Daily: Quality bonds should find support from cooling inflation

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From the studio

Podcast: AI's impact on the economy, Fed, and portfolios, on Apple and Spotify (7 mins)Video: Three reasons why we find Japanese equities attractive (6 mins)Video: CIO's James Cheo on the case for Singapore equities (5 mins)

Thought of the day

Oil prices extended their recent gains on Wednesday amid pessimism about a swift resolution to the conflict in the Middle East. While Pakistan's defense minister said the US and Iran are "close to some sort of arrangement" over the Strait of Hormuz, the US and the Houthis in Yemen reported separate attacks on shipping. Brent crude oil was trading near USD 90/bbl at the time of writing, and the 10-year US Treasury yield remained elevated near 4.7%.

The geopolitical uncertainty has kept investors cautious, especially ahead of crucial US inflation data due later today. With Federal Reserve Chair Kevin Warsh having reiterated that the US central bank would "not hesitate to act" where "necessary and appropriate," any print that points to a reacceleration of price pressure is likely to upset markets.

Our expectation is that core inflation trends should continue cooling, allowing the Fed to keep interest rates steady for the remainder of this year. This backdrop is supportive of quality fixed income.

Inflation should moderate further as the year progresses. The July CPI report is expected to show a second consecutive decline in annual inflation, with headline CPI forecast to ease to 3.4%, from 3.5% in June. Core inflation is also expected to move lower, with the annual rate seen easing to 2.5% from 2.6%, which would mark the smallest annual increase since February. While oil volatility remains a risk, we do not currently see higher energy prices as a source of sustained underlying inflationary pressure. Further disinflation in core goods and services should reduce some pressure on policymakers to deliver imminent rate hikes.

The labor market is not a source of inflationary pressure. The acceleration in job growth in the first half of the year did not extend into July, with a decline in nonfarm payrolls bringing the three-month average gain in jobs back within the estimated breakeven range, the pace of job growth needed to keep the unemployment rate steady. While the unemployment rate fell to 4.1%, it partly reflected lower labor force participation rather than a clear sign of overheating. Wage growth also softened, to 3.2% year over year, its weakest pace in more than five years. This should help alleviate concerns about demand-driven inflation pressure, keeping the Fed from adopting a more aggressive policy stance.

High starting yields make for an attractive entry point. Recent bond market weakness has led some investors to question whether it makes sense to lock in yields, but high starting yields can offset part or all of an initial price decline, subject to issuer credit risk. Our analysis shows that US Treasury yields in the preferred two- to five-year segment would need to rise by between 100 and around 230 basis points from current levels for falling bond prices to cancel out income returns. In our view, elevated yields provide a material cushion against further rate increases before potential losses are realized.

So, we continue to view quality fixed income as both a source of income and a portfolio hedge, favoring short- to medium-maturity bonds. Investors seeking a more diversified income approach can also consider select exposure to high yield and emerging market credit, as well as equity income strategies.

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