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INSIGHTS

Fixed Income Update and Outlook

1H23 review and outlook for 2H23

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Looking ahead to 2H23: Steering amid end-of-cycle turbulence

With the war on inflation in its last stages and real rates continuing to get tighter, the fixed income asset class presents multiple opportunities. However, credit underwriting to remain key, as peak rates could result in higher default rates.

Macro and Rates

- **US** TIPS anchored around 2.3% suggests inflation could be under control in a couple of years
- **Eurozone's** underlying inflation slows to 5.3% while the UK's inflation remains elevated at 6.9%
- Moderating inflation should limit the monetary tightening in the US, but the UK will likely continue to see rate hikes

Returns and Risks

- **Fixed income universe** performed well in 1H23, with positive returns for all instruments
- Most fixed income asset classes are offering **historically high yields** – US IG yields at 5.5%, 230bps more than their 10-year avg.
- However, **defaults are expected to increase** with higher rates. Fitch forecasts the US HY default rate at 8.75% over 2023-24

Investment Themes

- **Stay conservative on credit risk** with IG Corp preferred over HY, as HY-IG spread of 220bps is below historical average
- **Increase duration** at current yields; historically, intermediate bond have outperformed short-term bonds by 420bps after peak rates
- **Positive outlook on Europe,** with improved growth expectations and more conservative valuations

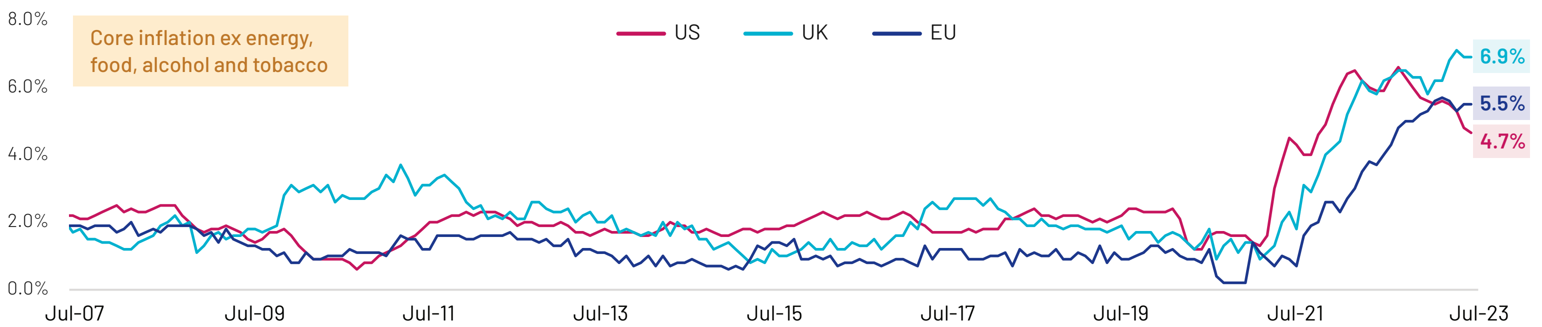
Asset Class Views

- **US IG** remains the most attractive, with better protection against rising defaults and attractive valuations
- **Euro IG** yielding 4.4%+ is attractive on an improving growth outlook and stabilising inflation
- **Distressed debt** to present large opportunities as defaults increase
- **Loans**, despite yielding 11.2%, could underperform as default rate increases

Inflation: Declining; breakeven anchored around 2%

- Headline inflation in the US and Europe is trending downwards, according to July 2023 data releases, while the UK is a notable outlier
- Meanwhile, Treasury Inflation-Protected Securities (TIPS) breakevens (across tenors) are anchored around 2%. This suggests that the US markets are pricing in an optimistic scenario, inflation will come back down to 2% in a couple of years. However, recently, 10Y was the highest since November 2022 at 4.1%, and 30Y reached a 9M high at 4.2%, indicating pressure on inflation
- Nevertheless, TIPS look attractive in the current environment – the 30Y TIPS yield is near 2% for the first time in over a decade, up from -0.5% in 2020-21

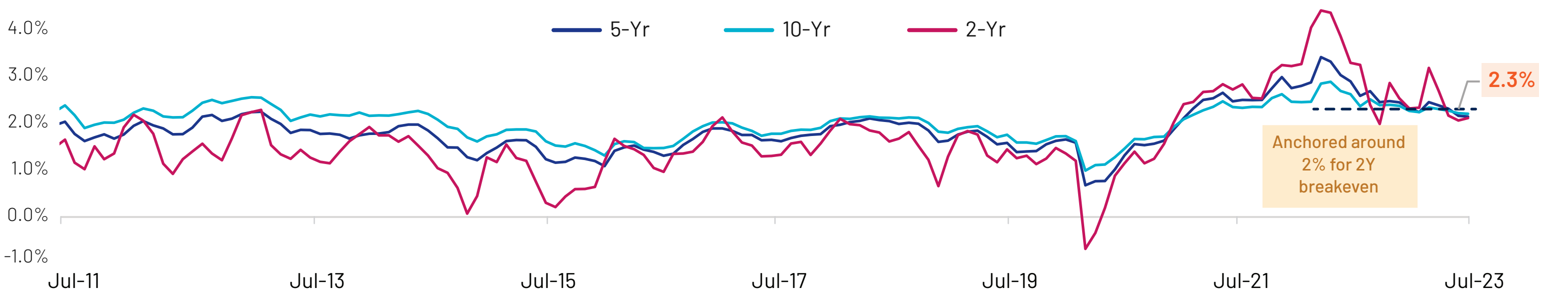
Moderating path of inflation should continue



Source: St. Louis Fed

The market expects US core inflation to decelerate, albeit at a slower pace, to 3.7% by end-2023 and then to 2.5% by end-2024 vs the Fed's target of 2%. Meanwhile, EU headline is expected to hover at 5-5.5% by end-2024. For US CPI, owners' equivalent rent (OER) inflation is critical, given one-third of contribution. The Eurozone's underlying inflation is improving despite rising wage growth. The market expects August headline CPI unchanged at 5.3% amid higher energy prices. UK wages rose at the fastest pace on record in the three months to June 2023, fueling the Bank of England's (BoE's) concerns about inflation.

Breakeven anchored – market forecasts inflation easing to approximately 2%



Source: St. Louis Fed

4.1%

Owner equivalent rent inflation (1/3rd of CPI) is declining and dropped to 4.1% in June 2023

2.3%

Across the tenor, average breakeven is anchored around 2%

~2.0%

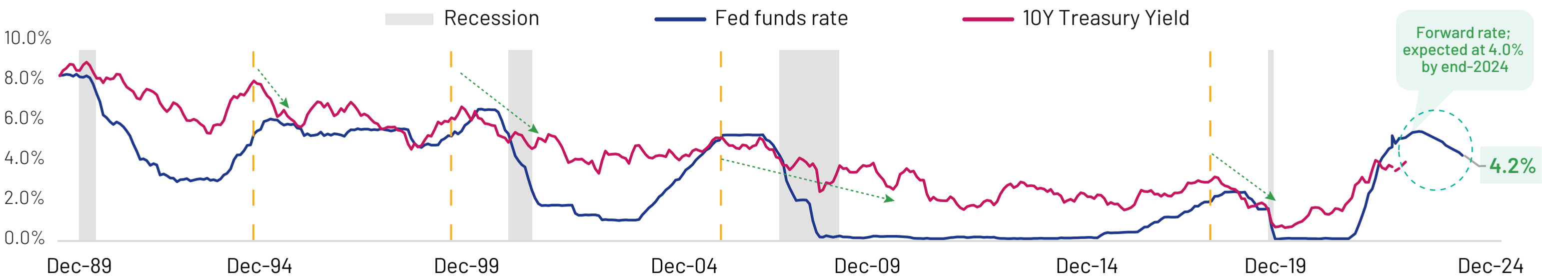
30-year real yields hover around 2%, up from -0.50% in 2020-21, after the Fed slashed rates and inflation protection demand soared

Interest rate (US): Most likely the final hike for the cycle?

- The Fed has raised rates by 500bps in just over a year, the fastest since the 1980s, with the latest 25bps hike delivered in the first week of July 2023
- Meanwhile, the market expects ongoing disinflation coupled with policy transmission on a lagged basis to lead the Fed to conclude the rate hike cycle in 2023
- As monetary policy is likely to head towards a pause, most fixed income asset classes would do well
- Historically, with a rate pause with no or mild recession, the 10Y yield has declined 100bps on average in the 12 months after the rate pause

High-quality assets outperform after a rate-hike cycle

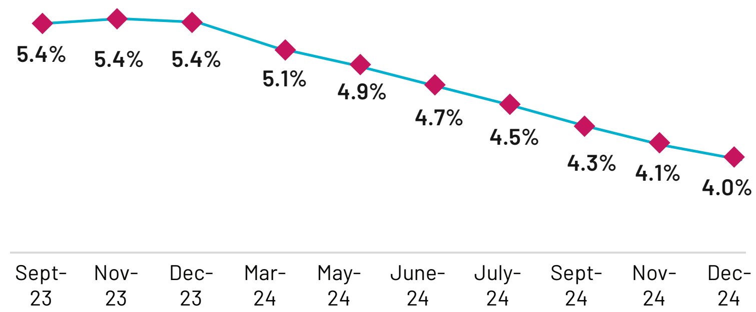
For fixed income investors, the final hike of each Fed cycle has historically been a turning point, transitioning from a headwind to a tailwind. Buying/lengthening duration at the terminal hike and selling/shortening the duration in the late stages of a recession have been a rule of thumb for obtaining the maximum benefit from the change (refer to left-hand-side chart – the final hike of each cycle is highlighted in yellow).



Source: St. Louis Fed

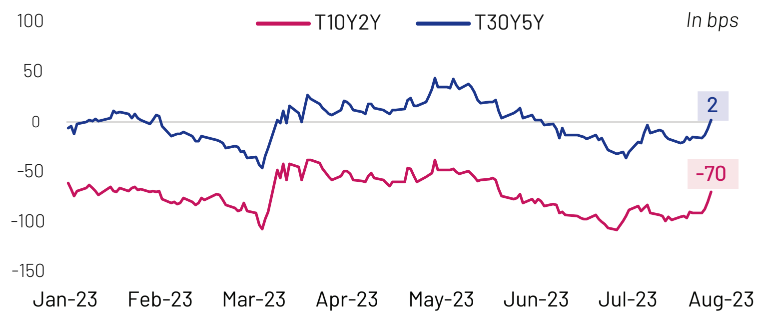
The soft-landing narrative is heightened; this should steepen the long-end yield curve further once growth slows markedly. This will likely lead the Fed to cut its policy rate. The forward implied rate, too, suggests the Fed could slash 100-125bps of the rate by end-2024.

Forward rate indicates 100-125bps cut by end-2024



Source: Bloomberg Net

Long-end steepening of the curve – inversion improved



Source: St. Louis Fed

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Number of Fed and ECB interest rate cuts expected in 2H23

Fed funds rate by 2024E

4.0%

Fed expected to cut rate by 100-125bps by end-2024

26%

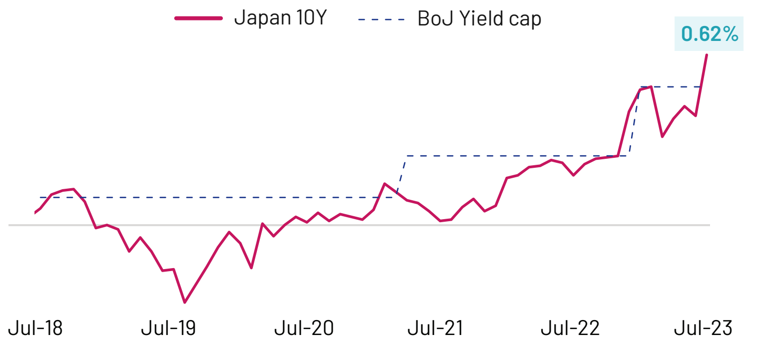
IG tends to deliver better returns than HY in two years after peak rates

Interest rate (global ex US): ECB and BoE likely to remain hawkish in 2H23

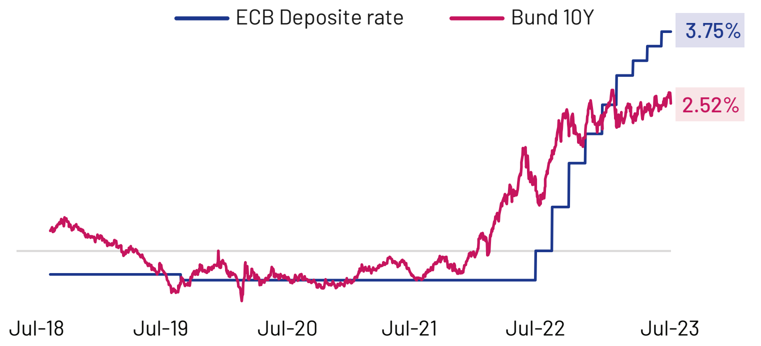
BoJ 10Y yields have risen to more than 0.5%, above its 0.5% cap, as pressure builds to adjust policy. Global fund flows would be affected significantly by a BoJ shift, as Japanese investors are among the largest foreign holders of US Treasuries (USD2tn) and European bonds.

ECB hiked deposit rate by 25bps in July 2023 to 3.75%, and the market expects it to hike by 25bps in September 2023. However, some market participants believe a terminal rate of 4.25% remains a possibility, owing to the stickiness of services inflation and strong wage growth.

Japan's yield breaks BoJ's ceiling



ECB seen raising rates in September 2023

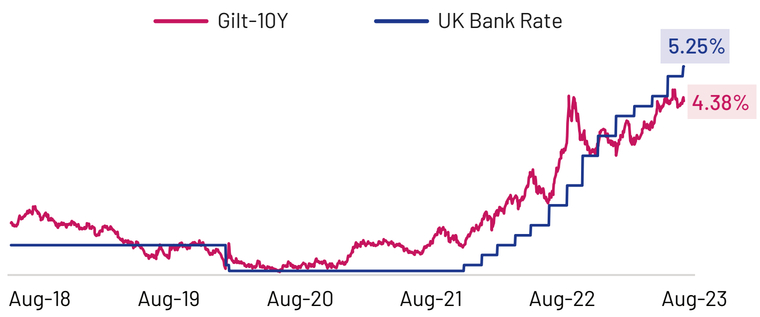


Source: St. Louis Fed, People's Bank of China (PBoC), medium-term lending facility (MLF), Bank of Japan (BoJ)

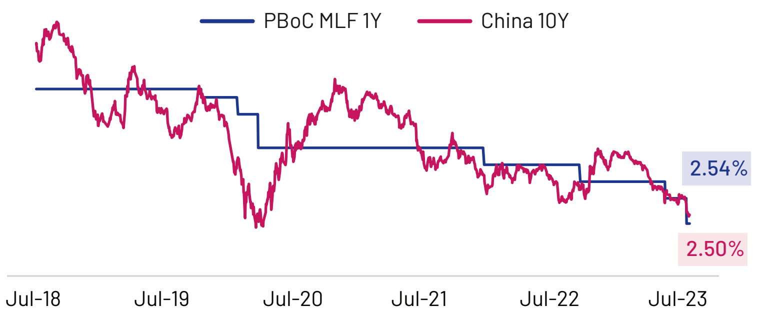
BoE hiked 25bps on 3 August 2023 to 5.25%, in line with market consensus, and the market expects another 25bps hike – for a terminal rate of 5.5%. Meanwhile, 10Y gilts remain below 4.5%; a higher rate hike could be a tough spot for bond investors.

PBoC cut 1Y MLF by 10bps in June 2023 for the first time, followed by 15bps in August 2023 – less than expected. China's 10Y benchmark govt. bond yield dropped to a three-year low, to 2.6% – a sign of worsening sentiment towards Chinese assets and a market begging for more stimulus to revive growth.

UK 10Y yield below 4.5%, below terminal rate



Beijing has more to do – yield drops on rate cut



Source: St. Louis Fed, People's Bank of China (PBoC), medium-term lending facility (MLF), Bank of Japan (BoJ)

BoJ relaxed yield control

>0.5%

BoJ's 10Y has risen to 0.6%, above its 0.5% cap

ECB's next hike priced in

25bps

Some market participants even expect a 50bps hike

China's 10Y yield dipped to

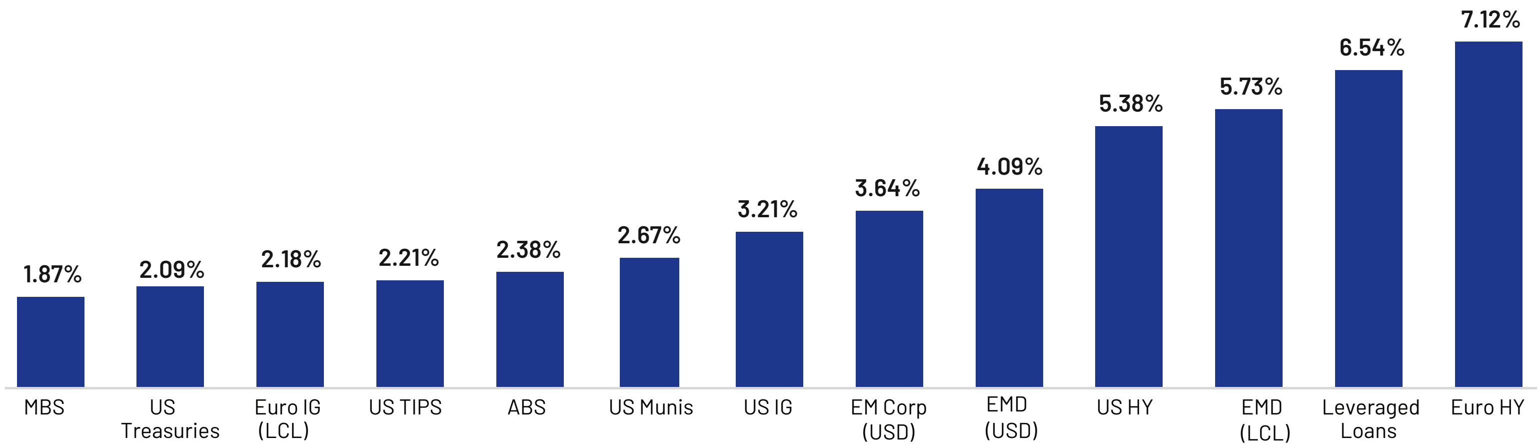
2.6%

Market expects more stimulus to push growth

Performance of the fixed income universe

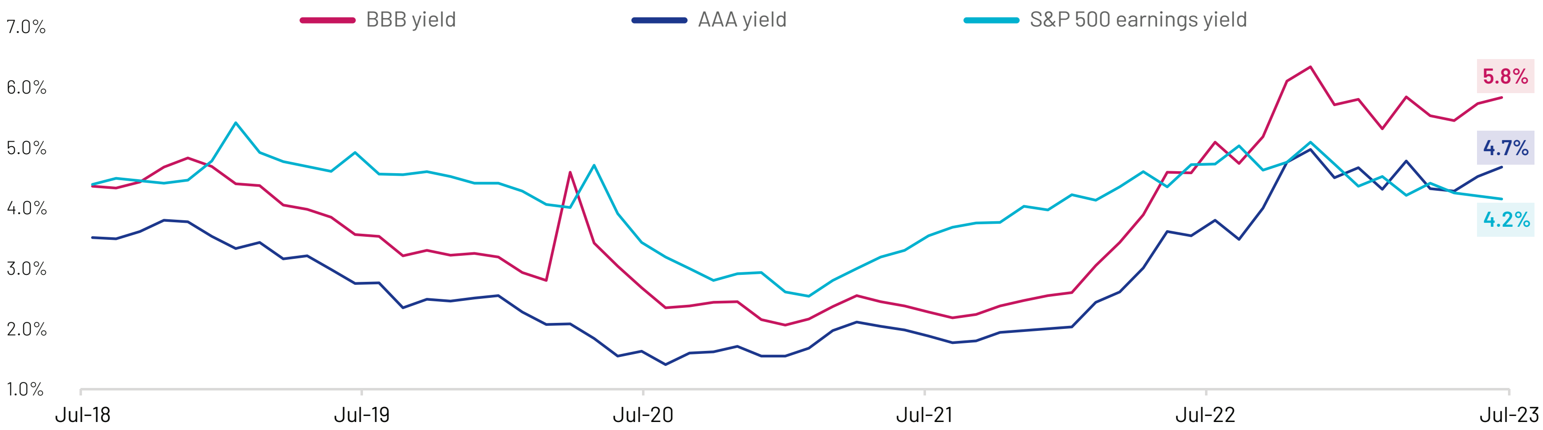
As we revisit our views in January 2023, it feels as if an eternity has passed. 2023 had a turbulent start, filled with a number of significant macro and micro events such as bank failures in the US, the rescue of Credit Suisse by UBS and the debt ceiling drama. Despite this, the fixed income universe has fared well so far, with all instruments giving positive returns over 1H23 after a torrid 2022.

All instruments gave positive returns in 1H23



Source: JP Morgan

Fixed income yields are extremely attractive compared to equity earnings yields



Source: St. Louis Fed, Standard & Poor's

4.1%

US 10Y yield has been higher only 1% of the time in the past decade

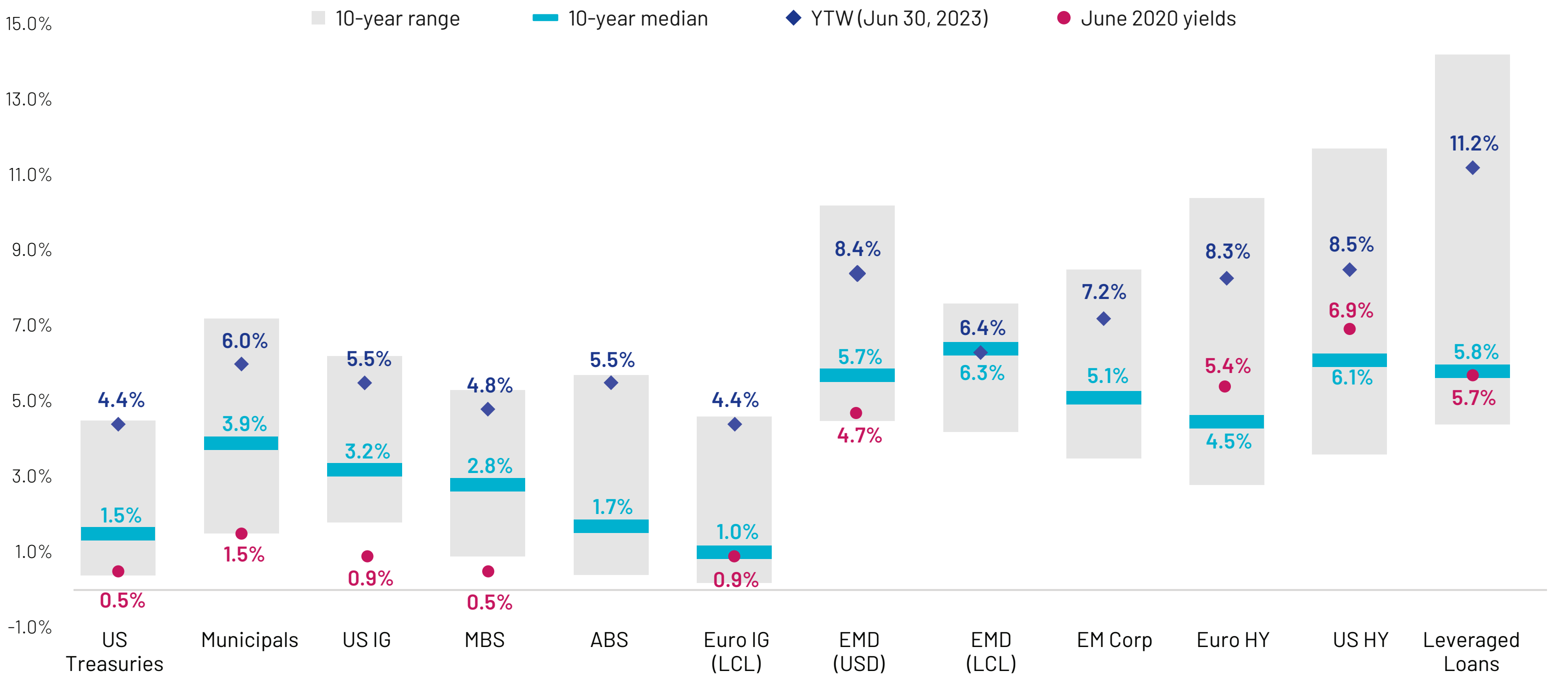
170bps

Incremental yield offered by BBB bonds over S&P 500 dividend yield vs average 40bps discount over the past five years

Softening Fed stance call for a shift in strategy

With a low likelihood of further rate hikes by the Fed, we believe benchmark rates are at their peak of this hiking cycle signalling a partial regime change. Accordingly, our investment views have now been adapted to suit the next stage of the interest rate cycle. While there is no overhang from expectation of further rate hikes, growth in the US, Europe and China is expected to remain weak. In this low-growth scenario, fixed income is even more attractive, as the high yields provide some downside protection. The following are a few high-level investment themes to consider:

Yields well above historical average and June 2020 levels



Source: JP Morgan, Citi

1. **Yield is still available across the risk spectrum:** US market yields have generally widened by a small margin of 10-20bps while emerging market yields have tightened by ~30bps over the last six months. Despite the divergent performance, most of the fixed income universe continues to offer significantly higher yields compared to their respective historical 10-year average and from June 2020 levels. Fixed income instruments with minimal credit risk such as US treasuries and AAA rated bonds are also available at yields comparable to the equity market earnings yield at this time. This makes a case for fund flows to be directed towards traditional fixed income asset classes by allowing investors to invest in appropriate instruments and not stretch their risk parameters unnecessarily.

460bps

Higher yield offered by US IG than in June 2020

37%

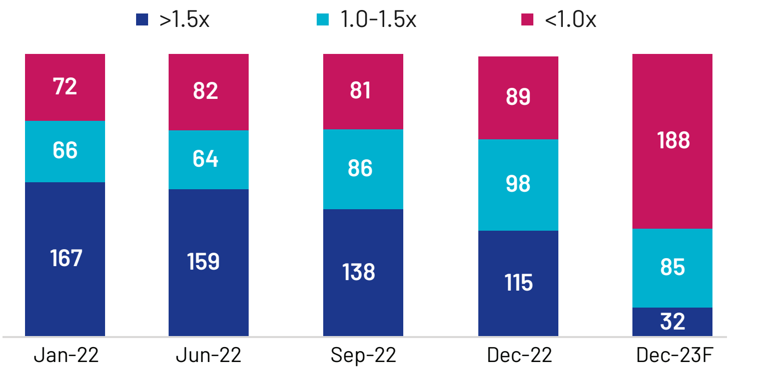
Non-financial US companies in financial distress, according to the US Fed

68%

10Y Munis/Treasury ratio at Jun'23-end, indicating Munis are trading expensive compared to treasuries

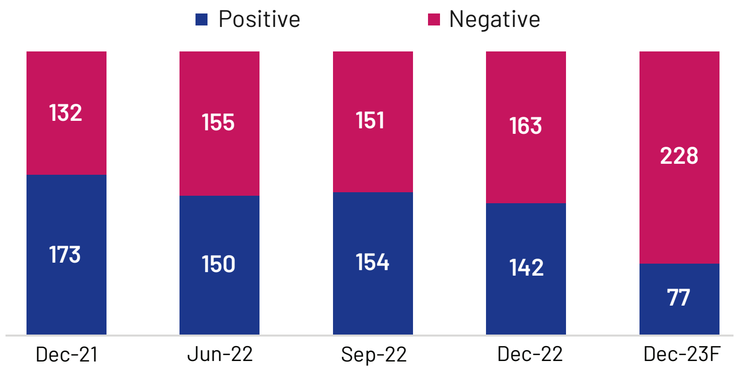
2. **Dial down the credit risk:** The likelihood of recession in major developed markets (the US and Europe) has reduced over the past six months. However, a number of lower-rated HY corporates are struggling with the deadly cocktail of weaker growth and higher rates, as reflected in weaker interest coverage (Moody's B3 universe aggregate forecast at 0.9x in December 2023 vs 1.3x in December 2022) and weaker free cashflow generation.

More than half of the B3 universe is expected to report interest coverage below 1.0x by year-end



Source: Moody's Investors Service

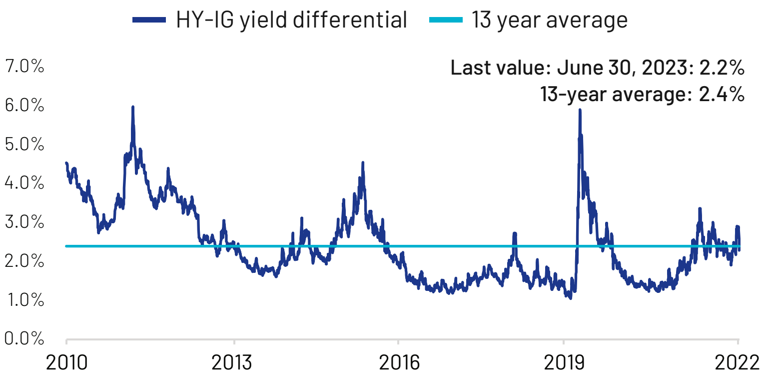
Interest costs will likely continue to erode free cash flow generation



Source: Moody's Investors Service

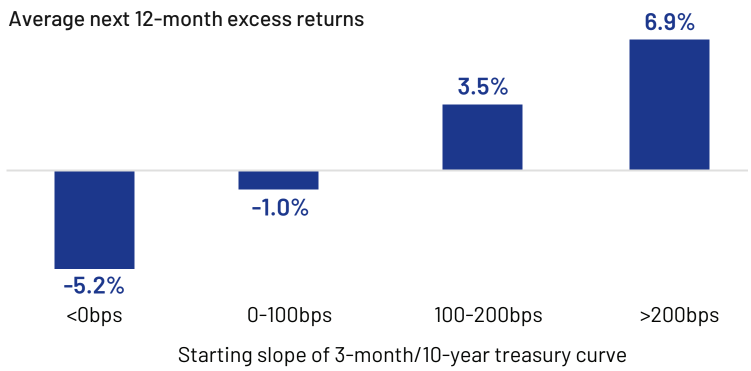
Against this backdrop, we believe the HY-IG yield differential is not remunerative enough to justify taking on the additional risk. IG markets also seem to be positioned better valuation-wise in terms of pricing for a recession. Furthermore, HY assets do not have a good record when the yield curve has been inverted. Therefore, we believe investors should position themselves conservatively within the fixed income space.

HY-IG (BB-AAA) spread below 13-year average does not justify taking on HY risk in current macro



Source: St. Louis Fed

Bloomberg US corporate HY bond index returns have been negative when the yield curve is inverted



Source: Charles Schwab

8.75%

Fitch's forecast for the US HY default rate over 2023-24, up from 6.75% in January 2023

55%

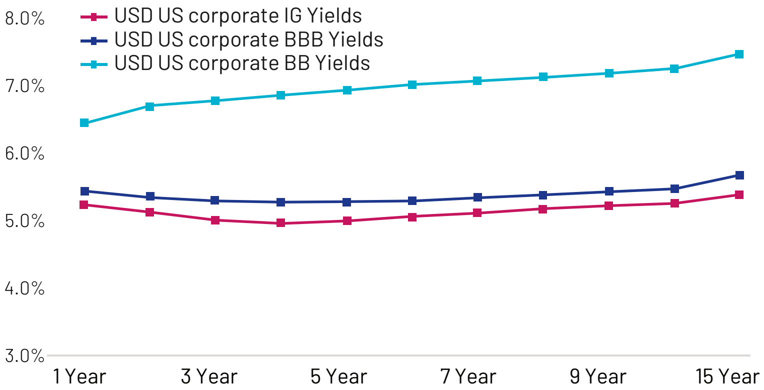
Moody's global downgrade ratio for 2Q23, improved from 64% in 1Q23

700bps

Average outperformance by US IG Index over US HY Index over two years after end of last five hiking cycles

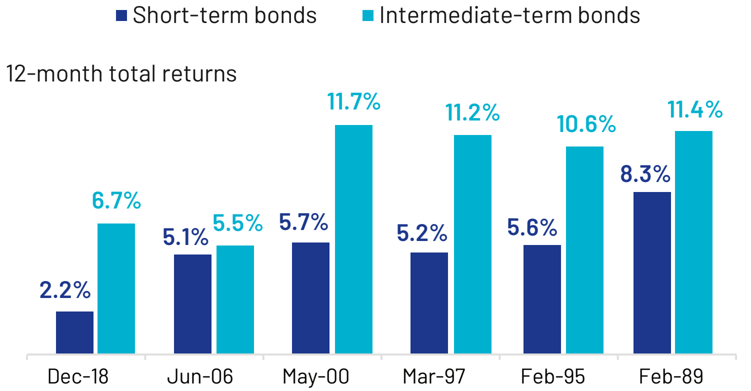
3. ...and dial up the duration: Although a risk-off stance on credit risk is beneficial at present, we recommend adding some duration risk to portfolios to take advantage when the yield curve normalises through bull steepening. We believe the duration multiplier will more than compensate for the slightly lower starting yields. Therefore, returns for intermediate-term paper should be higher than those for short-term paper, as has been seen in a number of instances when the Fed has been done with hiking rates.

Increasing duration locks in current rates for a longer period and reduces reinvestment risk



Source: HSBC Global Private Banking, as of 31 March 2023

Intermediate-term bonds have outperformed short-term bonds when the Fed has almost completed rate hikes



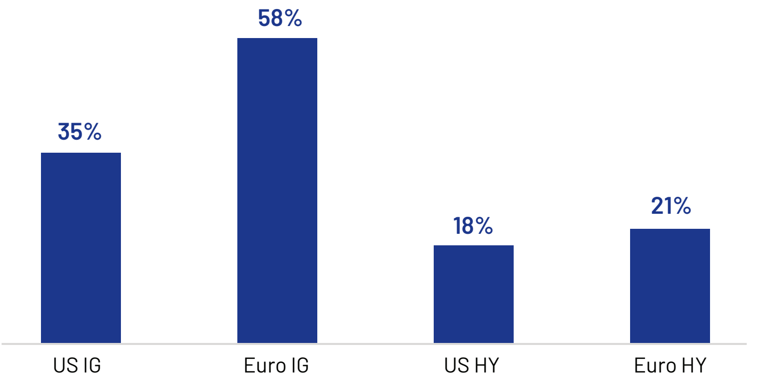
Source: Charles Schwab

4 months

Median period of peak Fed rates at the end of the past 10 hiking cycles, proving the attractiveness of locking in current high rates now

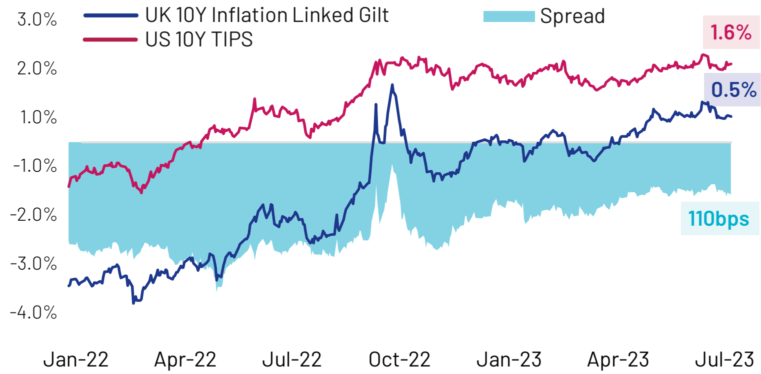
4. Europe rising: The European Commission raised its forecast for EU GDP growth to 1.0% (from 0.8% previously) in 2023 and 1.7% (from 1.6%) in 2024. Yield levels for Euro IG bonds are also attractive considering the improving growth and inflation picture. Although UK inflation has been stubbornly high, UK 10Y TIPS are a feasible option to earn real yields.

European markets better priced for recession



Source: Fidelity International

US and UK real yields are positive and look attractive



Source: St. Louis Fed

35%

European issuers likely to be downgraded by S&P in 2Q23, down from 53% in 1Q23 and the lowest in the past one year

1.0%

European Commission's forecast 2023 EU GDP growth, up from November 2022 forecast of a 3.6% contraction

Performance of the fixed income universe

Instrument	Attractiveness	Views
US Treasuries	●	» With yield-curve normalisation expected, we believe the belly of the curve (intermediate-term bonds) offers better return potential than the near end » The long end is less attractive, with yield compression expected to be lower than at the short end » Midpoint of expected 10-year returns is 3.8%
US TIPS	●	» Although inflation readings continue to come in lower, they are not expected to go back to the Fed's target rate of 2% in the near future, benefiting TIPS. Furthermore, TIPS are expected to gain the most in the event of unexpected high inflation readings » UK TIPS also look attractive, with positive real yields » Midpoint of expected 10-year returns for 10-year US TIPS is 3.2%
US munis	● ←	» Although tax-adjusted munis are still yielding 6%, the ratio of 10-year AAA G.O. munis/Treasury has trended lower over the past one year and stood at 68% at end-June, making them less attractive compared to US Treasuries
US IG	●	» We prefer to reduce credit risk in the current scenario of heightened risks of economic slowdown and volatile rates » IG corporates are still offering attractive yields of over 5%
US HY	●	» Overall, HY seems unattractive given the weak economic outlook, rising default rates, historically low spreads over IG and past performance when the yield curve is inverted » However, there are pockets of opportunity within the sector, so we prefer to stay within higher-rated credits » Midpoint of expected 10-year returns is 6%
Euro corporates	→ ●	» With lower energy prices and a surprisingly resilient economy, the fundamental scenario has improved over the year, and growth and inflation expectations are pointing in the right direction » Valuations look attractive in the IG space, and technicals are supportive, with most near-term maturities taken care of
Emerging markets	●	» The emerging markets coped with the inflation crisis well and are ahead of developed markets in the interest rate cycle; emerging-market central banks are, therefore, more able now to support growth in the event of weakness trickling down from developed markets » A weaker USD from the Fed's pause would provide an extra boost to local-currency debt returns » We suggest focusing on fundamentally strong economies and conservative sectors
Leveraged loans	● ←	» Loans continue to offer the highest yields among the major asset classes and have done their job of providing protection during the rising stage of the rate cycle » However, with rising default rates and expectations of being close to peak rates, we believe the downside risks outweigh the income opportunity
CLOs	●	» We prefer investing in leveraged loans through structured products such as CLOs due to their structural protections and higher risk-adjusted yields » We recommend staying within the upper tranches to avoid losses from rising default rates

Note: Return expectations are from Vanguard Investment Strategy Group, as of 31 March 2023

Least attractive — Most attractive

→ More attractive compared to previous report
← Less attractive compared to previous report

About the authors

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Pratik has over 8 years of experience in fixed income research. He is skilled in credit research, including financial modelling, report writing, investment recommendations and bond and index spread analysis.

He currently supports a European buy-side firm with credit and fixed income market research. He has a strong reputation among client traders and portfolio managers for a high percentage of correct rating calls. He holds a postgraduate diploma in Business Analytics from Great Lakes Institute of Management (India) and Stuart School of Business (IIT, Illinois), and an MBA in Finance.

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He currently supports sell-side analysts of a large investment bank, covering HY issuers in EMEA. Alankar holds an MBA in Finance and a bachelor's degree in Engineering.

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Acuity was established as a separate business from Moody's Corporation in 2019, following its acquisition by Equistone Partners Europe (Equistone). In January 2023, funds advised by global private equity firm Permira acquired a majority stake in the business from Equistone, which remains invested as a minority shareholder.

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» Private Equity: origination, valuation and portfolio monitoring support
» Asset Management services support: across marketing, investment research, portfolio management/ optimisation, risk and compliance
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» Compliance support: AML analytics, KYC, counterparty credit risk modelling and servicing across banks, asset managers and corporates
» Data Science: web scraping, data structuring, analytics and visualisation These services are supported by our proprietary suite of Business Excellence and Automation Tools (BEAT) that offer domain-specific contextual technology.

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