Allspring

MARKETING COMMUNICATION

Income Generator

Road map 2024

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Riding the curve

Bond investors worldwide can use three basic principles to manage risk in 2024:

- **Diversify duration.** Spread duration across the curve to maximize income and capture return potential.
- **Prioritize flexibility.** Diversify across sectors and securities to remain nimble.
- **Be intentional with risk.** Use high nominal and real yields to build durable, inflation-beating cash flows over multiple years. This was doable in 2023 and could be again in 2024.

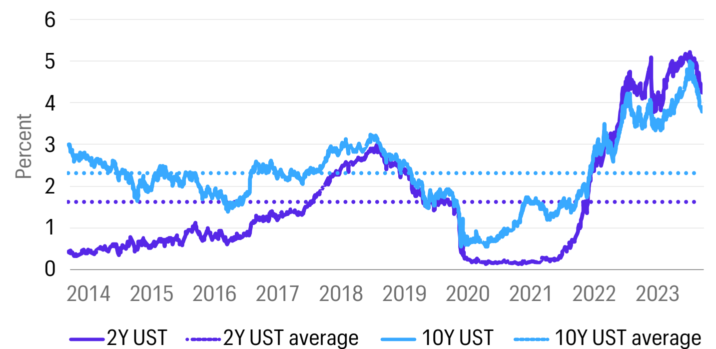
Bond market outlook for 2024

Financial markets start 2024 amid a "Goldilocks moment" for the U.S. economy and mixed economic backdrops in Europe and Asia. Globally, markets expect inflation to continue to trend lower and growth to decelerate to slightly below trend. Smooth and orderly disinflation appears to be the BIG assumption baked into these expectations. While the Federal Reserve (Fed) and other central banks have signaled a willingness to ease policy in response to softer inflation, markets have raced ahead to price in a near certainty that rate cuts are coming. Expectations appear to have run too far too fast—central banks rarely, if ever, cut rates simply because inflation is trending lower. Historically, they have responded more to slowing growth. Nevertheless, this macro backdrop should favor fixed income returns as it supports lower interest rates over time and a wide trading range for credit risk premiums.

Fixed income strategies for 2024

- Taxable, shorter maturity, high income debt strategies have the potential to generate generous yields and capture modest capital gains.
- Core strategies with a high-quality bias and mid-market duration should help provide protection against an economic hard landing.
- Multi-sector debt strategies that include the "plus" part of the bond market could offer extra yield and higher interest rate sensitivity.
- Tax-exempt broad market and tactical strategies should allow investors to capture potentially attractive tax-adjusted returns.

BOND YIELDS: ABOVE AVERAGE



Source: Bloomberg Finance L.P. U.S. Treasury pricing is represented by Bloomberg's generic pricing of U.S. Treasury yields.

In the near term, bond prices may pull back and push yields higher as the intense bond rally of late 2023 is reevaluated and an upsurge in bond issuance likely hits the market as borrowers take advantage of lower funding costs. A mini refinancing wave could weigh on technicals, especially if bond investors react to sticker shock after a 100-basis-point-plus (bp; 100 bps equal 1.00%) rally in bond yields during the fourth quarter of 2023. However, for reasons discussed above, yields are likely to fall over the course of 2024. History suggests that longer-maturity bond yields should decline when the Fed begins to signal the first rate cut. Indeed, both bond yields and credit spreads fell significantly in the weeks leading up to the Fed's meeting in December.

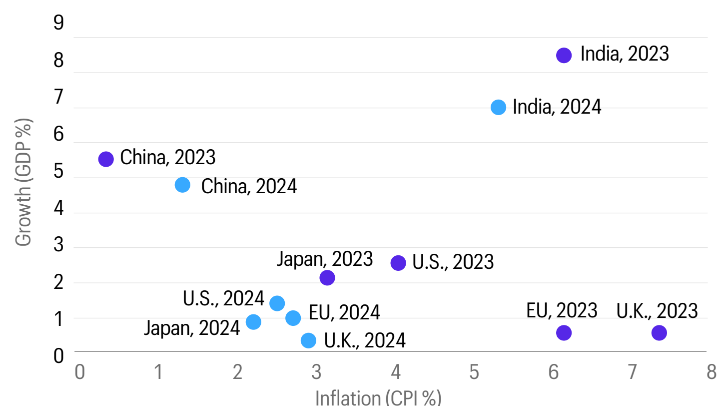
We expect U.S. inflation to decline in 2024, but less quickly than the market expects and perhaps less dramatically. Stubborn inflation could lead to a yield curve "reverse" twist, with lower front-end yields and stable to slightly higher long-end yields. Credit spreads are likely to be range bound in this environment as different borrowers are affected differently by this economic backdrop, which lends to a heavy emphasis on credit research and security selection.

Broadly speaking, bond total returns in 2024 are likely to be composed of "income plus some capital appreciation." Major risks to this bond-friendly environment include: a central bank policy error, uncertainty regarding the U.S. presidential election, and/or an escalation in the military conflicts in Eastern Europe and the Middle East.

Bond market road map for 2024

Economy: Decelerating. In many major economies, economic growth is expected to decelerate and inflation is expected to decline in 2024. In the U.S., inflation is falling and the robust economic growth that we saw in 2023 is showing signs of decelerating. Against this backdrop, the Fed appears willing to ease policy in response to softer inflation. We expect economic growth to stall out to around 0% by the middle of the year but avoid a recession.

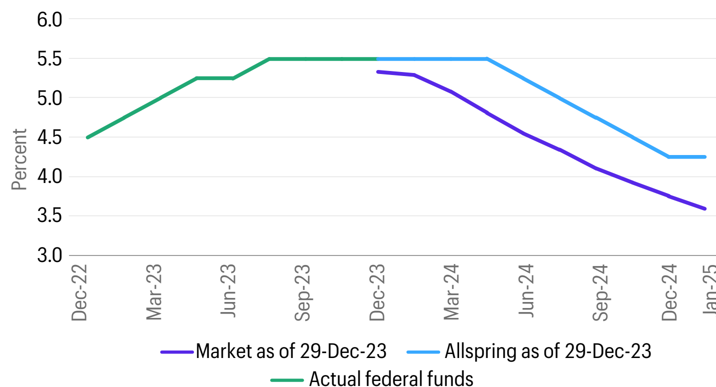
GLOBAL ECONOMIC CONSENSUS ESTIMATES: 2023–2024



Source: Bloomberg Finance L.P. Growth and inflation estimates are represented by average estimates of economists surveyed by Bloomberg.

Fed funds: Pivot toward easier policy. The Fed last hiked rates in July 2023, and we do not expect it to raise rates again in this cycle. However, with core inflation trending toward the Fed's 2% target, the probability of looser policy has increased. That said, while market expectations imply a first quarter rate cut, the Fed may not actually cut rates until the middle of the year. By then, if inflation is still trending lower and growth is stalled out around 0% as we expect, the Fed will be in a better position to start cutting rates.

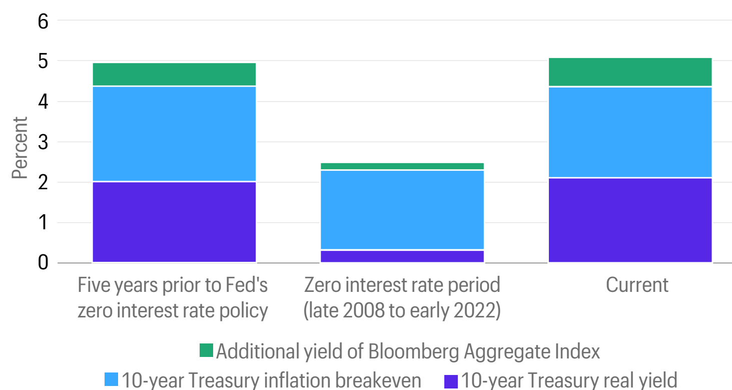
FED FUNDS EXPECTATIONS



Source: Bloomberg Finance L.P. Actual federal funds are represented by the federal funds target rate—upper bound. Market pricing is represented by Bloomberg's interest rate probability calculations for federal funds. Allspring pricing is represented by the opinions of Allspring's portfolio management team.

Yields: Back to "normal." Bond yields are back to levels seen prior to the Fed's zero interest rate policy that started in 2008. For reference, the U.S. Treasury 10-year yield rose from 0.5% in August 2020 to 5% in October 2023 and finished 2023 at 3.9%. Perhaps more importantly, real yields moved from negative 1% to a peak of positive 2.5% and currently stand around 2%. This 300- to 350-bp shift means today's investor in U.S. Treasury 10-year bonds could beat inflation by at least 2.0% over the next 10 years.

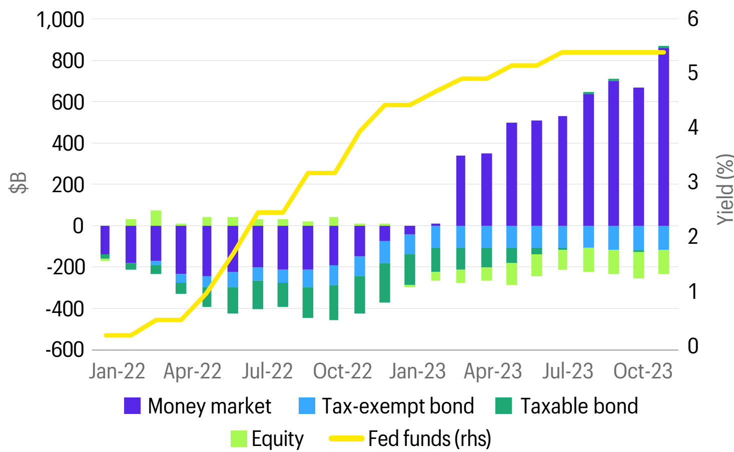
BOND YIELDS RETURN TO NORMAL



Source: Bloomberg Finance L.P. U.S. Treasury 10-year yield is represented by the generic U.S. Treasury 10-year note. Real yields are represented by the difference between the generic 10-year government bond yield and the 10-year breakeven inflation rate. Data presented from 02-Jan-03 through 29-Dec-23.

Cash: Is king (for now). With a current yield of around 5.5%, it's hard to bash cash. Many investors continue to harbor large sums of money in cash funds. However, we think the "Goldilocks moment" is upon us and duration should be added into portfolios to help generate better expected total returns over the coming years. Certain sectors, such as ultra short-term bond strategies and various high yield strategies—both taxable and tax exempt—meaningfully outperformed cash in 2023. We expect this outperformance to spread to other fixed income sectors this year.

FUND FLOWS: CUMULATIVE 2022–2023



Sources: Bloomberg Finance L.P. and Morningstar. Federal funds are represented by the federal funds target rate—upper bound.

Duration: Diversify it. We believe most investors can benefit by diversifying their duration positioning. High concentrations in one part of the curve can lead to meaningful (and avoidable) volatility in a bond portfolio. With the Fed on hold and the macro backdrop looking more bond friendly, we have been steadily extending duration in many portfolios we manage. The opportunity cost of waiting to add duration has risen lately. Our research shows us that, historically, those who waited to increase duration have tended to significantly underperform those who diversified.

Credit: Up in quality. We moved "up in quality" over the course of 2023, and we expect to preserve our higher-quality stance in early 2024. Broadly speaking, credit spreads appear to be on the tighter side of fair value. Nevertheless, we like certain segments of other markets, including mortgage-backed securities and some asset-backed securities. In corporate credit, we prefer higher-quality issuers, and we define these as companies with well-funded balance sheets (low-cost debt and long-term maturities) and earnings that can keep pace with inflation. As such, we can find "quality" issuers across all rating levels.

Security selection: Capitalize on mispricing. When volatility is high, we believe a diversified portfolio of dozens of security selection decisions based on fundamental research can deliver outperformance more consistently than betting the farm on one big macro-focused decision.

MOVE INDEX OF U.S. TREASURY VOLATILITY

ACTIVE MANAGEMENT PERFORMANCE

	3 year	5 year	10 year
Median core bond manager annualized return	-4.71%	0.61%	1.63%
Bloomberg Aggregate Bond Index annualized return	-5.21%	0.10%	1.13%

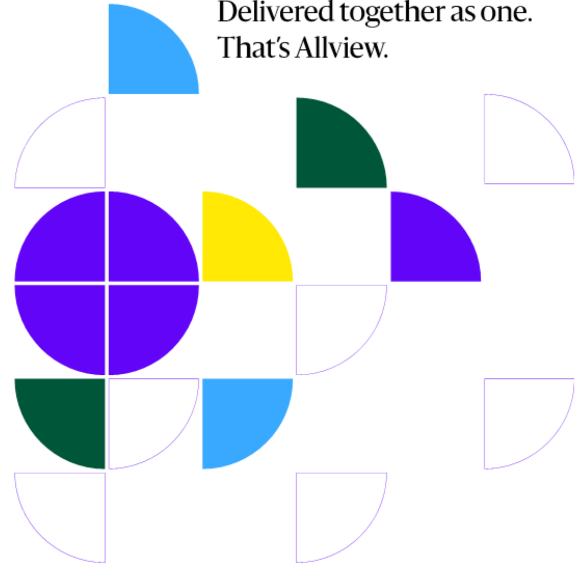
Sources: Allspring, eVestment, and Bloomberg Finance L.P. **Past performance is not a reliable indicator of future results.**

Ride the curve

After a wild ride in 2023, we believe fixed income markets should continue to progress along a path of normalization in 2024. Bond investors still have an opportunity to diversify their duration positioning and "ride the curve" to capture positive real yields and generate steady and predictable cash flows.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. Visit our website at www.allspringglobal.com.



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