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BOND MARKET REVIEW — THIRD QUARTER 2023

In the first half of the year, long-dated Treasury yields found themselves in a choppy, range-bound trading pattern between 3.5% and 4.0%, with widespread opinion that the cyclical peak in Treasury yields was behind us. That narrative unraveled in the third quarter as Treasuries sharply sold off with anticipation of "higher-for-longer" – a thesis that the Federal Reserve will maintain policy rates at elevated levels for an extended period – took hold. At the end of the quarter, an already weakening macro environment culminated with a "hawkish pause." The Fed Funds rate was left unchanged at the September meeting, but some dots on the dot plot shifted higher, implying a comfort level with higher rates over the long term. This hawkish shift in messaging was unexpected, and further weakness rippled through equity and fixed income markets alike in the final weeks of September.

The Bloomberg U.S. Aggregate Index fell 3.23% during the quarter as weakness in government bonds and securitized products offset surprising resilience in corporate credit. The curve steepened as the 30 year Treasury yield rose by 84 basis points while the 2 year rose 15 basis points. Market participants are increasingly focused on rising oil prices and the implications for inflation, impacts on the consumer, and any policy response from central banks. Importantly, core CPI has consistently declined each month on a year-over-year basis, with the most recent reading falling to 4.3% in August from 4.7% in July. When including food and energy prices, the most recent print was 3.7%, a slight uptick from the July reading of 3.2%.

The defining price action within investment grade credit during the quarter was the outperformance of long-dated bonds. As yields rise, deep-pocketed institutional investors such as insurance companies and foreign pension funds are drawn to increasingly attractive nominal yields in long duration corporate bonds. As a result, the long-end outperformed along the credit curve. Most flavors of agency mortgage-backed securities, on the other hand, were weaker during the quarter. Consensus opinion is growing that MBS offer attractive relative value versus corporate credit, but it's unclear when the continued slide in MBS valuations will come to an end.

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