Yields Invested Bonds Rebounded

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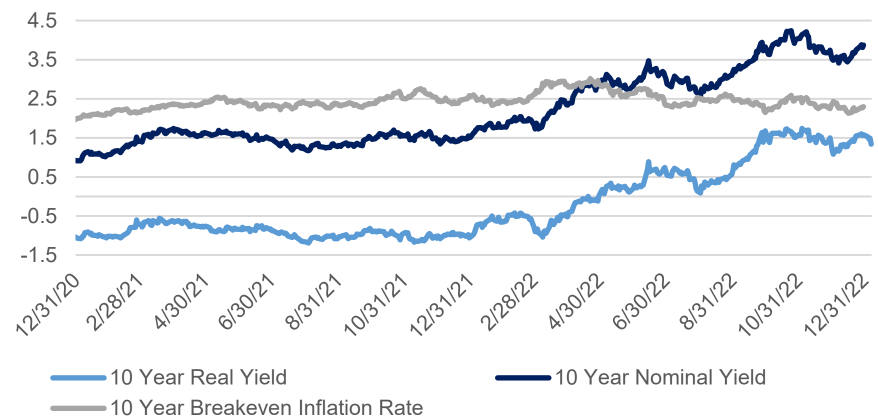
Treasury yields have fallen since the beginning of November due to a negative inflation data surprise at that time along with a dovish perception of the Fed's policy. They climbed higher in the last trading days of the year, however, when both the European Central Bank and the Bank of Japan surprised the market with hawkish policy decisions. The US nominal 10-year yields ended the quarter essentially flat at 3.87%, compared with 3.83% at the end of the third quarter. The real yield contributed negatively (down by 48bps), while inflation expectations, measured by the 10-year inflation breakeven rate, rose moderately from 2.15% to 2.30% (see Exhibit 1).

Exhibit 1: Treasury Yields ended flat in the fourth quarter of 2022

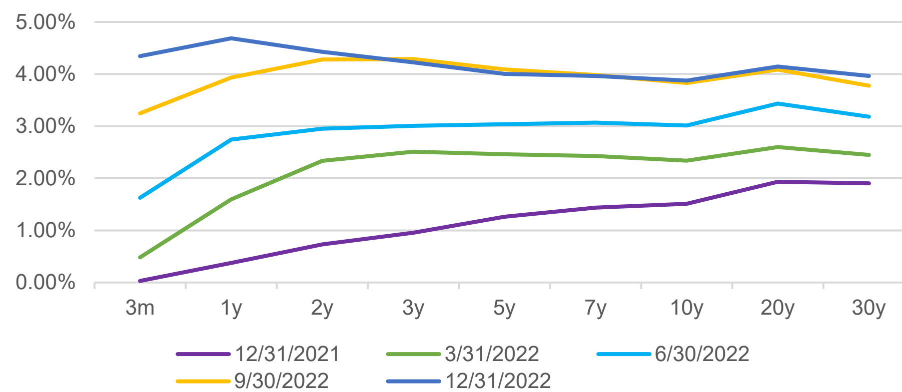


Source: Bloomberg.

After three quarters of deeply negative returns, the fourth quarter saw some rebound across different sectors in fixed income. The broad market, as represented by the Barclays U.S. Aggregate Bond Index and the Barclays Global Aggregate Bond Index, returned 1.9% and 4.6%, respectively, during the quarter.

Amid a further flattening of the Treasury curve, the yield curve inversion has become deeper during the fourth quarter, with the two-year yield now almost 55 basis points above the 10-year yield. Furthermore, the aggressive interest rate hikes from the Fed drove up the 3-month rates significantly from 3.25% to 4.34%, a level that is 47bps higher than the 10-year yields (see Exhibit 2). The Probability of Recession Model from the Federal Reserve Bank of New York (which looks at the difference between 3-month rates and the 10-year yield) currently predicts a 60% recession probability in the next 12 months.

Exhibit 2: U.S. Treasury Yields Curve



Source: Bloomberg.

Macro volatility may have peaked but is set to remain high

The bond market continues to be driven by expectations of inflation and Fed policy changes. We believe headline inflation has peaked for this cycle, but it remains uncertain how quickly and how low inflation might go in 2023. We have seen core goods disinflation and expect shelter inflation to decelerate as the housing market continues to cool down. However, core service inflation excluding shelter will be highly sensitive to labor market tightness and wage growth. We expect inflation to fall further in 2023 but will likely stay above pre-2020 levels for the foreseeable future.

Major central banks worldwide, except for the Bank of Japan and the People's Bank of China, have carried out their efforts to tame stubbornly high inflation. In the U.S., the Fed announced its fourth consecutive rate hike of 75 basis points in its November meeting, followed by a 50-basis point rate hike in December, bringing the Federal funds rate to a range of 4.25% to 4.5%. Despite the slower pace of rate hikes, we see central banks live with persistently above-target (above 2%) inflation, and unable to cut rates as quickly as some investors might have expected.

Bonds are Back

After a year of deeply negative returns, we believe that fixed income will likely deliver better performance in 2023.

First, we see compelling opportunities in fixed income, given higher yields across maturities and sectors (see Exhibit 3). Investors can earn higher income amid volatile markets as positive real yields now exist, with bond yields higher than expected inflation over the longer term. Also, compared with the equity earnings yield, bond yields have moved much higher during 2022. At the end of 2021, only asset classes such as leveraged loans and emerging market debt generated yields comparable with the S&P 500. An investor can now earn a higher yield without moving farther up the risk spectrum, with U.S. investment grade bonds yields higher than equities.

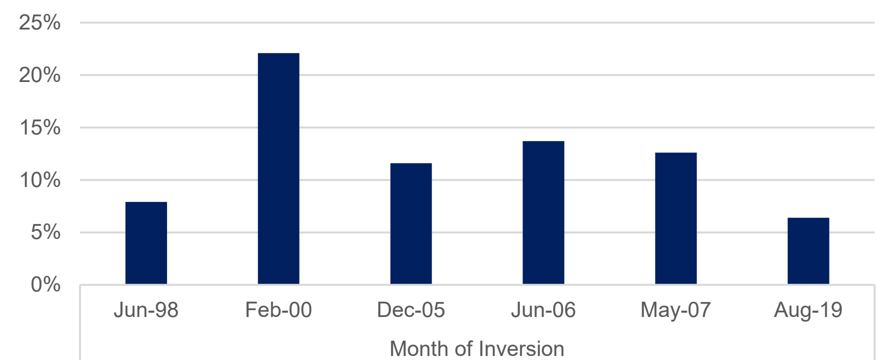
Exhibit 3: Yields of Key Fixed Income Markets

Treasuries	12/31/2022	12/31/2021	Difference
2-Year	4.4%	0.7%	3.7%
5-Year	4.0%	1.3%	2.7%
TIPS	1.6%	-1.0%	2.6%
10-Year	3.9%	1.5%	2.4%
30-Year	4.0%	1.9%	2.1%
Sectors			
U.S. Aggregate	4.7%	1.8%	2.9%
IG Corps	5.4%	2.3%	3.1%
Convertibles	7.1%	3.7%	3.4%
U.S. HY	9.0%	4.2%	4.8%
Municipals	3.6%	1.1%	2.4%
MBS	4.7%	2.0%	2.7%
ABS	5.9%	2.0%	3.9%
Leveraged Loans	11.4%	4.6%	6.8%
SPX	5.4%	4.4%	1.0%

Source: Bloomberg.

Second, in addition to more attractive yield potential, fixed income also looks more appealing given the current macroeconomic uncertainty – bonds tend to hold value better in a recession. We anticipate that when the economy continues to weaken and earnings estimates are cut, the traditional negative correlation between stocks and bonds will resume, and higher-quality fixed income should play its role as reliable hedging against risky assets. This year, we have witnessed a flattening of the Treasury curve with the inversion between the 2-year and 10-year yields triggering recession concerns. Empirical data has shown that bonds delivered good performance two years after the 2-year and 10-year U.S. treasury yields were inverted (see Exhibit 4).

Exhibit 4: Returns of the Bloomberg U.S. Aggregate Bond Index two years after 2-year and 10-year U.S Treasury yields invested



Source: Bloomberg.

Thirdly, the new regime of higher rates, a slower economy, and elevated market volatility requires us to take more granular views by actively allocating among sectors and sub-asset classes rather than depending on broad exposures. We favor a more cautious approach, allocating to higher-quality assets that tend to be less sensitive to economic downturns. We favor high-grade credit as we think it can hold up better in a recession than equities. In addition, corporate balance sheets are relatively healthy, with companies having already refinanced their debt at lower yields. Valuation for mortgage-backed securities also looks attractive as its spread increased to the widest levels in more than ten years, except during the liquidity crisis in 2020 at the beginning of the pandemic.

Investment Implications

In the wake of central bank tightening, stubbornly elevated inflation, and growing recession risks, we believe it is essential to actively manage duration and build more robust asset allocation while maintaining portfolio flexibility and liquidity. For YTD ending December 31, 2022, our Tactical Income strategy returned -9.8% net of fees, outperforming the U.S.

Aggregate Bond Index and the Global Aggregated Bond Index by 3.2% and 6.5%, respectively.

On duration, we remain moderately underweight to counter for policy risk and have moved closer to neutral in less tactical portfolios. For credit risk, we believe this is an environment where we make active decisions to balance near-term caution and a long-term focus on high-quality assets. We added short-term (IGSB) and intermediate-term (IGIB) investment-grade corporate bond ETFs to our more tactical portfolios. We've also added iShares Interest Rate Hedged Long-Term Corporate Bond ETF (IGBH) since last quarter as it provides exposure to long-term corporate U.S. investment grade corporate bonds with significantly less interest rate risk (effective duration: 0.02)

We believe that investing in a wide variety of assets can further help investors meet their income needs in this environment. We bought iShares U.S. Infrastructure ETF (IFRA) during the quarter as IFRA has 95% exposure to U.S. companies and is a relatively safe equity play as it invested in many super core regulated utility assets.

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