

Rates

A Positive Outlook for 2023

Looking to move into short duration assets and position for curve steepening.

As a new trading year begins, investors in U.S. Treasury and Agency markets stand to benefit from the potential recovery of one the worst yearly return periods of the last 50 years. This opportunity for positive total return comes on the heels of a year shaped by the Fed’s fight to tackle inflation that was more persistent than most market participants expected. As the FOMC increased the fed funds rate by a cumulative 425 basis points in less than nine months, Treasury yields pushed 200–370 basis points higher, reaching levels not seen for 15 years. Now, with inflation showing signs of abating, we believe that Fed tightening will reach its terminal rate by midyear.

As market participants become more comfortable with the potential end to the Fed’s tightening cycle, Treasury market liquidity should continue to improve and interest rate volatility should continue to decline. In this environment, callable Agency spreads will likely benefit and tighten from historically wide levels relative to Treasury securities of similar maturities. Additionally, we expect that attractive yields, historically wide spreads, and limited new supply for Agency bullet securities should help to drive positive performance for Agency debentures.

We believe that most of the flattening in the yield curve is behind us and that the Fed will keep rates on hold for longer than in past cycles. Accordingly, we have started to reduce some of our duration underweight positioning at the front end of the curve. Looking forward, as inflation continues to subside, the unemployment rate eventually rises from historically low levels, and the economy approaches a recession later this year, the Fed will likely wind down its hiking cycle, supporting the market’s current pricing of the next easing cycle. In anticipation of this chain of events, we will seek opportunities to invest in assets in the front and intermediate part of the curve, and consider curve positions that will benefit from an eventual steepening of the yield curve.

By Kris Dorr and Tad Nygren

With inflation showing signs of abating, we believe that Fed tightening will reach its terminal rate in the first half of 2023. We also believe that most of the flattening in the yield curve is behind us and that the Fed will keep rates on hold for longer than in past cycles.

2/10-Year Treasury Curve Before and After Rate Cuts



Source: Guggenheim Investments, Haver Analytics. Data as of 1.13.2023.

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