Fixed Income Allocation Strategy

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Fixed Income Market Update

After dropping in December, the Bloomberg Barclays U.S. Aggregate Bond Total Return Index rebounded and was basically flat in January, up only 0.5%. However, breadth improved sharply—all nine fixed income sectors we track had positive returns for the month. The biggest monthly reversal came from Long-Term Treasurys.

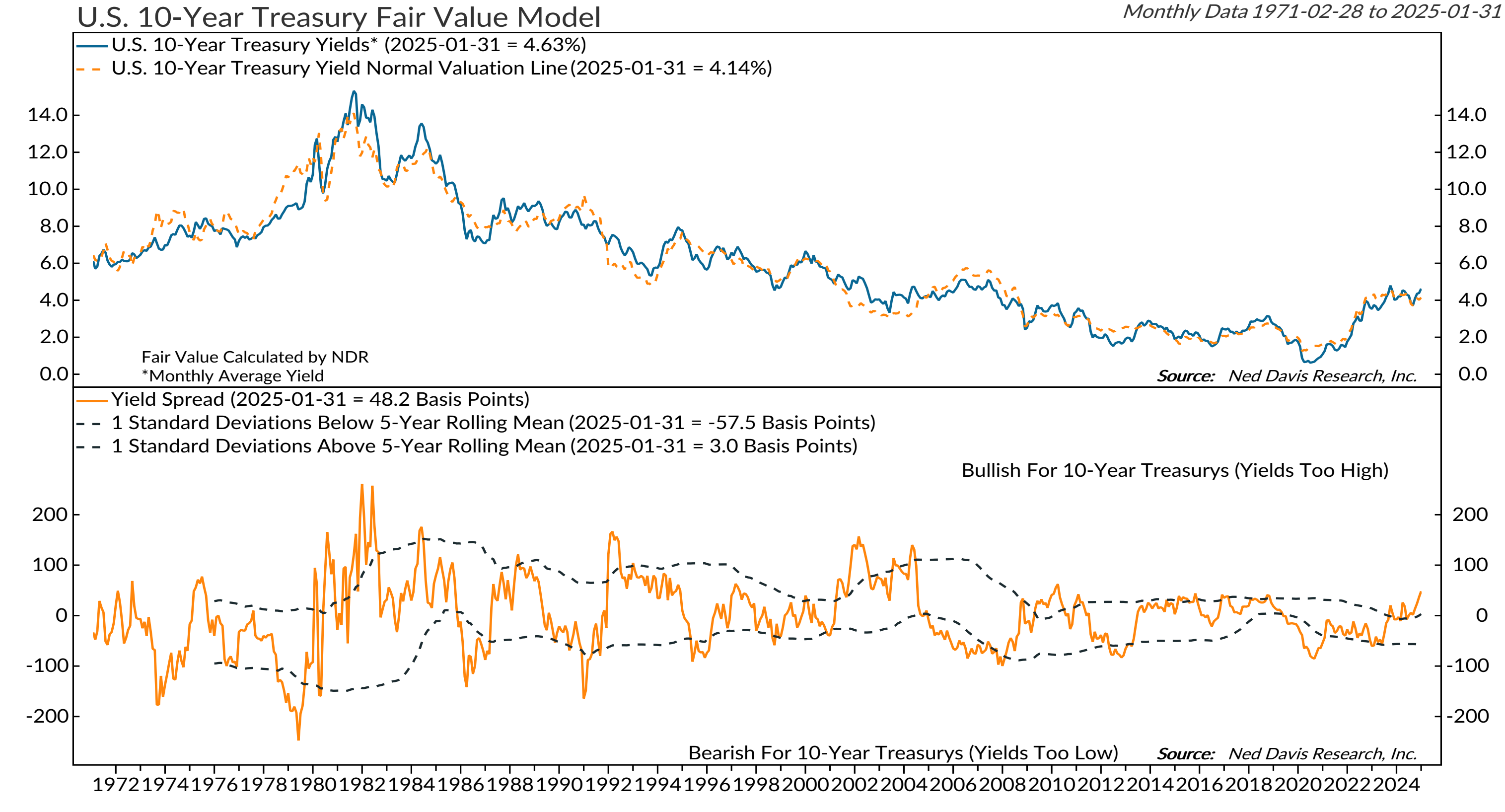
We use a macro approach for valuing 10-year sovereign securities. The original formulations were challenged by the pandemic, the inflation spike of 2021-22, and the phaseout of Libor and related contracts. So, we tweaked our models to use forward-looking data for inflation and monetary policy. The revised chart for the 10-year Treasury's fair value is shown below.

This model, as well as a rolling 30-year regression and a theoretical framework for forecasting yields, show U.S. yields are too high. The 10-year yield is currently at the mid-point of our 2025 outlook as we are not calling for a recession. We would buy the 10-year around 5.00% +/- 25 basis points. While there are risks to the economy due to tariffs and immigration, absent a recession, yields should not sustainably trade above 5.25%.

Entering February, Emerging Market bonds, U.S. Floating Rate Notes, U.S. High Yield, U.S. Investment Grade Corporate, and U.S. Treasury Inflation-Protected Securities are above benchmark weight. International Investment Grade dropped to benchmark weight, while U.S. Long-Term Treasurys and U.S. Mortgage-Backed Securities remained below benchmark weight.

U.S. 10-Year Treasury Fair Value Model

Monthly Data 1971-02-28 to 2025-01-31



Determinants of Fair Value	Sensitivity	Latest Reading
10-Year Inflation Swap	0.63	2.55
SOFR Futures	0.35	4.02
Real German Bond Yield	0.46	0.51

Bloomberg Long-Term Treasury Total Return Index
Analysis Dates: 1971-02-28 - 2025-01-31

Signal	Mean Return After:		
	6 Months	12 Months	18 Months
After > +1SD	0.79	-0.70	-0.89
After < -1SD	1.10	0.53	-4.14

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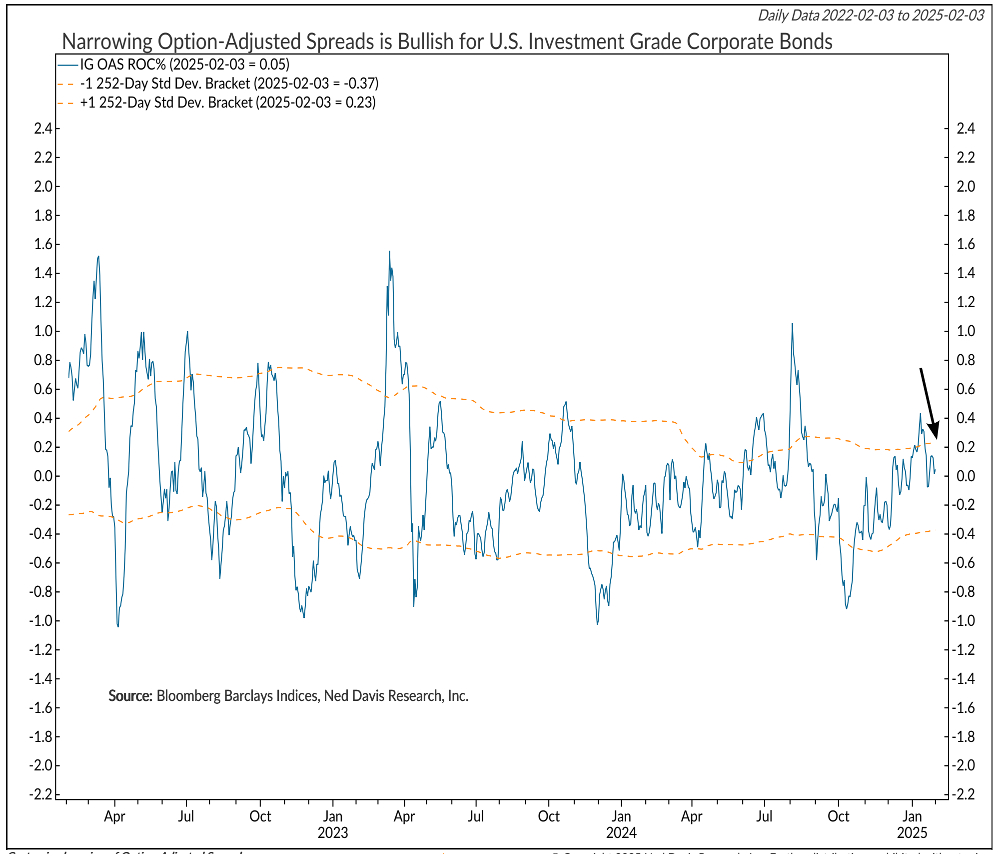
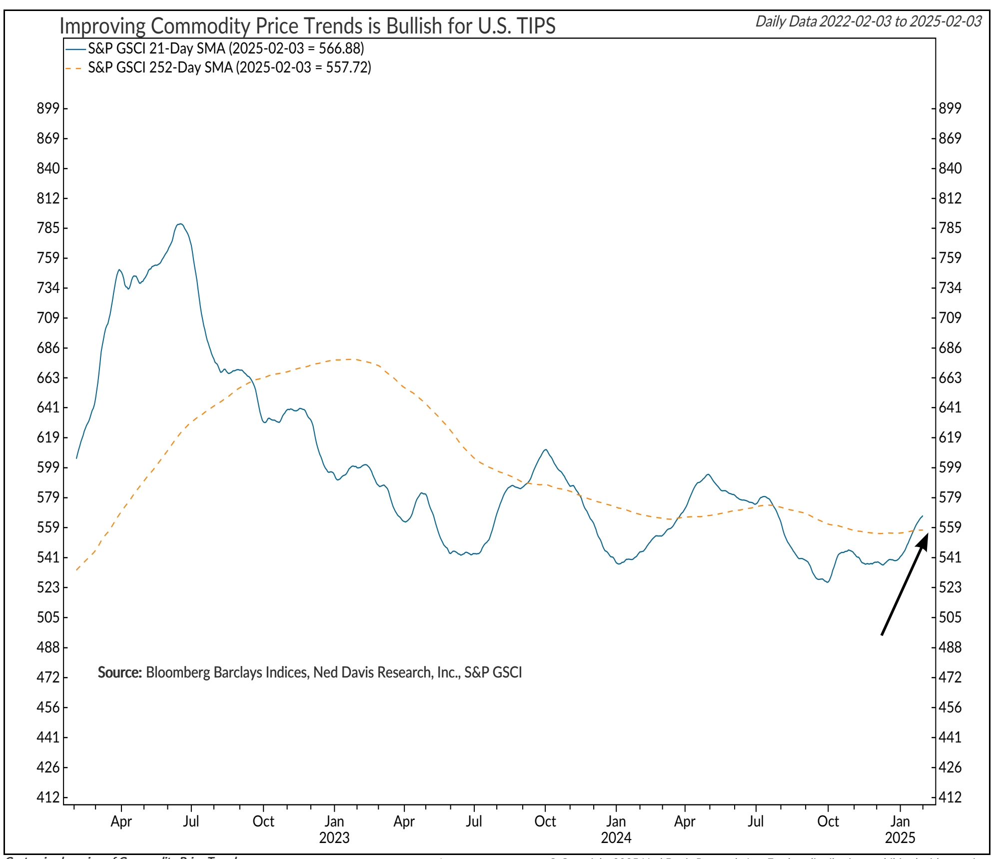
U.S. Investment Grade Corporate bonds' allocation is above benchmark weight. Four of the six indicators are bullish for the sector. During the month, narrowing option-adjusted spreads (chart right) joined bullish readings from bond volatility, the U.S. dollar, and mean reversion. Credit default swaps and trend remain bearish.



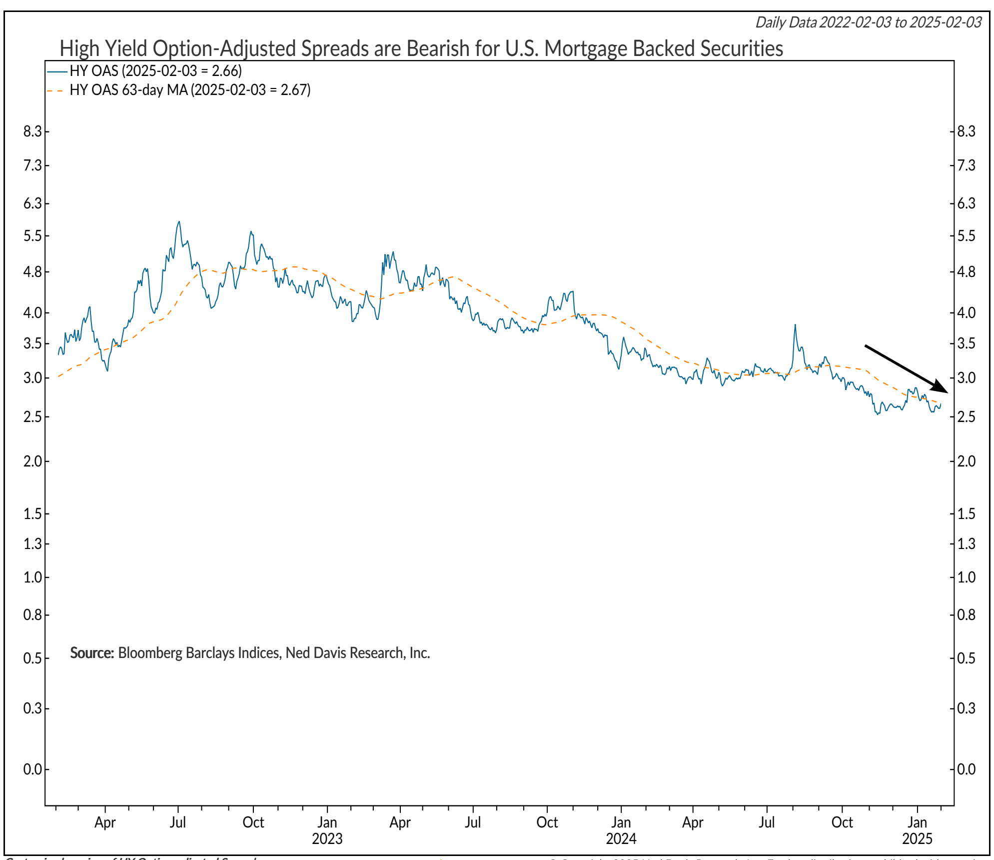
Customized version of Option-Adjusted Spread



Customized version of Commodity Price Trends

U.S. Treasury Inflation-Protected Securities' allocation is above benchmark weight. With investor concerns about inflation getting reignited by tariff and immigration policies, most of the indicators for this sector have improved to bullish levels. Commodity price trends (chart left) and inflation expectation extremes moved to bullish readings during the month. They were confirmed by relative strength trends.

Despite a reversal in performance in January, U.S. Long-Term Treasury bonds' allocation remained well below benchmark weight. Four of five indicators remain bearish. While U.S. stock market performance continues to be at a bullish level for Treasuries, it is offset by weak Treasury bond momentum, trend, rising inflation expectations (chart right), and U.S. swaps extremes.



U.S. Mortgage-Backed Securities (MBS) allocation is well below benchmark weight. Five of the six indicators are bearish for the sector. During the month, high yield option-adjusted spreads (chart left) joined bearish readings from trend, relative strength vs. inflation expectation extreme measures, and the relative strength index. The 10-year yield remained bullish for the sector.

Summary

Entering February, Emerging Market bonds, U.S. Floating Rate Notes, U.S. High Yield, U.S. Investment Grade Corporate, and U.S. Treasury Inflation-Protected Securities are above benchmark weight. International Investment Grade dropped to benchmark weight, while U.S. Long-Term Treasurys and U.S. Mortgage-Backed Securities remained below benchmark weight.

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