Portfolio Management Outlook

Tailwinds for Fixed Income

The fixed-income outlook appears bright as the Fed continues its easing cycle, though risks remain, making sector allocation and credit selection critical.

Our baseline U.S. economic outlook anticipates a gradual slowdown in growth, and inflation falling near the Federal Reserve's (Fed) 2 percent target. The election outcome tilts our inflation assumptions incrementally higher, while the growth outlook is more uncertain with both upside and downside policy-related risks. Consumer spending remains strong, supported by real income gains and elevated household wealth, and corporate profitability is robust. Still, as immigration slows and high interest rates continue to pressure some segments of the economy, growth is likely to slow from here, but the new administration will be loath for that to occur immediately on their watch.

The outlook is unusually uncertain given the regime change in Washington. At face value, a pro-tax cut, anti-regulation policy would skew growth and inflation higher. But immigration, tariffs, and the potential for trade wars or other geopolitical escalation are potential headwinds. And, while on balance labor market data still point to an ongoing gradual moderation in labor demand, noisy releases associated with special factors leave open questions about the strength of hiring. Meanwhile, the Fed will continue to recalibrate policy closer to neutral in the coming quarters.

In an environment of moderating growth and continued Fed easing, all-in yields remain attractive, particularly given the backup since September. Credit fundamentals are healthy overall, but somewhat dispersed. While much of the economy prospers, small businesses, low income consumers, and certain sectors of commercial real estate struggle under the weight of sharply higher interest rates. Spreads in most asset classes are back to their YTD tights, but some relationships still have room to compress.

With index spreads tight, our positioning skews defensive. We prefer higher quality credit, which tends to perform well in easing cycles, and structured products, which typically offer excess yield over similarly rated corporates, and wider spreads relative to fundamental risk. We are maintaining healthy cash positions and targeting an average level of credit beta to position our portfolios for potential opportunities.

In terms of duration, the yield curve has steepened significantly since the Fed began lowering interest rates, and we expect it to steepen further as rate cuts continue and the budget deficit grows. In this environment, we maintain a bias toward the belly of the curve given its historical outperformance during easing cycles. We prefer to express duration in this environment using Agency residential mortgage-backed securities (RMBS)—a liquid alternative to Treasurys with yield pickup—and Treasury inflation-protected securities (TIPS).

Historically, higher quality bonds have performed well in soft landings and even better in recessions, outperforming cash and riskier assets like stocks. Nonetheless, in this environment of growing disparity, credit and sector selection are critical—and an advantage for actively managed portfolios.

By Anne Walsh, Steve Brown, Adam Bloch, and Evan Serdensky