DUCENTA SQUARED
ASSET MANAGEMENT

# Monthly Fixed Income Insight
## June 2023

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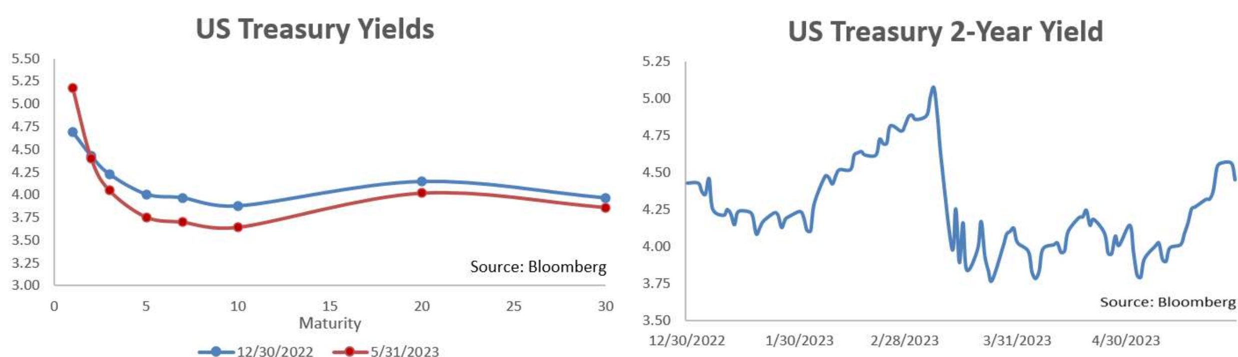
**US Interest Rates – Mid-Year Outlook**

The view from our Los Angeles offices is what Southern California natives refer to as “June Gloom”; a weather pattern that creates cloudy, overcast skies which linger well into the afternoon. The visibility for the bond markets has been equally foggy with uncertainty due to “sticky” inflation, the Federal Reserve, the banking crisis, and the debt ceiling drama. Year-to-date, US Treasury yields are marginally lower (left chart) which belies the extreme volatility that has occurred during the period. As the graph on the right highlights, the 2-year US Treasury yield is unchanged year to date at 4.40% but has wildly fluctuated from a high of 5.07% and a low of 3.77%. In the near-term, we expect interest rates to remain rangebound, but believe the clouds over the bond market will clear in the second half with the 10-year US Treasury yield ending the year between 3.00% and 3.25% compared to 3.75% currently.

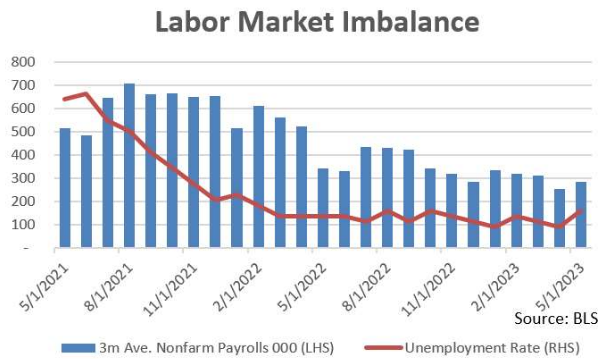



**The Federal Reserve – Are we there yet?**

We believe the Federal Reserve is now very close to the end of the rate hike cycle, which should be the first condition for a sustained decline in US interest rates. The Federal Reserve has raised rates 5% since March of last year, the fastest pace of increases in over 40 years, yet the US economy continues to defy expectations for a slowdown due to resilient consumer spending and strong labor markets. As a result, interest rates have been pressured higher as participants continually re-evaluate the terminal rate for fed funds and potential rate cuts in 2023. The heavy lifting required to move to restrictive policy, however, is accomplished, putting the Fed in a fine-tuning mode. We expect the Fed to raise rates one more time at its July meeting and then keep rates on hold for the balance of 2023.

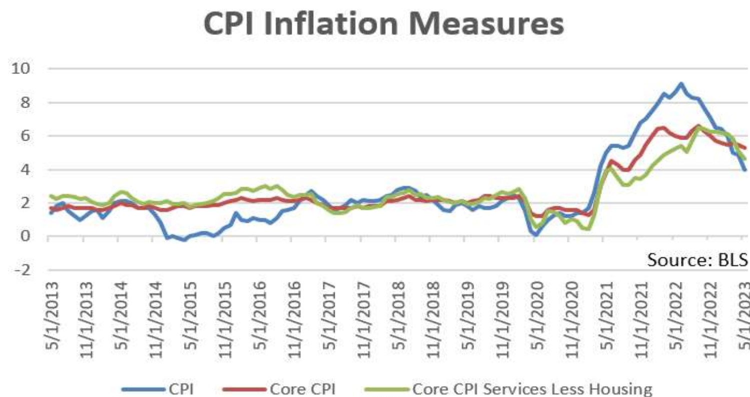
**Employment still too strong**

Another condition for lower interest rates is a definitive sign that the labor market is finally weakening. Early in the policy tightening process, Fed Chairman Powell described the potential for “pain” in the labor market in order to cool demand and bring inflation back to the 2% target. The Fed has made some progress on the labor front, but the jobs market remains too tight. Barring an unlikely economic soft-landing scenario, the unemployment rate will likely need to move from 3.7% currently to at least 4.5% and the three-month average non-farm payrolls fall from 283,000 to below 100,000 to restore balance to the labor markets. One early indication of softening in the labor markets is the gradual increase in initial jobless claims from an average of approximately 200,000 per week in recent periods to 240,000 currently. It will take time, but we believe the combined impact from tighter monetary policy, more restrictive bank lending standards, and weaker corporate profits should bring employment supply and demand back in balance.



**Inflation – Slow improvement**

The May CPI inflation report showed the Federal Reserve's campaign to cool inflation is working, but more slowly than hoped. Headline CPI inflation on an annual basis fell to 4.1%, a reduction by more than half the peak of 9.1% in June of last year. On the other hand, Core CPI, which excludes food and energy prices, has remained stubbornly strong. Core CPI is currently 5.3%, well above the Federal Reserve's 2% target, propped up by elevated used car and shelter prices. Good news came from the Core CPI services less housing category, a particular focus of the Federal Reserve for its link to employment, which declined to 4.6% in May compared to a 6.2% annual rate to start the year. Prices are "stickier" than anticipated and remain a long way from the Fed's 2% objective, but importantly for interest rates the peak for inflation has passed, and the direction is downward, albeit at a slower pace than desired.




**Conclusion**

We recently increased our portfolio duration based primarily on attractive valuations with 10-year US Treasury yields at the top end of the trading range of 3.75%. With inflation trending lower and the Federal Reserve soon to be on hold, we believe the haze is starting to clear setting the stage for a rally in interest rates. A meaningful softening in the labor markets, which we expect before the end of the year, should be the catalyst for bringing sunny, clear skies and significantly lower interest rates to the bond market.

**Past performance is no guarantee of future results.**

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