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Compelling Opportunities Across the Yield Curve and Credit Spectrum

By: Vishal Khanduja, CFA | & Andrew Goodale | August 25, 2023

KEY POINTS

1. We believe a shift in allocation towards higher quality securities is prudent.
2. We see compelling opportunities across corporates and securitized sectors.
3. The environment is suited for a flexible and active management approach to fixed income allocation.

Boston - Getting closer to the end of the year, fixed income investors are grappling with a broad range of uncertainties related to the U.S. economy, the Federal Reserve's policy reaction, the quick rise in long-end interest rates and the best strategies for their bond investments.

Fixed income market repricing is providing compelling opportunities across the yield curve and credit spectrum, in terms of valuation, entry points and total return potential. We believe this environment offers investors a strong opportunity to increase duration[1] and move away from cash.

As the effects of monetary policy tightening filter through the U.S. economy more broadly, we believe a shift in allocation towards higher quality securities, away from those with highly levered and more economically sensitive balance sheets, is prudent. In view of attractive valuations and strong fundamentals, we see compelling opportunities for investors across high quality corporates and securitized sectors. Finally, the environment is suited for a flexible and more active management approach to fixed income allocation.

Growth, inflation and the Fed

Underlying inflation in the U.S. has slowed considerably in recent months, whether measured using the core Consumer Price Index (CPI), the trimmed mean or the median measure. In July, core CPI, which excludes food and energy prices, rose by 0.16% — matching the 28-month low pace of the previous month — with the year-on-year rate falling to 4.7%. Moreover, market expectations of forward inflation have remained stable, which implies considerable confidence in the Fed's ability and resolve to keep inflation moving towards its long-term target of 2%.

In our opinion, a resurgence in inflation is now less likely. With the Fed resolute in their higher-for-longer restrictive stance, we expect price pressures to ease significantly over the coming quarters, with a gradual softening of the economy and loosening of the labor market. Although growth has been remarkably resilient thus far given the pace of Fed tightening, we see weakness emerging in some of the underlying data, which we believe will broaden out as the Fed holds rates higher for longer.

We believe that consumers and corporations both used the high stimulus and very low interest rate environment prudently to reduce interest costs and extend the maturities of their obligations. This lengthened the time it took for monetary policy to filter into the economy. We are now observing weakness in the most interest rate sensitive sectors of the economy. In the financial sector, there have been the regional bank failures, and we expect credit tightening to continue to weigh on the economy.

Signs of pullback for consumers and labor markets

While consumer spending has held up well amid strength in the job market, this could falter as the labor market weakens and excess savings are drained. Retail spending reported in July increased for the fourth straight month. However, sales of autos, electronics and furniture declined, as these areas are more sensitive to higher borrowing costs.

Slowing wage growth may be the first sign of a looser labor market. The number of layoffs announced by U.S. companies increased nearly 250% year-on-year during the first half of 2023.[2] These cuts often take several months to show up in the jobs data because of employee severance packages. In June, nonfarm payrolls grew by 209,000, the lowest rate of growth since December 2020.

The makeup of U.S. job growth has changed considerably — the latest ADP report shows that large businesses (500+ employees) reduced their head count by 67,000, while small businesses (fewer than 50 employees) increased head count by 237,000. Notably, leisure and hospitality have driven most of those gains recently.

We are maintaining a cautious view on the consumer, as we believe excess savings are starting to wear thin in a softening job market. Plus, federal student loan payments are set to resume this fall after a three-year hiatus.

Focus on quality

As the economic outlook remains uncertain, we are holding more higher quality bonds now than in past periods. Credit spreads have compressed more in the lower quality sectors relative to investment-grade corporate bonds, increasing their attractiveness.

We favor exposure to select, non-financial BBB rated corporates in sectors that are less economically sensitive. Among financials, we believe the balance sheet stress will continue to build — especially on weaker balance sheets. While we are cautious on U.S. regional banks for that reason, we continue to find opportunities in owning super regionals and money center banks.

In this environment, we believe a multi-sector approach can help mitigate portfolio risk and take advantage of opportunities across the curve and credit spectrum. We favor a combination of high quality, longer-term mortgage-backed securities and U.S. Treasurys with short, high-yield securities and higher-yielding BBB bonds.

Compelling characteristics

The rapid repricing of the U.S. fixed income market in the past 18 months has left valuations very attractive. Starting yields remain compelling, at their highest levels since the Global Financial Crisis — particularly in the area of agency and non-agency mortgage-backed securities.

We believe a higher-quality fixed income portfolio with an intermediate duration has strong potential to provide attractive income and diversification in a client's asset allocation. Higher-quality fixed income especially stands out for its strong income generation potential with very favorable valuations relative to lower-quality sectors — something uncommon during the easy monetary policy environment over the past 15 years.

Bottom line: We expect volatility to persist as both inflation and growth continue decelerating in the coming quarters. In this environment, we think active strategies with sector and quality flexibility offer the best opportunities. A multi-sector approach allows active managers to make relative-value calls between sectors and across the maturity and credit-quality spectrum. If inflation continues to come down and growth gradually declines, we believe fixed income is poised to provide clients' portfolios with both income and diversification.

1. Duration measures the price sensitivity of a bond or fixed income portfolio to changes in interest rates.

2. Challenger, Gray & Christmas.

Risk Considerations: *Diversification does not eliminate the risk of loss. Fixed income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Longer-term securities may be more sensitive to interest rate changes.*

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