U.S. Fixed Income
Q3 2022 Update

October 2022

Three quarters of 2022 are in the books, and it is certainly three quarters fixed income investors would all like to forget. As has become our custom, we present a Market Scorecard to document what has occurred across fixed income markets. The numbers are breathtakingly bad and putting them (once again) in a historical context, the bond vigilantes have delivered on the worst three quarter stretch (for some sectors) ever. The broad corporate market, for example, has seen its worst three quarters in succession since inception of modern corporate indices. The same can be said for the broad US Treasury market. At this point, however, we are beginning to see the light at the end of the tunnel.

Authors

Noel McElreath, CFA
Director, Sr. Portfolio Manager, U.S. Fixed Income

Charles L. Curry, Jr.
Managing Director, Sr. Portfolio Manager, U.S. Fixed Income

Table 1 Xponance Market Scorecard

	ICE Corporate			ICE High Yield			ICE Corp, Gov't & Mtge		
	OAS	$ Price	Yield to Worst	OAS	$ Price	Yield to Worst	OAS	$ Price	Yield to Worst
12/31/2021	98.00	$109.14	2.36	301.00	103.49	4.24	32.00	$105.36	1.71
3/31/2022	122.00	$99.95	3.63	332.00	97.05	5.93	41.00	$98.37	2.88
6/30/2022	164.00	$92.30	4.71	570.00	85.77	8.77	54.00	$93.19	3.65
9/30/2022	167.00	$86.78	5.71	516.00	83.90	9.28	56.00	$88.02	4.67

	ICE Corporate		ICE High Yield		ICE Corp, Gov't & Mtge	
	Total Return	Excess Return*	Total return	Excess return*	Total return	Excess Return*
12/31/2021	0.170	-0.402	0.706	1.016	0.103	-0.169
3/31/2022	-7.738	-1.772	-4.526	-0.458	-6.102	-0.866
6/30/2022	-6.708	-2.533	-9.915	-8.052	-4.621	-1.070
9/30/2022	-5.110	0.100	-0.686	2.813	-4.921	-0.172
YTD Annualized	-18.326	-3.739	-14.582	-8.137	-14.848	-1.906

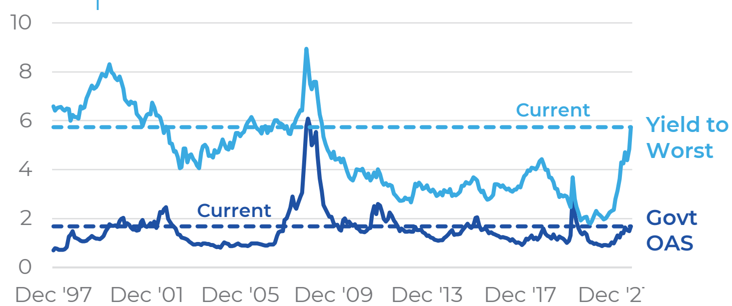
Select United States Treasury Yields

	2-year	5-year	7-year	10-year	20-year	30-year
12/31/2021	0.732	1.263	1.436	1.51	1.933	1.903
3/31/2022	2.335	2.460	2.429	2.338	2.599	2.448
6/30/2022	2.953	3.038	3.068	3.013	3.434	3.183
9/30/2022	4.279	4.090	3.981	3.829	4.088	3.776

*vs equivalent duration Treasuries
Source: Bloomberg, ICE Indices, Xponance

We continue to believe that risk assets could see spreads widen given our underlying view of the domestic (and global) economy. Overall yields, however, are significantly more attractive than they have been for an extended period. Looking at yields for the broad corporate investment grade market, for example, current yield levels are higher than at any point since the immediate aftermath of the Great Financial Crisis. At 5.74% at quarter-end, this is the first month-end reading above 5% for the ICE BofA corporate index since 8/31/2009. There are clear and obvious differences between the two time periods (relatively tight spread levels being the main difference now) but yields currently on offer are beginning to present a case for compelling forward returns. Given fairly tight spread levels against what is likely a recessionary backdrop, the real question at hand is whether yields stay fairly stable with rates falling and spreads widening? Or, does the macroeconomic backdrop (including potentially higher structural inflation) portend stable or upward pressure on rates while spreads are simultaneously widening? The answer has real implications for sector, curve and rating exposures.

Chart 1 | **IG Corporate Yields and Spreads**



Source: Bloomberg, ICE BofA Indices, Xponance

One way we attempt to decipher value in such an uncertain environment is by looking at yield and spread breakevens, defined as the yield increase or spread widening that a bond can take before the yield is overwhelmed by negative price return. We discuss this and other value propositions in **Table 2**.

Table 2 | **Yield and Spread Breakevens**
Dec 2009 to Present

	High Yield Corps	Inv. Grade Corps	Broad market*	ABS	MBS	Taxable Muni
Current	2.20	0.84	0.74	2.49	0.75	0.55
Mean	1.53	0.47	0.40	0.94	0.66	0.37
Min	0.95	0.21	0.16	0.43	0.37	0.20
Max	2.20	0.84	0.74	2.49	1.73	0.59
St Dev	0.27	0.12	0.12	0.40	0.19	0.09
Z-score	2.45	3.01	2.76	3.83	0.47	1.94

	AAA Corps	AA Corps	A Corps	BBB Corps	BB Corps	B Corps	CCC Corps
Current	0.51	0.64	0.82	0.91	1.68	2.51	4.42
Mean	0.30	0.39	0.43	0.53	1.08	1.71	3.25
Min	0.11	0.15	0.18	0.25	0.63	1.27	2.22
Max	0.58	0.69	0.82	0.91	1.68	2.51	6.15
St Dev	0.10	0.12	0.12	0.13	0.21	0.28	0.76
Z-score	2.25	2.01	3.14	2.90	2.90	2.90	1.54

Current	High Yield 1-3 yr	High Yield 1-5 yr	High Yield 1-10 yr	Inv. Grade 1-3 yr	Inv. Grade 1-5 yr	Inv. Grade 1-10 yr	Inv. Grade 10+ yr	Tax Muni 1-3 yr	Tax Muni 1-5 yr	Tax muni 1-10 yr	Tax muni 10+ yr
Mean	4.83	3.65	2.31	2.76	2.01	1.37	0.47	2.23	1.69	1.17	0.50
Min	3.79	2.78	1.68	0.98	0.80	0.64	0.34	1.18	0.93	0.69	0.36
Max	1.77	1.73	1.09	0.30	0.28	0.26	0.18	0.23	0.24	0.24	0.20
St Dev	8.13	4.35	2.38	2.76	2.01	1.37	0.53	4.13	1.69	1.17	0.57
Z-score	0.96	0.51	0.29	0.44	0.29	0.18	0.08	0.49	0.32	0.21	0.09

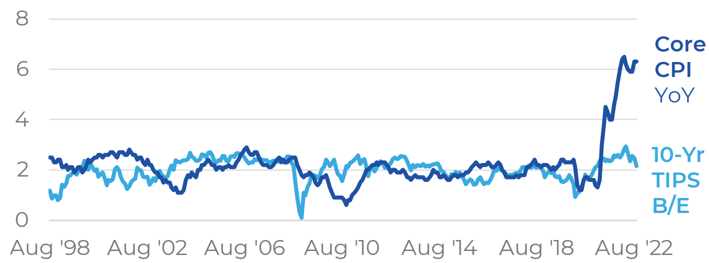
** ICE BofA Corporate, Government and Mortgage

Source: Bloomberg, ICE BofaA Indices, Xponance

A host of factors are emerging to present opportunities across the fixed income markets. As noted above, spread and yield breakevens are beginning to show value in a few select places. Further, even sector, maturity and rating bands that were extremely unattractive by this metric are moving towards investability (when analyzing the period immediately following the GFC to the present). If we look over the shorter term, breakevens look even more attractive. Mortgage-backed securities and high yield corporates look the least attractive by these measures, while short and intermediate investment grade corporate bonds seem to provide good value. As is generally the case, longer duration instruments seem unattractive, though a steepening in the Treasury and/or credit curves will provide a nice entry point as we get deeper into the business cycle. As noted in last quarter's update, low dollar prices for much of the fixed income universe also present a unique risk/reward, somewhat akin to the post-GFC period (and most prevalent in long-dated assets, providing a counterpoint to the breakeven story). Lastly, given the move in rates during 3Q22, these dollar prices are even more attractive now.

As our Founder and CEO/CIO discusses in her Q4 2022 Market Outlook entitled The Times They Are A-Changin', structural inflation could well be on the rise after decades of secular disinflation. If this is truly the case, as we believe, then Treasury Inflation Protected Securities (TIPS) also present a compelling longer-term investment opportunity. Breakeven levels have come down from well north of 3% to around 2.25% for intermediate tenors (specifically the 5-year and 10-year points along the curve). As a reminder, TIPS breakevens represent the difference between the yields on TIPS as compared to the nominal Treasury of the same maturity (and distinct from the yield and spread breakevens discussed above). Short-term sentiment and technical factors often drive trading in the relatively small and illiquid market for TIPS, but current levels of inflation protection seem very low against an inflationary regime change. We looked at a range of inflation indicators, including trimmed mean and sticky CPI measures as well as the more familiar core Consumer Price Index, but these all present a similar story. From a trading perspective, TIPS often do not perform as advertised (see **Chart 2**). It is worth noting, however, that TIPS performance is predicated on the inflation accrual in addition to market movement. Inflation that runs consistently above these relatively low breakeven levels is a winning trade.

Chart 2 | **10-year TIPS Breakevens vs Core CPI**



Source: Bloomberg, Bureau of Labor Statistics, Xponance

2022 has been a year of trying to use volatility to find trades that were relative winners against the unrelenting backdrop of rising rates and widening risk premia, understanding that the overall return picture has been bleak. By its very nature, fixed income cannot lose forever, and we are beginning to see the outlines of a positive return stream. While we may not see this for the remainder of the year, we can continue to add higher yields in relatively defensive corners of the market. This should help to propel returns into 2023. Garnering outsized yields in short maturities can help to insulate against the next few moves by the Federal Reserve, and we can slowly rotate into these from the floating rate securities that have helped to insulate some of the upward moves in the Fed Funds rate. At some point, high yield will fully price in a worsening default picture and these securities should allow for outsized performance as this happens. While we remain cautious, we do finally see a hint of blue sky on the horizon. And this most welcome sight cannot come soon enough!