WEALTH MANAGEMENT / JEFFERIES INVESTMENT ADVISERS

Mid-Year Outlook

Jefferies

MANAGED FIXED INCOME

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The views represented in this piece are solely those of the wealth management managed fixed income team and may not reflect the views of other groups within Jefferies.

KEY TAKE-AWAYS | Q2 MANAGED FIXED INCOME QUARTERLY INVESTMENT MEETING

As we look forward, the timing of Fed cuts and the US Presidential election are top of mind.

- We anticipate the Fed will cut interest rates twice by year-end, with the first cut in September followed by another in December.
- Our baseline outlook over the next 12 months points to a constructive environment for fixed income assets with mid-to-high single-digit returns.
- Risks to the US economic outlook have increased as the US labor market has moderated, and monetary policy remains restrictive. We view the probability of a recession over the next twelve months as slightly above the historical average of 15%.
- We forecast heightened asset price volatility over the next several months due to US election uncertainty and the prospect of single party control of both the executive and legislative branches.

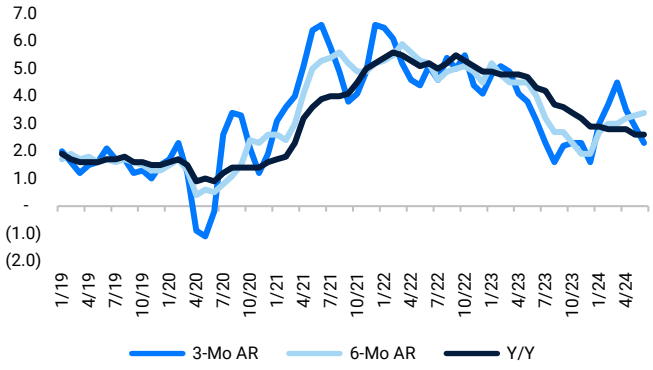
Our View | Outlook for Second Half of 2024

Our base case continues to be that positive labor market and inflation data will allow the Fed to cut interest rates starting in September. We also expect the US election in November to drive heightened asset price volatility in the coming months as markets anticipate the policy implications of both candidates. Risks to the economic outlook remain and will likely increase over the remainder of the year. We are extending maturities in liquidity portfolios but maintaining a neutral duration stance in our bond strategies. Sector and security selection will continue to be differentiating factors, while short-term performance is likely to be driven by interest accruals and rate movements. In short, we expect mid-to-high single-digits returns over the next 12 months.

Macro | Rates | Fed

At the end of 2023, inflation appeared to be rapidly approaching 2% (see Chart 1), resulting in market expectations of six interest rate cuts for 2024 and a US Treasury 10-year yield of 3.88%.

Chart 1 | U.S. Inflation (PCE Core Price Index[1])



Source: US Bureau of Economic Analysis, Personal Consumption Expenditures (PCE) Index, ex Food & Energy. As of 7/26/24.

Our year-end 2023 perspective was more cautious, with an expectation of only two-to-three cuts in 2024 due to the uncertain trajectory of inflation. The first three months of the year reflected an increase in the pace of inflation across a broad set of underlying categories but, since the first quarter, recent inflation data has aligned with what the Fed needs to see to feel confident in lowering interest rates. Looking ahead, we expect inflation to gradually decrease toward 2%, primarily attributable to falling housing rents. In that scenario, we anticipate the Fed will cut rates in September and December. We expect GDP growth to settle around 2% and the labor market to be in equilibrium with the unemployment rate around 4%. The current levels of job openings, hiring and quits rates, and wage growth supports this view. As election day nears, the US election is expected to exert greater influence on market pricing as future tax, trade, and regulatory policy move to the forefront.

With the backdrop of expected Fed cuts, we are cognizant that the inverted yield curve means negative carry until front-end rates decline. As such, we are maintaining a neutral duration position across our longer-dated strategies. In liquidity management portfolios, however, we see benefit in extending maturities to stabilize portfolio accruals in the likelihood of lower interest rates.

Credit | Sector Positioning

In line with the strength of equity markets year-to-date, US Corporate Investment Grade issuer spreads have trended lower due to strong operating metrics and a buoyant US consumer. We expect spreads at year-end to be largely unchanged and near their historically low levels.

With respect to US Corporate Credit, we continue to favor financials and select utilities over industrials due to healthier balance sheets and more attractive valuations. Within financials, Global Systemically Important Banks (GSIBs) offer compelling yields levels when compared to regional banks and consumer finance companies. This partly reflects the slow but notable deterioration in commercial real estate, and the softening in consumer sectors as seen in credit card and auto loan delinquency rates. US Corporate debt new issue supply is expected to downshift over the second half of the year, with net supply being relatively flat. Issuer fundamentals have softened over the past 12 months with leverage moving higher and interest coverage trending lower.

In municipals, while state-level tax receipts have softened in some areas (e.g., California) credit quality remains strong and rainy-day funds are near historical highs. Differentiation in credit is less notable in the market than bond structure and we continue to find value in 4% coupons with 4+ years of call protection. We covered this topic in depth last month (listen to our July 3, 2024 audiocast).

Our View | Strategy Update

Looking beyond expected rate cuts and asset price volatility related to the election, we see a constructive opportunity to allocate to fixed income with the prospect of mid-to-high single-digit returns. Specifically, multi-sector portfolios should continue to offer relative value opportunities and municipal bonds should remain compelling on both a nominal and relative basis for tax-sensitive investors.

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