U.S. Fixed Income

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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

For fixed income markets, volatility remains the recurring theme across fixed income markets. We have discussed this for more than a year, and we are once again left to contemplate volatility around the market direction narrative versus realized volatility in fixed income markets. Bond practitioners have been discussing **bond market stress** with their clients since the tightening campaign began in earnest early in 2022 (and the recent banking system stress is really the other side of the same coin). It takes about a year for a tightening to have significant economic impacts, and signs are emerging that the effects are now spreading and deepening. A key way that tightening cycles slow economic activity is by creating breaks in the excesses that have built up through the cycle. The recent bank failures and the cracks we see emerging in the startup ecosystem and commercial real estate (CRE) sector are the latest examples of this and will have ripple effects for investors and the economy. As we write this, however, markets look (on the surface) as if they have largely ignored the recent banking system turmoil.

Therefore, we thought it would be a worthwhile starting point to evaluate returns and characteristics for the major fixed income indices as compared to both recent history and the trailing five-year period. The significant amount of interest rate volatility seems old hat at this point, but we also provide a historical perspective to put 1Q23 in context. Further, the change in expectations for the path of interest rates provides an interesting perspective on a bifurcated outcome for further moves by the Federal Open Market Committee (FOMC). When we look at risk premia from a granular perspective and in a relative and comparative context, there are a range of near-term threats that could potentially morph into investment opportunities. Dispersion among sectors within the corporate index, for example, is increasing even with the recovery of many corporate sector spreads between early March and quarter-end. Further, spread differentials for the more esoteric securitized corners of the broad investment grade market also provide a granular perspective surrounding potentially deteriorating fundamentals in these asset classes. Lastly, we attempt to make sense of these developments in the context of the outlook and opportunities for fixed income over the next few quarters.

The **Xponance Market Scorecard** depicts where we are and where we have been in terms of spreads, yields, and returns (see **Table 1**). As compared to year-end 2022, investment grade spreads widened marginally, while high yield spreads tightened modestly. Given the moderation in interest rates, this dynamic has led yields to fall across most subsectors of the broad bond market. Dollar prices for the major indices (and subcomponents of them) remain deeply discounted but have recovered from the lows reached at the peak in rates last year. Absolute levels of spreads, while slightly cheap to the 5-year average, still look expensive as compared to recessionary periods or the near-term wides reached last summer. Spread and yield break-evens, however, do look relatively attractive as compared to recent history in the sense that a larger cushion against upward moves in either yield or spread is available.

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	$109.14	2.36	301	$103.49	4.24	32	$105.36	1.71
6/30/2022	164	$92.30	4.71	570	$85.77	8.77	54	$93.19	3.65
12/31/2022	138	$89.09	5.51	475	$86.02	8.94	51	$89.08	4.67
3/31/2023	144	$91.41	5.24	449	$88.12	8.37	63	$91.23	4.38
5-year mean^	129	$104.09	3.36	423	$97.26	6.22	48	$102.72	2.56
5-year max.	305	$115.93	6.00	873	$105.38	9.37	111	$112.85	4.95
5-year min.	86	$85.48	1.78	298	$83.81	3.80	26	$86.60	1.03

	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	-0.95	1.527	5.291	6.725	-1.624	0.253
12/31/2022	-15.444	-1.370	-11.105	-2.905	-13.310	-0.971
2023 YTD**	3.448	0.311	3.678	1.352	3.004	0.026

Select United States Treasury Yields

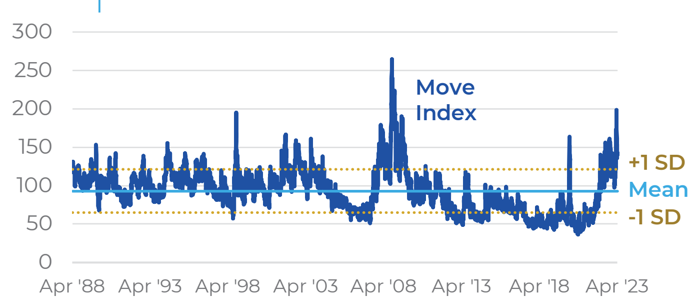
	2-year	5-year	7-year	10-year	20-year	30-year
12/31/2021	0.732	1.263	1.436	1.51	1.933	1.903
6/30/2022	2.953	3.038	3.068	3.013	3.434	3.183
12/31/2022	4.429	4.005	3.969	3.877	4.147	3.966
3/31/2023	4.025	3.573	3.531	3.468	3.795	3.650

^ 5-year analysis uses month end data * vs equivalent duration Treasuries ** 2021 and 2022 full year, 2023 annualized

Source: Bloomberg, ICE Indices, Xponance

Despite what seems like an orderly move lower in rates coupled with inflation moving down from the high-water mark of mid-2022, interest rate volatility remains extremely elevated by historical standards. The MOVE index remains near levels that were only previously reached during the Global Financial Crisis (GFC) (see **Chart 1**). The MOVE index measures fear in the bond markets and uncertainty in rates. Typically, it is reasonably correlated to the equity market VIX except during inflection points in the business cycle or atypical scenarios such as the GFC or pandemic. These risk-off scenarios presage risk widening across our sectors. This Move index volatility is particularly acute given its composition of short-dated options across the maturity spectrum in concert with an inverted yield curve which all leads to an impending bifurcated outcome as we approach the Fed terminal rate.

Chart 1 MOVE Index Since Inception

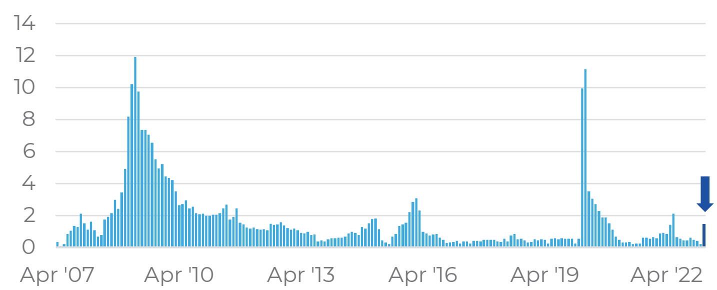


Source: Bloomberg, Xponance

Moreover, and as noted above, there has been a marked change in the market's outlook for interest rates going forward. Market sentiment about a potential near-term reversal of the FOMC tightening campaign has been a volatile indicator by itself but is currently pricing in potential rate cuts by 3Q23 (and the potential for 50bps of cuts by year-end). Our view is that this is a bifurcated outcome (i.e. either no cuts will occur or a significant amount of easing will), as we believe the Federal Reserve will not begin to cut rates absent a significant decline in economic activity or an unforeseen capital markets crisis. Though base effects should allow inflation to moderate through June (for the July data print), many economists predict a potential pause in disinflation after those two monthly data points.

We track a dataset for corporate bond sectors whereby we look at the dispersion of spreads across level 4 subsectors of the corporate market. During much of the business cycle, the range of spreads from the widest subsector to the tightest subsector is typically in line with the overall spread on the corporate index. This is obvious when one thinks of investor behavior (chasing yield during low volatility periods) and the construction of the indices (market value weighted by cusip). Periods of economic and/or market dislocation tend to result in a wider spread range, even when the overall spread levels are still relatively low and well behaved. At the end of March, for example, the OAS on the corporate index is in the middle of the range it has been in since the beginning of 2022, yet index OAS dispersion is at the highest level we have seen since the recent spread wides of mid-2022 (see **Chart 2**). If we take this analysis back to the GFC, dispersion increased dramatically during March 2023 but remains relatively low by standard statistical measures. It remains to be seen if this most recent dislocation in spread markets is the beginning of a trend or is simply a short-term anomaly related to fear of further bank failures.

Chart 2 | **Spread Range Less Corporate OAS**

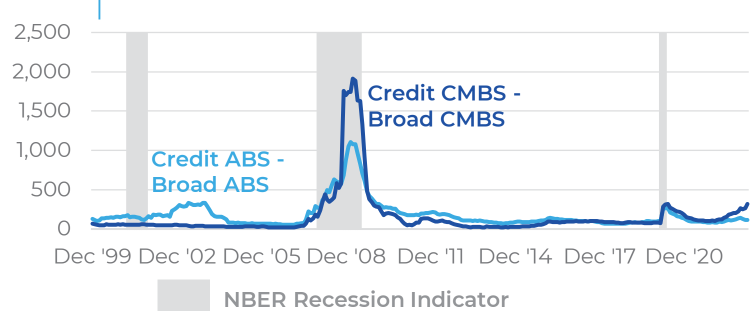


Source: Bloomberg Indices, Xponance

When we move beyond simple mathematical measures of dispersion into the stratification of the underlying subsector data we note that those sectors at the high-end of the spread range are those that are most affected by the increase in rates and the potentially changed nature of the economy post-pandemic. The widest spread sectors are in the broad financial subsectors, including insurance and REITS, which is to be expected. Given the index skew towards the largest banks, which have not widened in the most recent panic, the banking sector itself is roughly in line with the broader corporate index. This seems counterintuitive given the focus of the most recent panic. A handful of regional banks do remain very cheap, but this dynamic does not show up in our analysis. On the tight spread end of the spectrum, many typically defensive sectors remain tighter on a spread basis than the corporate index. These include various consumer non-cyclical subsectors like consumer products, food and beverage, etc. Interestingly, however, there are a range of economically sensitive sectors that also look expensive as compared to the broader index (i.e. automotive, manufacturing, and retailers) which is atypical during periods of FOMC rate increases and Treasury yield curve inversion.

While much of the top-line index data suggest no imminent problems for fixed income risk markets, we analyze the signals generated from risk premia in other spread markets (specifically private label securitized product) beyond the more conventional signals from interest rate and corporate markets. One indicator we track, for example, is spreads for "credit" CMBS (in this analysis, those CMBS rated below AAA) as compared to the overall CMBS index. We also track a similar metric for ABS (see **Chart 3**). CMBS "credit" tranches are widening as compared to the broader sector benchmark (and have been since 2Q22). The same

Chart 3 | **Credit ABS and CMBS Spreads**



Source: Bloomberg, ICE BofA indices, NBER, Xponance indicator for ABS widened throughout the second half of 2022 but has recovered since year-end. We are watching these metrics closely as a proxy for a potential risk-off tone in the less liquid spread markets should economic fundamentals deteriorate further. These sectors often represent the "canary in the coal mine" as together they account for around 2% of broad market indices but are part of a nearly $2 trillion investable market.

Admittedly, we at Xponance fixed income have been in the camp that says yield curve inversion is a reliable indicator of recession. But, as we have noted in previous commentaries, that does not necessarily mean we expect a deep or protracted economic downturn. While we are wary of tail risks given the extended period of ultra easy monetary policy coupled with the fiscal largess of the government covid response and pandemic-related changes to the economy, we cannot dispute the resilience of the U.S. economy (the labor market in particular). We began our quarterly review by viewing broad market metrics, and the conclusion remains that fixed income is a significantly more attractive investment opportunity than it was a year ago. From an asset allocation perspective, this factor should remain a tailwind for fixed income at the margin. Volatility has been the rule of the day for the broad fixed income markets, led by interest rate gyrations, but this market condition should wind down in conjunction with the end of the FOMC tightening cycle. More importantly, this should serve to reduce volatility in front-end rates markets but also remove the wild dislocations in short duration spread product. Despite the market's constant reassessment of timing of the end of the Federal Reserve's tightening cycle (or the beginning of a new easing cycle), we are still looking at a new phase of monetary policy regardless of timing. While we think the time to add lower-quality, higher-beta or less liquid sectors is not yet upon us, we also see potential near or intermediate term opportunities in the corporate and securitized sectors we discussed above. Individual corporate issuers and subsectors should allow for security selection to win out over broad market over-weights, and alpha opportunities should remain prevalent for nimble investors. We are more circumspect about the opportunities in the private label securitized areas of the market, as trading and valuation in these sectors often remains challenged until well after the more liquid spread sectors (i.e. corporates) have long since recovered.