BOND MARKET REVIEW

FOURTH QUARTER 2023

What a difference a quarter makes. In October, market strategists were lamenting what was sure to be the third straight year of negative total returns in the U.S. bond market. Throughout October corporate credit, certain areas within securitized products, and U.S. Treasuries all weakened to varying degrees. Then the market changed in a flash. November and December witnessed a remarkable turnaround in risk appetite following the November 1st Federal Reserve meeting as the "Fed pivot" narrative took hold. The U.S. Aggregate Index surged 8.53% in the final two months of the year, rapidly easing financial conditions and bringing full year total returns into positive territory.

At the end of the quarter, unanimously dovish messaging from Fed Chairman Powell and the FOMC was preceded by improving inflation data. On a year-over-year basis, core CPI continued to decline. This measure of inflation, which excludes food and energy prices, started the year at 5.7% and declined to 4.0% in the most recent reading. However, this metric has remained stickier than the headline figure. At the beginning of the year, headline CPI was 6.5% versus the most recent reading of 3.1%.

Softening inflation, a resilient domestic growth picture, and shifting Federal Reserve rhetoric proved to be a powerful combination. Certain macro challenges such as significant looming U.S. Treasury issuance and ongoing conflict in the Middle East were all but ignored. Treasury yields collapsed as the correlation with risk assets remained positive. Spread product performed well. In corporate credit, lower-quality outperformed higher-quality. The agency MBS basis to Treasuries tightened. In short order, we "pulled forward" a lot of outperformance in risk assets that was expected to occur in 2024. Now, we enter the new year from a more challenging position of tighter spreads and fewer pockets of relative value. Market participants will continue to acutely monitor various measures of inflationary pressure, as any reacceleration of inflation presents a significant risk to the market in 2024.

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