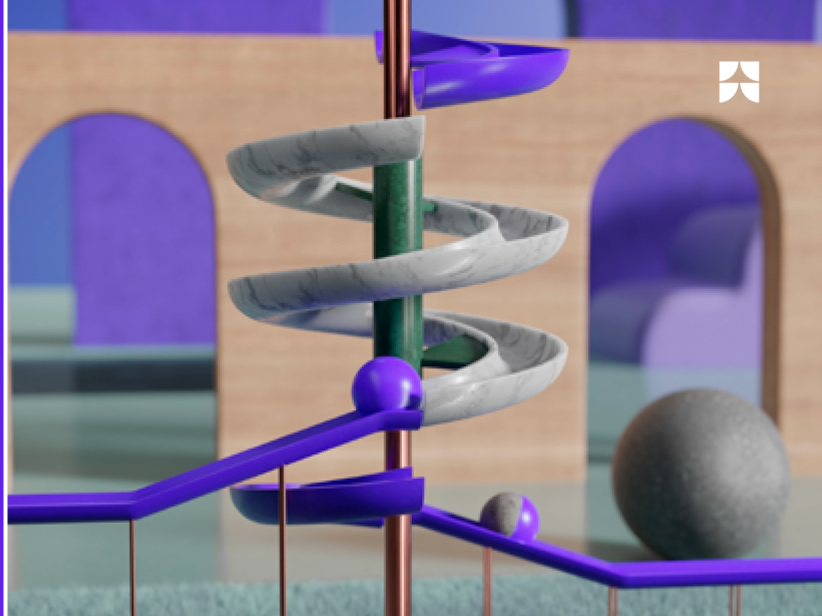
RIDING THE CURVE

A balancing act:

Fixed income playbook for 2H 2023



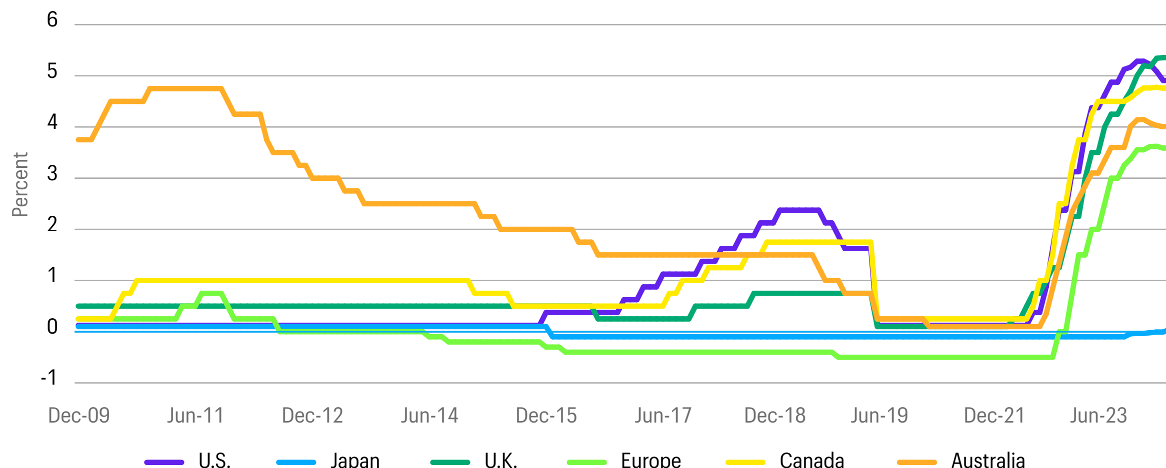
GEORGE BORY, CFA
+ Chief Investment Strategist
+ Fixed Income

Fixed income investors are in the hot seat as inflation pressures, fragmented growth, and political strains present ongoing global challenges. For many, yield-based strategies can help investors pursue attractive total returns, preserve capital, and maintain adequate levels of liquidity.

BACKGROUND

Higher yields have boosted returns in many bond portfolios to date this year, helping investors weather economic uncertainties that continue to unfold around the world. Inflation remains hot in both Europe and the U.K., and core inflation in the U.S. remains sticky—this is keeping central banks in inflation-fighting mode. However, an inflection point may have been reached in the first half of 2023, when central banks had to begin dealing with challenges beyond fighting inflation as global growth slowed and cracks appeared in the financial system. The liability-driven investing crisis in the U.K. last autumn made the first kink in the armor. This was followed by the failure of Silicon Valley Bank in the U.S. and the forced merger of Credit Suisse with UBS in Europe this spring. Questions remain about banking system stability. In our view, these events reflect a general increase in financial market risk following the aggressive monetary tightening cycle that began in 2022. As a result, regional economies have desynchronized and pulled capital away from U.S.-dollar-denominated bonds. Many non-U.S. investors are choosing to remain invested in their domestic currencies, and some U.S. investors are following suit and diversifying away from the dollar.

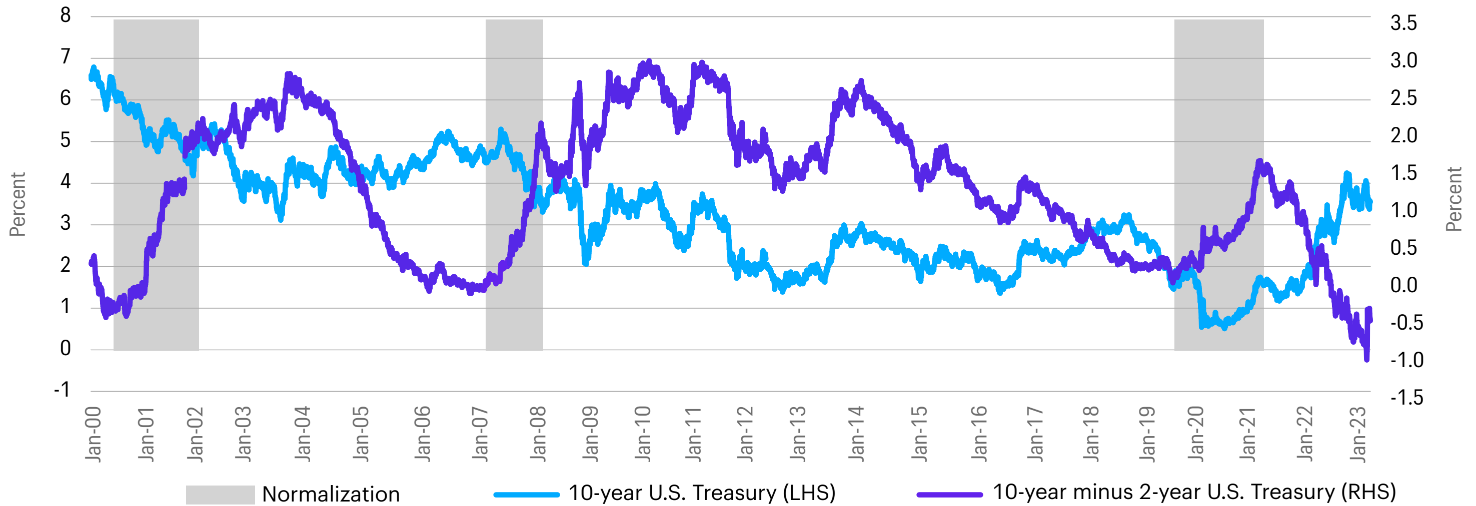
FIGURE 1: CENTRAL BANK POLICY RATES AND FORWARD EXPECTATIONS



Source: Bloomberg. Data presented from 31-Dec-09 through 31-May-23. Market implied forecast from 30-Jun-23 through 31-Dec-23.

Looking forward, policymakers must walk a tightrope, balancing weakening growth prospects and financial system fragility against persistent inflationary pressures. We may currently be working through a period of "slowflation," which represents slowing growth and persistent inflation. It remains to be seen if this ultimately transitions to stagflation (no growth and persistent inflation—our base case), a hard landing (outright recession), or a soft landing (accelerating growth and receding inflation). With such wide divergence in plausible outcomes, we think portfolios optimized for high income and some interest rate exposure may be the sweet spot for generating attractive risk-adjusted returns in this macro environment.

FIGURE 2: YIELD CURVE NORMALIZATION*



Source: Bloomberg. Data presented from 03-Dec-00 through 30-Mar-23. *A normal yield curve is upward sloping, or when long-term rates are higher than short-term rates.

Beyond the inflection point

Many bond investors are looking for less volatility and the return of more stable and predictable returns after a difficult 2022. Bonds of many different stripes and flavors have historically provided 1) attractive income generation, 2) a buffer against volatility, and 3) diversification against cyclical risks. High-quality bonds are particularly well positioned to pursue stable income and attractive yields to offset volatility. Publicly traded bonds should provide an attractive alternative to more cyclical assets such as equities and to less liquid assets such as private debt in the next several years.

Beyond the inflection point in monetary policy, we think bond investors should focus on building out five key strategies going forward. We discuss these in turn below.

01 **Position for yield curve normalization** → Add duration

02 **Seek to maximize yield** → Use income to drive total returns

03 **Stay up in quality** → Use structured products to seek to reduce risk

04 **Pursue stability** → Use municipal bonds to seek to reduce volatility

05 **Pursue global yield** → Diversify beyond the U.S. dollar

01

POSITION FOR YIELD CURVE NORMALIZATION: ADD DURATION

With the Fed much closer to the end of its rate-tightening cycle than the beginning, fixed income investors should start to position for normalization of the yield curve. Adding duration should benefit portfolios if yields fall, as we expect they will. The opportunity cost of waiting for a perfect entry point is high and difficult to time.

> "Falling intermediate rates should steepen the investment-grade credit curve and drive returns. Tighter monetary policy and credit conditions within the banking sector will likely contribute to ongoing volatility in credit spreads. Opportunities within structured products are mixed, but we favor quality, a liquidity bias, and opportunities to diversify away from consumer-backed debt. Overall, diverging fundamentals among issuers and higher volatility should provide ample selection opportunities for the balance of 2023.

SCOTT SMITH, CFA
+ Senior Portfolio Manager
+ Head of Investment Grade Income

02

SEEK TO MAXIMIZE YIELD: USE INCOME TO DRIVE TOTAL RETURNS

Income remains the primary driver of returns for any fixed income portfolio. The most efficient way to harvest income opportunities is to maximize income per unit of risk at various locations along the yield curve and among various credit sectors. Currently, the flatness of the curve means that income is most attractive on the front end, and this is particularly true for lower-rated segments of corporate and structured product markets.

> "With the rise in short-term interest rates and recent widening of credit spreads, European loans stand out for their ability to offer attractive levels of income. All-in yields for this asset class are near 9% at the time of this writing. In addition to their portfolio diversification benefits, European loans offer creditor protection through their senior-secured status, and defaults are expected to remain below historical averages in the next 12 months. Moreover, a lack of new supply and strong demand for loans should provide strong price support.

JENS VANBRABANT, CFA
+ Senior Portfolio Manager
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03

STAY UP IN QUALITY: USE STRUCTURED PRODUCTS TO SEEK TO REDUCE RISK

Slowing growth and a lack of expected monetary and fiscal policy support suggest that moving up in quality will be attractive. Corporate credit fundamentals are deteriorating, as evidenced by rising leverage, declining interest coverage, and rising default rates. Collateralized pools of receivables can provide higher-quality cash flows than bonds that are dependent on only one issuer. We expect that higher-quality cash flows will likely outperform in the foreseeable future. Evidence of quality includes collateral coverage, cash flow generation, healthy balance sheets, and financial flexibility. Dispersion among issuers on these quality metrics should create many attractive selection opportunities across structured products.

04

PURSUE STABILITY: USE MUNICIPAL BONDS TO SEEK TO REDUCE VOLATILITY

Healthy fundamentals and strong technicals should support municipal bonds this year. Municipalities are still basking in the glow of $5 trillion in federal support paid out from COVID-19-era stimulus. Higher yields raise the value of the municipal bond tax exemption, creating technical support for the asset class that can offset overall bond market volatility. We caution that municipals are not immune to cyclical trends—for example, we expect that municipal credit spreads will widen if the economy slows down. However, tax revenue streams are generally more stable than corporate revenue streams (at least initially), and some municipal issues that support public services, like water and sewer, are often much less affected by cyclical factors that might wreak havoc on a typical industrial company.

05

ADD GLOBAL YIELD: DIVERSIFY BEYOND THE U.S. DOLLAR

Global capital flows continue to seek diversification, and they are finding attractive value within the deep and broad European credit markets. Stubborn inflation is beginning to subside with falling input prices, which is boosting business confidence. Moreover, the eurozone economy, while growing very slowly, is showing some signs of acceleration in the second quarter. However, as in other developed regions, policymakers must balance sluggish growth against still-resilient price pressures.

> “ Yield has returned to higher-quality, liquid segments of European fixed income markets through a combination of higher government bond yields and wider credit spreads. We think this presents an opportunity for European and global bond investors to return to euro-denominated credit after many years of sourcing yield globally. The size of European credit markets offers significant diversification opportunities as well. Currently, European investment-grade debt yields about 4%, and yields rise close to 6% when hedged back to the U.S. dollar.

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We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

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