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MARKETS AND ECONOMY | OUTLOOK

2023 Investment Outlook: Global Income

By: EV Forward | December 14, 2022

Fed Pivot Trade Likely to Drive 2023 Fixed Income Markets

KEY POINTS

1. The Fed's pivot to a less aggressive monetary policy is likely to set the tone for the markets in 2023.
2. High-quality spread products like agency MBS and securitized debt, U.S. duration and emerging markets debt are positioned to do well.
3. We believe that inflation will continue to come down, in combination with a significant slowdown of the U.S. economy.

The 2022 fixed income markets were characterized by across-the-board selloffs, sparked by both duration exposure, as inflation surprised to the upside and the U.S. Federal Reserve began raising rates, and credit spread widening, as investors anticipated a slowing economy.

As November ended, the yield curve continued to invert, with the front end selling off and the back end rallying. But moving into December, we saw the beginning of a shift — we have started to see some spreads come in somewhat as the credit markets start to price in a Fed "pivot."

While the Fed pivot clearly hasn't happened yet, the market is a forward-looking mechanism, and investors now expect rate increases to come at a slower pace than most of the second half of 2022. Even though the Fed "pivot trade" is starting to get priced in, we still think that the pivot will be the major factor in considering fixed income opportunities in 2023. Here are three areas that we believe are the most attractive:

High-quality spread products. Particularly in agency mortgage-backed securities (MBS) and some securitized products, spreads have stayed wide and have not come in as much as high yield and investment grade issues. We expect an environment in which investors still want a little extra yield than U.S. Treasury securities, which would make MBS and securitized products attractive and draw asset flows.

U.S. duration. Duration is starting to look attractive, particularly as the curve inverts. While we would not overlook opportunities in the front end, we think there is value in U.S. Treasurys when the 10-year is in the range of 3.60% to 3.80%, even though that is down from the recent peak of 4.20%. To play that, investors can buy U.S. Treasury issues directly, or consider duration-heavy strategies like core plus or municipal bonds.

Emerging markets (EM) debt. We see EM debt as an attractive place for investors comfortable with a riskier asset class, particularly issues denominated in local currency. While the U.S. dollar has started to weaken, it is still at very strong historical levels. If it continues to weaken in 2023, that would certainly be good for EM debt priced in non-dollar local currencies. Additionally, EM corporate debt — credit sectors — typically do well in a weak-dollar environment.

It's worth stressing that the most important variable looking forward is what inflation will be over the medium term. We believe that inflation will continue to come down consistent with a slowdown in demand as the U.S. economy weakens, and improvements in various supply side constraints. However, if inflation surprises on the upside and prompts the Fed to be more aggressive, fixed income broadly will have another poor year.

Our view is that the Fed will moderate its increases. Policymakers have begun to note that monetary policy operates with "long and variable lags." We view this as dovish messaging that the Fed is closer to its pivot. It also implies that the Fed has done far more in 2022 than anyone would have expected at the end of 2021. In sum, fixed income markets are likely to be driven in 2023 by a less aggressive Fed and a slowing economy.

Eric Stein, CFA

Chief Investment Officer, Fixed Income

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