

U.S. Fixed Income

Q2 2023 Update

July 2023

As we embark on the second half of 2023, we find a market in conflict. Despite the continued (relative) hawkishness by the Federal Reserve Open Market Committee (FOMC) and its members, most risk assets have continued to perform well. While interest rate volatility remains elevated, it has declined markedly from the levels reached near the end of 1Q23. Equity volatility has reached the lowest level since the FOMC began its tightening cycle. The correlation between equity volatility and credit spreads is well-known, and volatility will typically rise after the peak in the Federal Funds target rate. For the time being, however, the drop in volatility coupled with higher overall yields has produced positive sentiment for corporate bonds and other spread product (credit CMBS (Commercial Mortgage-Backed Securities), credit ABS (Asset Backed Securities) and capital securities are the exceptions). The fact that credit spreads continue to compress despite the massive increase in the Fed Funds target runs counter to the experience of the last three Fed tightening cycles, as spreads typically widen as the Fed approaches its terminal rate. Nonetheless, current market conditions have provided a solid backdrop for returns (see [the Xponance Market Scorecard](#), below). There are a range of ways to assess the yield on offer today. For investment grade markets, **dollar prices** have never been this persistently low for any period of time. High yield markets, which tend to exhibit significantly greater price variability (both to the discount and premium side of par) than investment grade, are experiencing low dollar prices as well. Only the Global Financial Crisis produced a period of lower dollar prices for high yield. Looking at **yields** in isolation, investment grade fixed income looks attractive, especially if we add spread break-evens into the calculus. Overall spreads are, however, relatively unattractive against a backdrop of the still unseen effects of greater than 500 basis points of increases in the Fed Funds rate. These data send conflicting signals around relative value, but also potentially provide trading opportunities and strategies that have rarely been present in our markets.

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Table 1 | Xponance Market Scorecard

	ICE Corporate			ICE High Yield			ICE Corp, Gov't & Mtg		
	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
12/31/2022	138	\$89.09	5.51	475	\$86.02	8.94	51	\$89.08	4.67
3/31/2023	144	\$91.41	5.25	449	\$88.12	8.44	55	\$91.23	4.38
6/30/2023	130	\$90.59	5.57	401	\$88.73	8.52	50	\$89.97	4.81
5-year mean [^]	130	\$103.58	3.36	427	\$96.76	6.33	49	\$102.22	2.63
5-year max.	305	\$115.93	6	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 & Mtg	
	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**	3.232	1.703	5.341	4.175	2.145	0.653



Select United States Treasury Yields

	2-year	5-year	7-year	10-year	20-year	30-year	10-2 Slope
12/31/2021	0.732	1.263	1.436	1.51	1.933	1.903	0.778
12/31/2022	4.429	4.005	3.969	3.877	4.147	3.966	-0.552
3/31/2023	4.025	3.573	3.531	3.468	3.795	3.650	-0.557
6/30/2023	4.895	4.156	3.993	3.837	4.072	3.860	-1.058
YTD Change	0.870	0.583	0.462	0.369	0.277	0.210	-0.501

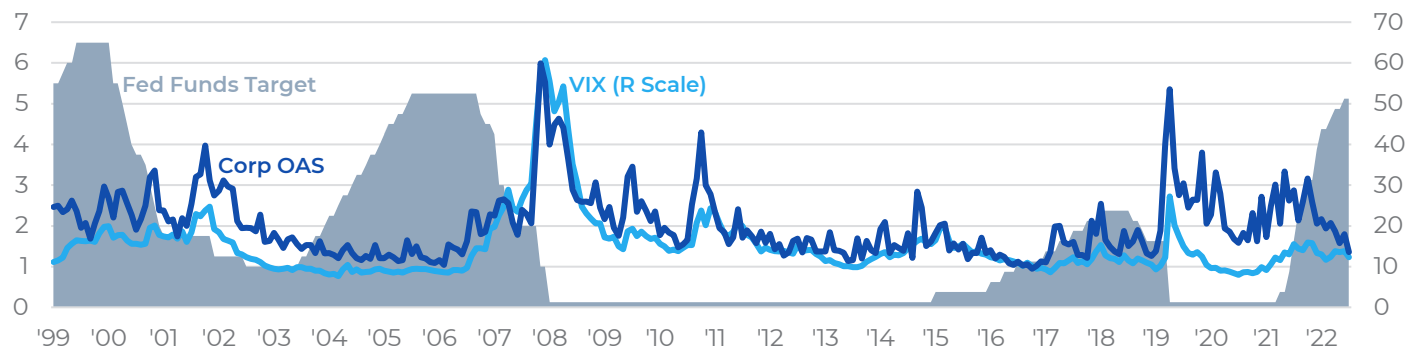
Option Adjusted Spreads (OAS) for Select ICE Sector/Rating Indices

	Inv. Grade Corps	BBB Corps	High Yield Corps	CCC Corps	AA-BBB ABS	AA-BBB CMBS	Capital Securities	AAA-A EM Corps	BBB EM Corps
Current	130	161	401	933	255	610	243	103	210
5-year mean [^]	130	164	427	943	216	285	203	119	235
5-year maximum	305	396	873	1,799	599	610	424	226	495
5-year minimum	86	107	298	545	128	155	100	93	177
Current-Mean	0	(3)	(26)	(10)	39	325	40	(16)	(25)

[^] 5-year analysis uses month end data * vs equivalent duration Treasuries ** 2021 and 2022 full year, 2023 annualized
 Source: Bloomberg, ICE Indices, Xponance

Given how orderly markets have been thus far in 2023, we remain wary about the outlook for fixed income risk assets over the remainder of the year from a spread perspective. As noted above, volatility has subsided as we near the end of the monetary tightening campaign. We do not believe policy will immediately pivot to an easing stance after the final increase in the Fed Funds rate, but risk markets do seem to be pricing in a “no landing” scenario for the economy. When we parse interest rate sensitive economic data, (i.e., auto loans, credit card rates, mortgage rates), there is little reason to believe that this tightening cycle’s sharp increases in interest rates will not filter through to the real economy. As such, the “no landing scenario,” is unlikely, making the conflicting signals from the Treasury market and risk markets untenable. The relationships between equity markets, credit markets, the yield curve, the fed funds rate, etc. are the result of historical experience as markets react to reduced economic activity (see [chart](#), below). We expect these relationships to normalize as the economic cycle plays out.

Chart 1 Corporate Spreads vs VIX and Fed Funds
 As of 6/30/2023



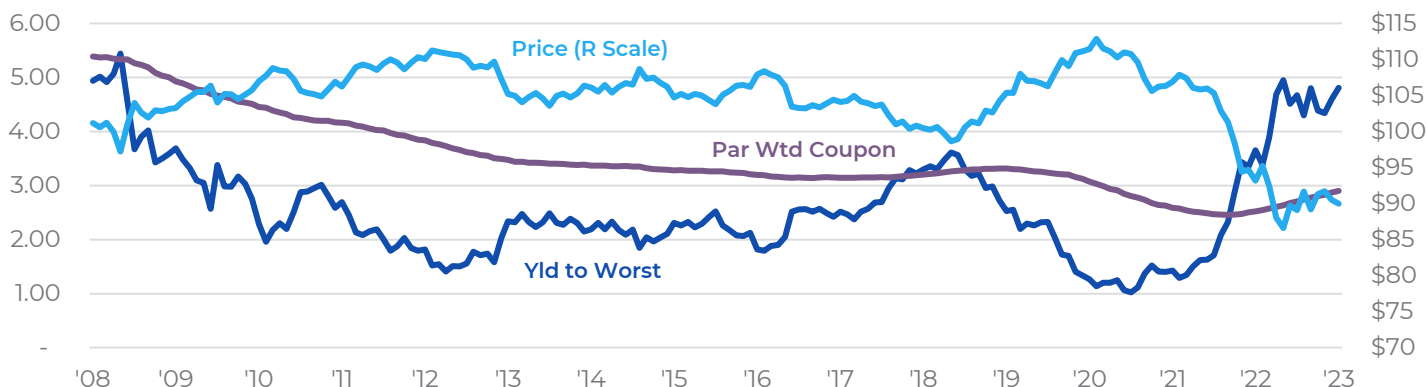
Source: Bloomberg, Federal Reserve, ICE BofA Indices, Xponance



Besides the drop in volatility giving an all-clear signal to markets, another primary explanation for these anomalous relationships is the yield available in the marketplace and the various technical factors this produces. We have written in the past about yield and spread break-evens, which measure the amount of increase in yield (whether from rates or spreads) that a given fixed income security can withstand before negative price return outweighs the yield (creating negative total return). Given the current rate regime, break-evens are relatively attractive. And, while spreads are at best fair value, the average coupon available for a par bond is currently much higher than the average coupon available for the market as a whole (and as measured by the major investment grade indices). This factor has produced positive sentiment for current coupon spread product and has put a floor under new issue pricing in both corporate and securitized markets. The fact that so many bonds are trading with exceptionally low dollar prices (given meagre coupons) has contributed to pockets of negative sentiment that contrasts with the overall desire for yield. This condition has led to a bifurcated market for deeply discounted versus par bonds or even premium bonds. Extremely low coupon (i.e., sub 1%) callable US Agency paper, for example, has become extremely illiquid. Clearly, directionality of rates and not yield level is the most significant determinant of total return. The composition of the underlying yield, however, has never been as important as it is today for a range of reasons.

Since rates have been generally falling over the past three plus decades, investment grade bond indices have had an underlying coupon greater than the yield on the index (with the corresponding dollar price above \$100). Now, however, that paradigm has been turned on its head. With the yield much higher than the coupon, most of the yield on the index (and thus most tradeable bonds in the marketplace) comes from **accretion rather than income**. This dynamic has major real-world implications for return streams. While we can think of that accretion as straight-line accounting occurring equally over the remaining years until maturity, the actual market value change (“pull-to-par” in the jargon) does not occur until the bond is approaching maturity (all else equal). By extension, the deeply discounted bond will not realize its yield until nearing maturity (since the semi-annual income will only be a small portion of the overall yield and the accretion happens in the last couple of years). While this seems obvious from a bond math perspective, it has never been so stark, as the coupon range for the constituents of the indices has been closely distributed on either side of \$100 for most bonds. This phenomenon also contributes to increased portfolio volatility and tracking error since rate moves will have an outsized impact on total returns. It is worth noting that the dollar price history is much different for high yield, as these instruments and indices have traded at meaningful discounts during every historical period of economic dislocation given the default component of high yield spreads coupled with lower correlation to interest rates.

Chart 2 ICE Corp/Gov't/Mtg Index: Yield, Coupon, and Price
As of 6/30/2023



Source: Bloomberg, ICE BofA Indices, Xponance



If we dig deeper into the discounted bond phenomenon, there are a range of trading strategies one can employ to capitalize on the phenomenon in investment grade markets. These exist across the high-grade fixed income sector landscape. Consider, for example, the agency MBS (Mortgage-Backed Securities) market. For many years, a primary trading strategy was to try to buy prepayment protection as cheaply as possible, or by finding diverse ways to achieve prepayment protection than the market anticipated. Now, the exact opposite is true. Since MBS pays a portion of principal monthly, investors can buy discounted bonds with the intention of receiving faster prepayments than the market anticipates. This gets around the problem of the “pull-to-par” only happening in the final couple of years of a bond’s life. For high grade paper with a potential “regulatory” call (i.e., bank paper with changing capital treatment, like some hybrid securities) there is the potential to buy discounted paper where the option is out of the money on an economic basis, but the need to call the paper for regulatory reasons can result in an outsized yield-to call. In corporate or other credit markets, there are opportunities in **pairing** high coupon trades with lower coupon trades to achieve a dollar price barbell. One can, for example, buy a high beta (but still investment grade) security at a deep discount (which protects against downside price action.) This can be combined with a higher dollar price/high coupon instrument for a lower beta issuer. In this way, we can create a higher yield and income trade while maintaining a convexity advantage at the **pair** or portfolio level. By deploying this strategy through a fundamental lens, we have been given a rare opportunity (for investment grade bonds) to express a view not only through relative spread levels but through dollar prices as well. In the case of high yield bonds, we can give ourselves greater protection by buying slightly discounted bonds that still have solid coupon income as compared to the broader markets.

While we think the second half of the year could see a return to volatility as economic data continues to moderate, we also see more opportunity in fixed income from a total return perspective than we have seen in quite some time. Excess returns will likely be volatile as market conditions change, the yield curve re-steepens, and certain asset classes continue to exhibit idiosyncratic returns. Nonetheless, as we have noted, attractive yields should serve to keep returns in positive territory for the investment grade space. We are more cautious about high yield returns given greater economic sensitivity and lower correlation with interest rates.

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