation is bottoming out as in the rest of the world.
Sector views

Floating-rate bank loans
Floating-rate loans outperformed other fixed income markets for the third quarter with a return of 3.43% (as measured by the Morningstar LSTA US Leveraged Loan Index). With loan price dispersion expected to remain elevated, attractive investment opportunities have presented themselves, in our view. That said, prudent credit selection will be an important driver of alpha (excess return on investment relative to the return of a benchmark index). Most non-IG issuers continue to be challenged by shrinking profit margins due to inflationary pricing and a more discerning consumer.

Floating-rate loans continue to provide stability against interest-rate volatility. If inflation remains high, loans may benefit from higher rates, with elevated SOFR (Secured Overnight Financing Rate) levels providing higher yields. On the other hand, if inflation falls, and the Fed begins to reduce rates, floating-rate income will decrease, but prices will generally remain stable, we believe.

Figure 2. Risk assets outperformed in Q3 except for mortgage-backed securities

Excess returns* relative to Treasuries, Q3 2023

* Excess returns are calculated relative to comparable-maturity U.S. Treasuries for each index. Excess return does not always mean “outperformance.”

Source: Bloomberg, as of 9/30/23. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index. Past performance is not indicative of future results. High-yield bonds are represented by the Bloomberg U.S. Corporate High-Yield Index, which covers the U.S. dollar-denominated, non-investment-grade, fixed-rate, taxable corporate bond market and includes securities with ratings by Moody’s, Fitch, and S&P of Ba1/BB+/BB+ or below. EM (emerging market) debt is represented by the Bloomberg EM Hard Currency Aggregate Index, which is a flagship Emerging Markets debt benchmark that includes USD, EUR, and GBP denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. U.S. IG (investment-grade) corporate debt is represented by the Bloomberg U.S. Corporate Index, a broad-based benchmark that measures the U.S. taxable investment-grade corporate bond market. CMBS (commercial mortgage-backed securities) are represented by the Bloomberg U.S. CMBS Investment Grade Index, which measures the market of commercial mortgage-backed securities with a minimum deal size of $500 million. Agency MBS (mortgage-backed securities) are represented by the Bloomberg U.S. MBS Index, which covers agency mortgage-backed pass-through securities (both fixed-rate and hybrid adjustable-rate mortgages) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).
Corporate credit
We have a cautious view on the corporate credit market, although we continue to find pockets of idiosyncratic opportunities across the risk spectrum. Corporate fundamentals were strong entering 2023 and remained resilient based on earnings results through the second quarter. Margins, leverage, and balance sheet health are slightly off their peaks but are still near decade highs. Given the strength in earnings and resulting implications for the health of consumer spending, we do not believe a recession is imminent absent further distress in the financials sector.

We believe technicals in high-yield and investment-grade credit are strong, driven in large part by a persistent bid from pension and liability-based buyers taking advantage of higher yields and lower prices after this year’s rate sell-off. Spread valuations are largely reflective of a non-recessionary economy, which leaves little room for earnings volatility. All-in yields (which are calculated based on spreads as well as rates), however, create an attractive total return backdrop, which should be supportive. Still, macro forces of high inflation, tight central bank policy, and tighter credit conditions remain considerable risks to both fundamentals and market technicals. As a result, we are positioned for slower growth as we enter 2024.

Commercial mortgage credit
The commercial real estate sector is facing meaningful headwinds and increased risks, including the effects of a post-pandemic shift in office demand and rising costs of capital. Property values will likely face pressure over the medium term, but prices will vary significantly by geography and property type. However, this scenario is more daunting for the equity investor, in our view. Debt holders only need the borrower to pay off the remaining interest and principal owed, which we believe limits the impact on commercial mortgage-backed securities. We believe much of this risk is already reflected in the market given the significant spread widening in the last year and a half. The most attractive relative value opportunities require detailed loan-level analysis and security selection, in our view.

Residential mortgage credit
We believe U.S. homeowner balance sheets are well positioned. Many homeowners are benefiting from locked-in, ultra-low mortgage rates and substantial home price appreciation in recent years. We expect home prices to remain stable for the rest of 2023. However, certain locations that became overheated may be susceptible to retractions, in our view. While sector spreads have tightened compared with 2022, they remain wider compared with 2021. At current levels, we believe attractive risk-adjusted return opportunities can be found across the capital stack.

Prepayment
We expect prepayment speeds will be stable going forward. The sector may provide helpful protection against a recession scenario that negatively impacts home prices or employment. In our view, many prepayment-sensitive assets now offer an attractive risk-adjusted return at current price levels and significant upside potential if rates stabilize and volatility declines.

Tax exempt
We continue to find opportunities across the municipal bond market, uncovering value in rating, sector, and coupon dislocations. Municipal credit fundamentals remain stable, in our view. Higher employment and increasing wages have bolstered tax receipts in the past few years. We continue to monitor the housing market, including home values, an important factor in property tax revenues.

Total state and local tax collections fell 7.30% in the first half of 2023 compared with the first half of 2022. At the same time, total tax revenues are nearly 16% above their five-year average. Also, state and local governments’ rainy-day funds and financial reserves are close to 30-year highs. Municipal defaults through September are down 28% versus the average of the past five years and continue to represent a very small percentage of the market. As such, we believe the credit outlook remains favorable, though we continue to actively evaluate credit conditions.
Current valuations are attractive, in our view. At the close of quarter-end, taxable equivalent yields were close to 7.00%, suggesting municipal bonds were relatively cheap on a long-term basis. We regard any market volatility as an investment opportunity and continue to be vigilant for dips in the market that can present attractive entry points.

**Emerging market credit**

We remain cautious on our intermediate outlook in EM, although we are beginning to see recession risks and inflation risks declining for now. China’s expected recovery has been disappointing, challenging the idea of a sustained recovery. Additionally, escalating geopolitical tensions could add to sticky inflation and have a negative impact on risk assets if the situation worsens. However, the global growth outlook does not appear as challenging as we expected earlier in the year. While we anticipate some adjustment in monetary policy should a severe slowdown materialize, central banks will be somewhat constrained as long as inflationary pressures remain, in our view.

Regardless of the policy path, we continue to believe higher-grade EM names are overvalued given the current environment, even with recession and inflation risks declining, although the latter condition should be supportive of EM over the near term. Distressed names now also appear relatively rich given the current market dynamics. As such, we expect a bit more downside within the next 3–9 months, but timing remains challenging. We prefer for now to stay beta neutral (where risk is not correlated with broader market volatility) and seek relative value opportunities, remaining very selective in our high-yield risk exposure.

**Currency views**

**Dollar continues to dominate**

Although the Fed’s rate-hiking cycle is coming to an end, monetary tightening through balance sheet reduction will continue. Among major economies, the U.S. now has the highest policy rate and pace of growth. Given that China is dealing with its structural issues, and Europe remains weak due to its energy transition and exposure to China’s weakness, U.S. outperformance is set to continue. This dynamic is likely to dominate in the near to medium term, strengthening the dollar further, in our view.

**Euro hurt by weaker activity**

The European Central Bank (ECB) raised rates in September by 25 bps and signaled the end of the hiking cycle. The ECB’s key policy rates are below the Fed’s, while the euro area growth rate is fluctuating around zero, well below U.S. growth. The European production model — and Germany’s model, in particular — has been changing, as cheap energy and labor along with strong Chinese demand are no longer available. This backdrop is likely to further weaken the euro, although the currency might occasionally benefit from rising optimism for global growth and stabilization in government bond markets.

**Pound sterling carries less downside risk**

The Bank of England (BoE) left its policy rate unchanged in September for the first time in two years. The meeting statement mentioned signs of loosening in the labor market and weaker-than-expected inflation in August. However, inflation remains uncomfortably high, and the BoE is likely to maintain high interest rates for longer, even though economic activity has little momentum. The pound sterling might gain some strength against the euro if government bond markets and, hence, risk appetite stabilize, but it might weaken a bit against the dollar.

**Yen weakened by policy caution**

The interest-rate difference between Japan and the rest of the world has materially weakened the yen. The Bank of Japan (BoJ) is significantly behind in tightening policy, and domestic inflationary pressures have risen. The “higher for longer” interest-rate environment in major economies is likely to accelerate the BoJ’s exit from the yield curve control and negative interest-rate policies. Until the eventual exit from these policies, the yen is likely to remain under depreciation pressure.
The Fixed Income Outlook represents the insights of our investment research teams.

Michael V. Salm
Chief Investment Officer, Fixed Income

Navin H. Belani
Head of Credit Research

Albert Chan, CFA
Head of Portfolio Construction

Joanne M. Driscoll, CFA
Head of Short Term Liquid Markets

Onsel Gulbitem, Ph.D., CFA
Director, Global Macro Strategy

Brett S. Kozlowski, CFA
Co-Head of Structured Credit

Jatin Misra, Ph.D., CFA
Co-Head of Structured Credit

Robert L. Salvin
Head of Corporate and Tax-Exempt Credit

As of September 30, 2023.

Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

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