Yield Advantage: Riding the Curve

2024 fixed income road map

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George Bory, CFA
Chief Investment Strategist,
Fixed Income

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

01 **Diversify duration.** A relatively flat yield curve reduces the opportunity cost of extending or shortening duration, but it increases the risk of being too concentrated in one part of the curve.

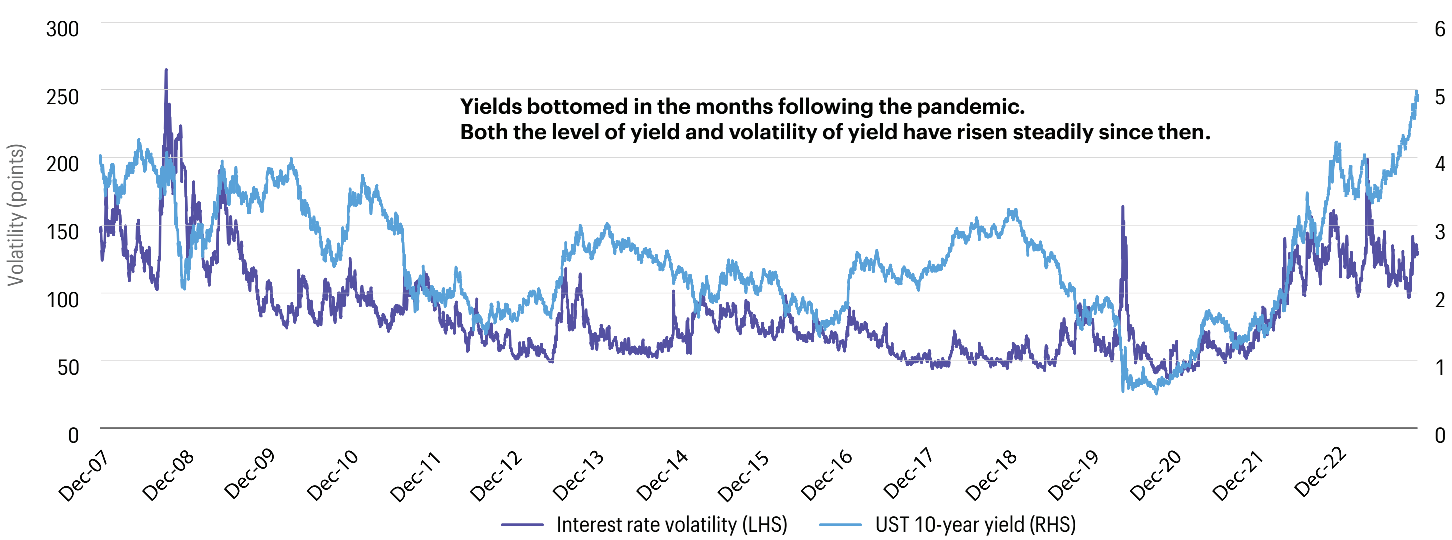
02 **Prioritize flexibility.** A wide range of macro risks has increased the dispersion of expected outcomes. Implementing many small decisions across multiple sectors and maintaining investment flexibility is preferable to investing based on one big macro view.

03 **Be intentional with risk.** High nominal yields and generous real yields create an opportunity to build durable, inflation-beating cash flow streams over the coming years.[1]

The global macroeconomic backdrop heading into 2024 is a mix of peak (or near peak) front-end interest rates, modest disinflation, and uneven growth. This is coupled with notably higher real yields across the sovereign bond landscape. We believe the coordinated move higher in global bond yields could fragment as the broad reset in asset prices runs into domestic macroeconomic considerations and business cycles.

Fixed income markets should progress along a path of “normalization” in 2024 as policymakers around the world continue to remove many of the support structures set up after the Global Financial Crisis and carried through the COVID pandemic. Many investors will find it challenging to separate structural shifts from cyclical changes as they recalibrate to this new environment. Highly indebted entities face fiscal, or even solvency, pressures due to higher borrowing costs and tighter financial conditions. However, prudently financed public and private sector borrowers possess considerable advantages. In this environment, the cone of uncertainty has widened considerably as investors confront a broad range of potential economic, political, and social outcomes in 2024 and beyond. As such, higher levels of volatility will likely continue during this transition phase.

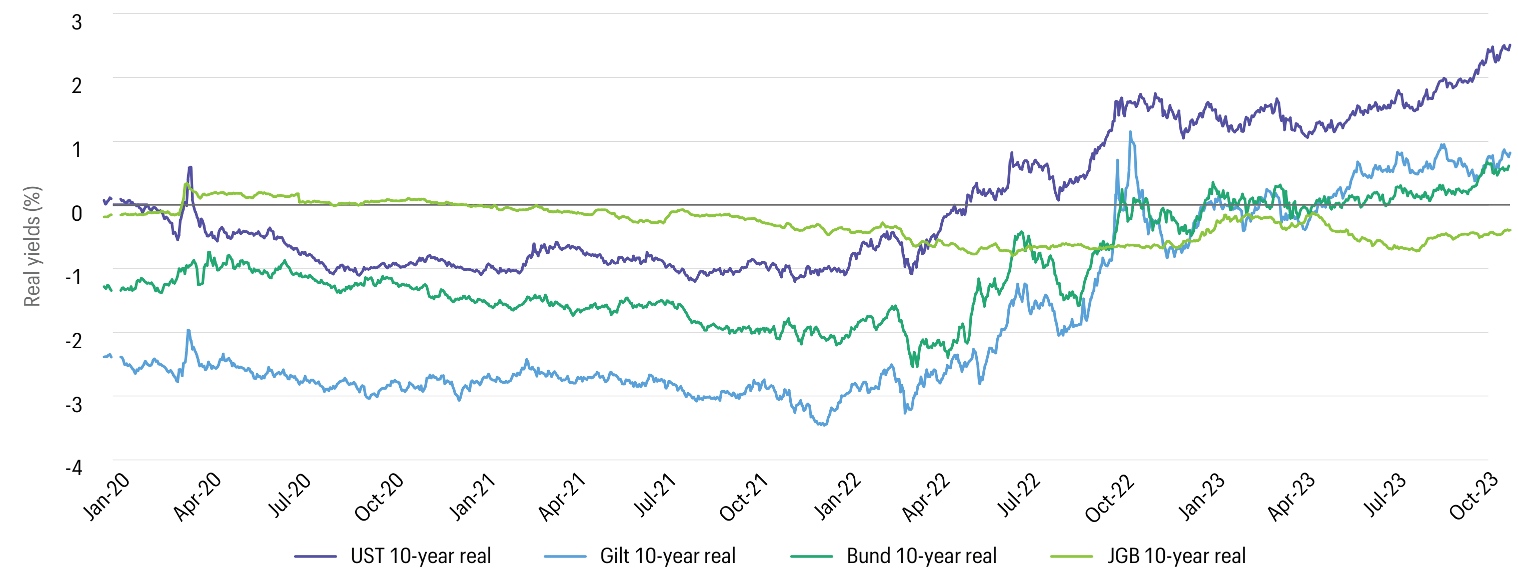
INTEREST RATE VOLATILITY & YIELD



Source: Bloomberg Finance L.P. Interest rate volatility is represented by the ICE BofA MOVE Index. UST 10-year yield is represented by the generic U.S. Treasury 10-year note. Data presented from 31-Dec-07 through 05-Oct-23.

1. Nominal yield is the stated yield or coupon rate of a bond. Real yield subtracts the expected inflation rate from the nominal yield.

GLOBAL REAL YIELDS



Source: Bloomberg Finance L.P. 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 01-Jan-20 through 24-Oct-23.

Volatility in fixed income markets presents both challenges and opportunities. Long-held assumptions about the market’s structure and/or valuation principles may need to be revisited. However, volatility also presents an opening for educated investors. Risk premiums tend to widen and grow as uncertainty mounts, allowing investors a chance to capture these premia and carry them forward. In addition, price dispersion across sectors, issuers, and securities will likely expand, which should benefit investors who can monetize security selection and reduce dependence on large macro or directional positions.

With nominal yields at multidecade highs, higher interest rate uncertainty is currently priced into markets. Further, breakeven inflation rates remain anchored around 2.5% in the U.S., and they hover around 2.3% in Germany and 3.5% in the U.K. As a result, real yields around the world appear generously high, reflecting a disconnect between near-term uncertainty about inflation and longer-term expectations. This suggests issuers will face higher borrowing costs and, where possible, may adjust their funding decisions, including limiting their use of debt financing in the near term.

For investors, this presents an attractive opportunity to lock in long-term real yields of 100 basis points (bps; 100 bps equal 1.00%) to as much as 300 bps in liquid, higher-quality bonds. These bonds may exhibit near-term volatility, but over time, they should outperform the gnawing effects of inflation and compensate for an uptick in credit risk. Given this repricing, bond investors in all regions have the opportunity to diversify their duration positioning, Ride the Curve to capture positive real yields, and generate a steady and predictable stream of cash flows.

Riding the Curve in Fixed Income

Allspring's fixed income managers invest along the curve

Jeffrey Weaver, CFA
Senior Portfolio Manager,
Head of Global Liquidity Solutions

OUTLOOK

The Fed is likely on hold from raising the federal funds target rate but should keep policy "higher for longer," allowing front-end investors to stay defensive while capturing yields. Normalization of the yield curve should improve the return profile of longer tenures and reduce the burden on timing duration.

OPPORTUNITIES

- Favor **higher-quality investment-grade credit and securitized sectors** to maintain a competitive yield while protecting against an unexpected flight to quality
- Focus on security selection in anticipation of an economic slowdown but stay mindful of **market liquidity of underlying holdings**

Henrietta Pacquement, CFA
Senior Portfolio Manager,
Head of Global Fixed Income

OUTLOOK

In Europe, recession and an end-of-cycle dynamic are influencing our 2024 playbook, while the European Central Bank remains in a tightening mode. Japan is diverging from the rest of the world—the Bank of Japan will be tightening policy in 2024 against a backdrop of stable-to-lower global sovereign interest rates. Heightened geopolitical risk is here to stay, primarily from developed rather than emerging markets.

OPPORTUNITIES

- Seek a conservative risk budget, focusing on **defensive sectors** and an underweight to cyclicals
- Focus yield enhancement efforts on **short duration and senior bank debt**
- Look for ways to benefit from an uncertain economic backdrop that highlights the **virtues of active security selection**—it's important to know what you own

Janet Rilling, CFA
Senior Portfolio Manager,
Head of Plus Fixed Income

OUTLOOK

Duration risk appears more attractively priced than credit risk heading into 2024. Diverse, global, high-quality credit portfolios can help preserve liquidity and ensure flexibility.

OPPORTUNITIES

- Seek to **extend duration tactically over time;** breakeven yields provide considerable cushion to absorb higher yields
- **Focus on securitized products** to reduce the impact of interest rate volatility
- **Consider strategic allocation to higher-quality yield,** which offers generous income and potential capital appreciation

Nicholos Venditti, CFA
Senior Portfolio Manager,
Head of Municipal Fixed Income

OUTLOOK

Municipals offer late-cycle protection against an economic hard-landing scenario. While the long end of the municipal market is expensive, modestly extending duration at different points along the curve may be beneficial.

OPPORTUNITIES

- Remain comfortable holding **lower-rated municipals (single-A and triple-B)** to capture additional yield
- **Consider general obligation bonds and essential service revenue bonds**, which should provide some protection against slower economic growth

Yield (%)

0 5 10 15 20 25 30

Duration (years)/market risk

For illustrative purposes only

Allspring fixed income key statistics[1]:

- **170+** dedicated fixed income investment team members
- **$415 billion** in total fixed income AUA across the platform
- Over **2,250** corporate credits analyzed globally
- **11th-largest** money market fund sponsor/family[2]
- **Galliard Capital:** One of the largest managers of stable value assets in the nation[3]

1. Allspring and affiliates. Figures are as of 30-Sep-23, unless otherwise noted. Please note that the assets under advisement (AUA) figures provided include discretionary and nondiscretionary assets and have been adjusted to eliminate any duplication of reporting among assets directed by multiple investment teams and includes $86 billion from Galliard Capital Management ($68 billion stable value; $17 billion fixed income). AUA includes nondiscretionary assets that are not captured in Allspring's assets under management (AUM) figure of $491 billion, which includes Galliard, an investment advisor that is not part of the Allspring trade name/GIPS firm. Numbers may not add up to the total presented due to rounding.

2. iMoneyNet. As of 30-Sep-23.

3. Pensions & Investments, data as of 31-Dec-22; total assets "ranked" are managed by Galliard and reported under Allspring Global Investments.

To learn more

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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- To reach our intermediary sales professionals, contact your dedicated regional director, or call us at **+1-866-701-2575**.
- To reach our institutional investment professionals, contact your existing client relations director, or email us at **AllspringInstitutional@allspringglobal.com**.
- To reach our retirement professionals, contact your dedicated defined contribution investment only specialist, or call us at **+1-800-368-1370**.

FOR EMEA AND APAC INVESTORS ONLY

- To reach our EMEA- and APAC-based investment professionals, contact us at **AllspringInternational@allspringglobal.com**.

FOR SUSTAINABLE INVESTING

- To discuss sustainable investing solutions, contact **Henrietta Pacquement**, head of Sustainability, and **Jamie Newton**, deputy head of Sustainability, at **henrietta.pacquement@allspringglobal.com** and **jamie.newton@allspringglobal.com**.

Diversification does not ensure or guarantee better performance and cannot eliminate the risk of investment losses.

The ICE BofA MOVE Index is a measure of U.S. interest rate volatility that tracks the movement in U.S. Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-, 5-, 10-, and 30-year Treasuries. You cannot invest directly in an index.

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