Q1 2023 | Fixed Income Outlook

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Recession on the far horizon

We believe data in the first half of 2023 may offer evidence for both a soft landing and a near-term recession, while high interest rates gradually wear down corporate profits and the labor market.

Our base case is a U.S. recession, but in 2024, not 2023.

Global growth is likely to rise when economic activity in China increases over the next few months.

Inflation has slowed but could reverse course in the U.S. given signs that housing is stabilizing.

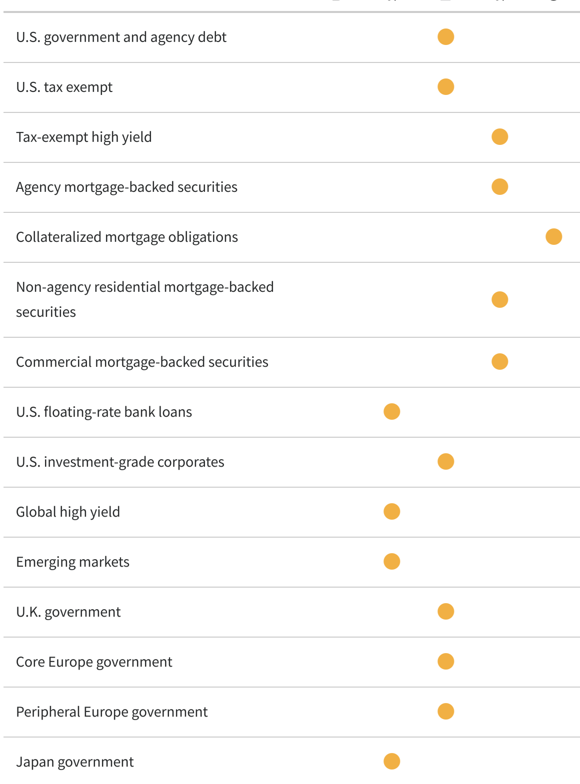
Mixed signals of recession

Several well-known sentiment indicators — such as the University of Michigan Consumer Sentiment Index and the NFIB Small Business Optimism Index, among others — are at or near recession levels. The same is true for some semisoft indicators, including the Chicago PMI, which is known to have predicted all U.S. recessions. However, final consumption has been holding up and might stay resilient for some time.

Although the gap between hard and soft data cannot stay forever, it can stay long enough to extend the cycle. Households start retrenching expenses only after losing their jobs. In the U.S., jobless claims reached a bottom in March 2022 and started rising, but they have not gathered speed, as usually happens ahead of recessions.

Profits as a leading indicator

Declining profitability is the main driver of job losses, which means the change in corporate profits can be a leading indicator, although it can also produce some false positives. Typically, earnings start decreasing before



Sector weights

● Current quarter
○ Previous quarter
> > Change from previous quarter

	Underweight	Small underweight	Neutral	Small overweight	Overweight
U.S. government and agency debt			●		
U.S. tax exempt			●		
Tax-exempt high yield				●	
Agency mortgage-backed securities				●	
Collateralized mortgage obligations					●
Non-agency residential mortgage-backed securities				●	
Commercial mortgage-backed securities				●	
U.S. floating-rate bank loans		●			
U.S. investment-grade corporates			●		
Global high yield		●			
Emerging markets		●			
U.K. government			●		
Core Europe government			●		
Peripheral Europe government			●		
Japan government		●			

Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro	● < <	○	
£ Pound	● < <	○	
¥ Yen	● < <	○	

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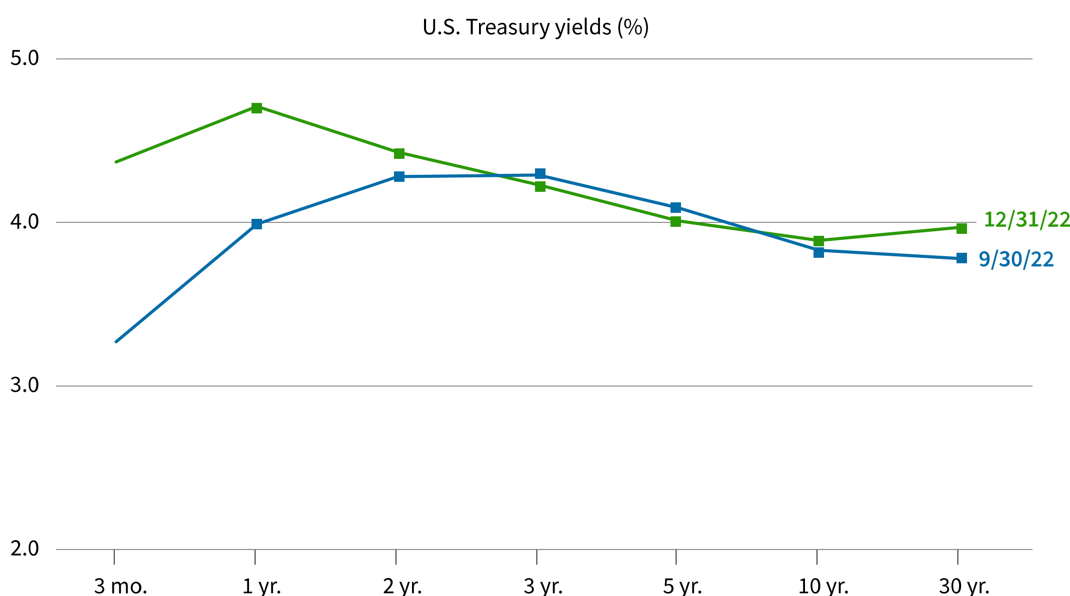
recessions and continue to decrease for a period after the end. In the current cycle, nominal profits peaked about six months ago; real profits have been flat for over a year and have been coming down for about six months.

Soft landing possibility

Given the trends in profits and job losses, is a soft landing attainable? We believe the rapid tightening in 2022 has not hit the real economy yet. Strong household balance sheets and a tight labor market have been supporting consumption and reducing consumers' sensitivity to prices. Similarly, corporate sector refinancing needs were low in 2022 and will likely remain low in 2023. Many firms extended the maturity profile of their debt during the low-rate environment in the decade after the 2008 global financial crisis.

In this cycle, it might take longer for rising-interest-rate costs to impact corporate margins and household spending than in a typical recession. Our base case is growth can stay positive in 2023, but the U.S. is heading toward a recession in early 2024.

The Treasury curve inverted further during Q4



Source: U.S. Treasury Department. Past performance is not indicative of future results.

China's reopening can accelerate global growth

In China, authorities have eased Covid-19 pandemic restrictions across major cities. With the Lunar New Year on January 22 behind us, mobility can start to rise and economic activity can gain momentum. We believe China's growth is likely to surprise to the upside in 2023. Senior Chinese officials have announced a consensus on increased policy support for economic development and rapid recovery. Their focus is on an accelerated recovery in the first half of the year through a combination of fiscal, monetary, and industrial policies.

As in the rest of the world, households in China have accumulated savings during lockdowns. Although a part of those large savings can fuel consumption, consumer confidence (especially confidence in housing) might need to be restored for a type of recovery the West had in 2020 and 2021. Recovery in household credit is likely to take time due to low housing demand and weak consumption amid elevated Covid cases. We believe Chinese household loan growth can be a second-half story in 2023.

Also, the largest change in demand for oil in 2023 is likely to come from China. China's implied crude oil consumption stagnated in 2022 due to recurring lockdowns.

Monetary policy outlook

The December U.S. CPI (released in January) showed a change of –0.1% (headline) and +0.3% (core), and the Federal Reserve slowed its pace of hiking to 25 bps at its February 1 meeting. However, we believe the "inflation is slowing" narrative is beginning to fade. Housing has shown signs of stabilizing at recent low activity levels, and retail sales have not been that disappointing. The Fed is expecting economic weakness in the second quarter, but if that does not come, we could see Fed surprises.

Europe is likely to benefit more than the U.S. from the disinflation story in the near term. Although the ECB has made 50-bp increases in recent moves, the March decision could be a struggle between the hawks favoring another 50 bps and the doves favoring 25 bps.

Meanwhile, the market is looking ahead to rate cuts everywhere. If inflation is going to surprise to the upside, we believe it is going to surprise first in the U.S., even while inflation in Europe continues to come down.

Sector views

Corporate credit

We have a cautious outlook on U.S. corporate credit, with an expectation for elevated volatility. Macro forces of high inflation, central bank tightening, slowing growth, and geopolitical impacts on energy remain considerable headwinds to both fundamentals and market technicals (supply/demand metrics), though we are likely nearing a point in the coming months where the hiking cycle will start to wind down.

Corporate fundamentals, while strong, have likely peaked for this cycle as higher rates and slower growth weigh on financial conditions. Technicals have improved as flows have moderated in recent months. Lower new issuance in 2022, coupled with record volume of rising stars, creates a somewhat supportive technical backdrop. Valuations are somewhat more attractive than this time last year, and credit spreads are not reflective of potentially recessionary conditions in the future.

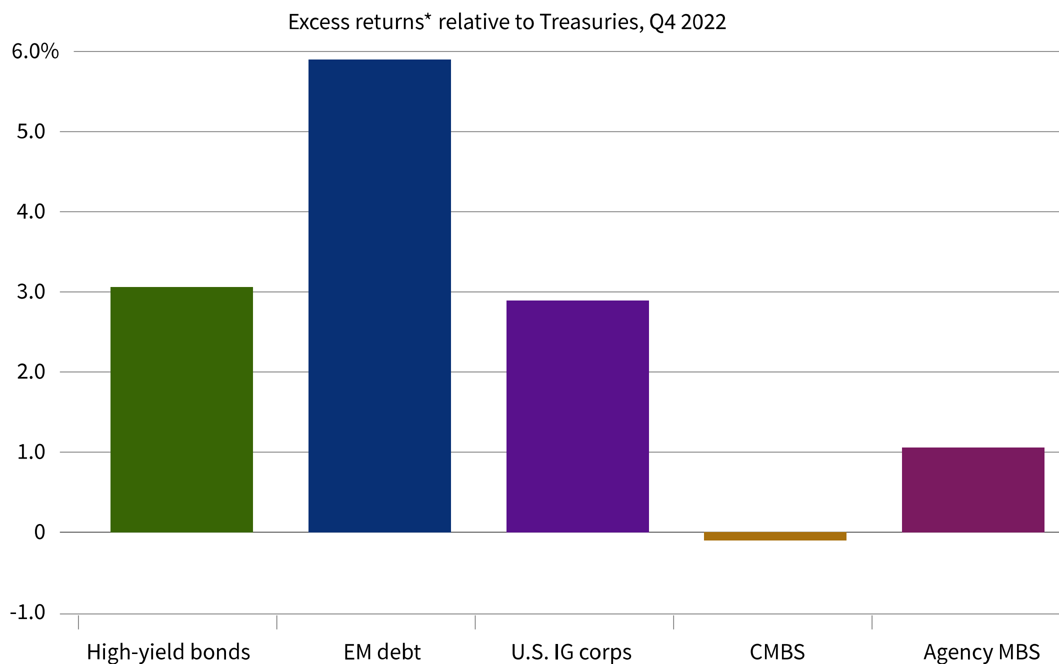
Risks to our outlook include policy missteps from global central banks, a more severe slowdown or recession, ongoing supply chain disruptions, commodity price volatility, heightened geopolitical tension, and/or surges in Covid cases.

Floating-rate bank loans may outperform

Corporate fundamentals, generally speaking, have persisted, but most non-investment-grade issuers remain challenged to maintain or recover margins impacted by inflation and a much more discerning consumer. While we expect default rates to gradually increase throughout 2023, loan market prices can actually move higher in such scenarios, and they have historically done so. Prudent credit selection will continue to be paramount for generating alpha.

Our team did a recent analysis of the three most significant periods of volatility in the U.S. leveraged loan market over the last 15 years: the global financial crisis (2008–2009), the energy sector sell-off (2015–2016), and the Covid-19 pandemic (2020). It showed loan market volatility as measured by price dispersion (the difference between the worst and best performers) is highly correlated with the level and the change of returns rather than default rates. Loan price dispersion hit 13% at the end of 2022 — its highest reading since the onset of the pandemic in Q2 2020. Yet there were no defaults in Q4 2022, and the number of loan gainers outnumbered decliners in the quarter. We believe the U.S. leveraged loan market may be at, or very close to, a price dispersion inflection point and poised for attractive returns in 2023.

Excess returns in risk assets turned mostly positive



* Excess returns are calculated relative to comparable-maturity U.S. Treasuries for each index. Excess return does not always mean "outperformance."

Source: Bloomberg, as of 12/31/22. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index. Past performance is not indicative of future results. High-yield bonds are represented by the Bloomberg U.S. Corporate High-Yield Index, which covers the U.S. dollar-denominated, non-investment-grade, fixed-rate, taxable corporate bond market and includes securities with ratings by Moody's, Fitch, and S&P of Ba1/BB+/BB+ or below. EM (emerging market) debt is represented by the Bloomberg EM Hard Currency Aggregate Index, which is a flagship Emerging Markets debt benchmark that includes USD, EUR, and GBP denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. U.S. IG (investment-grade) corporate debt is represented by the Bloomberg U.S. Corporate Index, a broad-based benchmark that measures the U.S. taxable investment-grade corporate bond market. CMBS (commercial mortgage-backed securities) are represented by the Bloomberg U.S. CMBS Investment Grade Index, which measures the market of commercial mortgage-backed securities with a minimum deal size of $500 million. Agency MBS (mortgage-backed securities) are represented by the Bloomberg U.S. Mortgage Backed Securities Index, which covers agency mortgage-backed pass-through securities (both fixed rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Structured credit

Macro-driven volatility pushed spreads wider across the sector in 2022 despite continued fundamental improvements, creating strong opportunities for security selection. We expect greater return dispersion across the market in the near term, which increases the importance of rigorous loan-level analysis to uncover relative value. We currently favor shorter spread duration assets, namely seasoned mezzanine tranches on deals with high-quality collateral, which offer very attractive relative value and should be insulated from losses even in recessionary scenarios, in our view. Overall, we believe structured credit currently offers both diversification benefits and attractive relative value to corporate debt.

Commercial mortgage credit

Our outlook for commercial real estate is mixed. We expect fundamentals to improve as more people return to travel, offices, and retail stores. This view is tempered by the Fed's hawkish interest-rate policy, which could cause a recession. We believe those property types that can pass along inflation costs, such as hotels and apartments, will hold their value and perform well in this environment. On the other hand, property types that have longer leases, rising capital costs, or require large capital improvements will come under pressure. We continue to favor seasoned mezzanine tranches on high-quality deals that offer attractive relative value and are insulated from losses or a recession, in our view.

Residential mortgage credit

We expect home prices to decline modestly in 2023 and to grow more slowly thereafter. After sharply rising during the pandemic, home price appreciation is slowing due to affordability constraints for many buyers and a gradual increase in supply. Within residential mortgage credit, wider spreads have created better value across all credit tiers. We are finding attractive investment opportunities in higher-quality areas of the market, as well as seasoned collateral that can withstand declining home prices.

Prepayment

We believe many prepayment-sensitive securities offer attractive risk-adjusted returns at current price levels and prepayment speeds. Many of these securities may also offer meaningful upside potential if mortgage prepayment speeds slow further, which we believe is likely. We also find value in the mortgage basis, which is now historically wide, but we are maintaining a cautious position amid heightened interest-rate volatility. Given last year's repricing of the sector, we are finding what we believe are compelling investment opportunities across a variety of collateral types.

Tax-exempt bonds

Municipal credit fundamentals continue to be stable, in our view. Higher employment and increasing wages have bolstered tax receipts. Home values, a factor in property tax revenues, are facing headwinds in the form of rising mortgage rates. We believe assessed values, another factor in taxes, should continue to reflect growth given the roughly two-year lag between tax assessments and actual property values. Market technicals improved during the fourth quarter. New-issue supply was very light, aiding returns. At the same time, demand rebounded amid the improvement in investor sentiment.

Emerging market credit

Within emerging market credit, we expect global economic conditions to be challenging, but some valuations and countries appear to be attractive. China's reopening near quarter-end has been a positive development. We continue to look for opportunities in countries that are less exposed to geopolitical turmoil as well as to global and domestic policy risks.

Currency views

Dollar to trend down

With inflation moving in the right direction, any softening in the labor market data should be key to the near-term trading of the U.S. dollar. At some point, the Fed may be forced to respond to the loosening in financial conditions, but for the time being, the message is likely to be more balanced. And as such, it's likely we've seen the highs in the U.S. dollar. Meaningful rallies in the U.S. dollar will be opportunities to sell for expected weakness later in the year.

Euro has more support

The European Central Bank (ECB) is in similar circumstances as the Federal Reserve. It's likely to step down the pace of rate hikes, for while inflation is incredibly high, it may have peaked. Meanwhile, the labor market remains very tight. For the euro, positioning remains short. The energy story in the near term is less negative, and the global growth backdrop should be supportive, driven by a better outlook for China. The lows for the single currency appear to be in place, but data in this environment are noisy, which should create tradable ranges in the near term. Meaningful dips will be opportunities to buy.

The pound is past its low point

The Bank of England appears hesitant to be more hawkish than other central banks, but like the ECB, it too must face higher-than-expected inflation and tighter labor markets. This suggests tighter policy than previously envisioned. With a more supportive global backdrop in the near term and less consternation from fiscal policy, the pound has seen its lows. It remains cheap to its longer-term valuation, so meaningful dips should be opportunities to buy.

Japan prepares for yield surge

The Bank of Japan (BoJ) was the policy outlier. At its December meeting, however, it made an announcement of a modification of its yield curve control (YCC). It will widen the YCC range to +/–50 bps around 0%, from +/–25 bps earlier. On top of its daily unlimited fixed-rate purchase operation, the BoJ also announced an increase in the amount of bonds it will regularly buy under a competitive auction method in the first quarter of 2023. The purpose is to prepare for any potential surge in yields. While described as a solution to poor bond market functioning, the market will likely expect more changes in policy over the coming months and quarters, especially with Governor Kuroda stepping down in April. As such, rallies in dollar-yen rates are likely to be sold due to Fed/BoJ policy reconvergence and as expectations of recession risk for 2023 rise.

The Fixed Income Outlook represents the insights of the collaborative process of our 100+ member team and of our senior leadership.

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As of January 31, 2023.

Agency mortgage-backed securities are represented by the Bloomberg U.S. Mortgage Backed Securities Index, which covers agency mortgage-backed pass-through securities (both fixed rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Commercial mortgage-backed securities are represented by the Bloomberg U.S. CMBS Investment Grade Index, which measures the market of commercial mortgage-backed securities with a minimum deal size of $500 million. The two subcomponents of the U.S. CMBS Investment Grade Index are U.S. aggregate-eligible securities and non-eligible securities. To be included in the U.S. Aggregate Index, the securities must meet the guidelines for ERISA eligibility.

Emerging market debt is represented by the Bloomberg EM Hard Currency Aggregate Index, which is a flagship Emerging Markets debt benchmark that includes USD, EUR, and GBP denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The index is broad-based in its coverage by sector and by country, and reflects the evolution of EM benchmarking from traditional sovereign bond indices to Aggregate-style benchmarks that are more representative of the EM investment choice set.

Eurozone government is represented by the Bloomberg European Aggregate Bond Index, which tracks fixed-rate, investment-grade securities issued in the following European currencies: euro, Norwegian krone, Danish krone, Swedish krona, Czech koruna, Hungarian forint, Polish zloty, and Swiss franc.

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High-yield bonds are represented by the JPMorgan Developed High Yield Index, an unmanaged index of high-yield fixed income securities issued in developed countries.

Japan government is represented by the Bloomberg Japanese Aggregate Bond Index, a broad-based investment-grade benchmark consisting of fixed-rate Japanese yen-denominated securities.

Tax-exempt high yield is represented by the Bloomberg Municipal Bond High Yield Index, which consists of below-investment-grade or unrated bonds with outstanding par values of at least $3 million and at least one year remaining until their maturity dates.

U.K. government is represented by the Bloomberg Sterling Aggregate Bond Index, which contains fixed-rate, investment-grade, sterling-denominated securities, including gilt and non-gilt bonds.

U.S. floating-rate bank loans are represented by the Morningstar® LSTA® US Leveraged Loan Index, an unmanaged index of U.S. leveraged loans.

U.S. government and agency debt is represented by the Bloomberg U.S. Aggregate Bond Index, an unmanaged index of U.S. investment-grade fixed income securities.

U.S. investment-grade corporate debt is represented by the Bloomberg U.S. Corporate Index, a broad-based benchmark that measures the U.S. taxable investment-grade corporate bond market.

U.S. tax exempt is represented by the Bloomberg Municipal Bond Index, an unmanaged index of long-term fixed-rate investment-grade tax-exempt bonds.

Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

The Bloomberg U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed income securities.

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