Three Factors That Make the Case for Fixed Income

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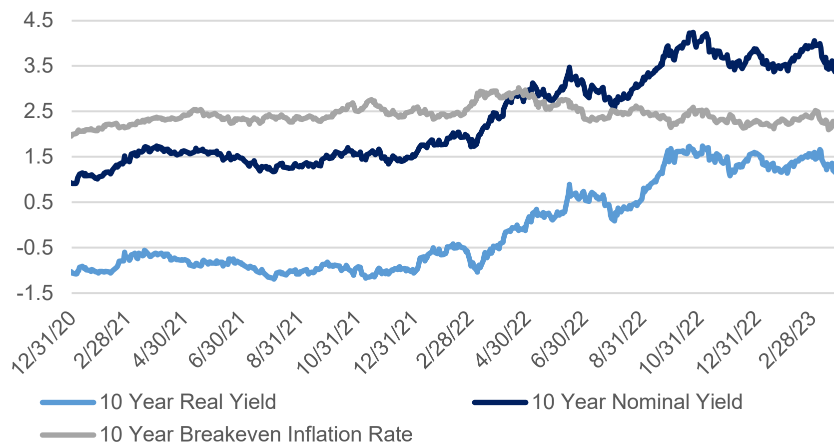
Market Recap

The first quarter of 2023 was generally a good one for bond investors, with the U.S. Aggregate Bond Index and the Global Aggregate Bond index returning 3.0% for the quarter. However, the road came with a few bumps. U.S. treasury yields shifted lower in January with relatively lower inflation but rose sharply in February with persistent inflation overall, robust job reports, and hawkish Fed speeches. In March, U.S. rates markets significantly repriced the path of monetary policy amid stress in the banking sector, resulting in a massive decline in treasury yields. The U.S. nominal 10-year yields ended the quarter lower at 3.47%, compared with 3.87% at the end of last year. The real yield contributed primarily to the move (down by 41bps), while inflation expectations (measured by the 10-year inflation breakeven rate) were essentially unchanged at 2.32% (see Exhibit 1).

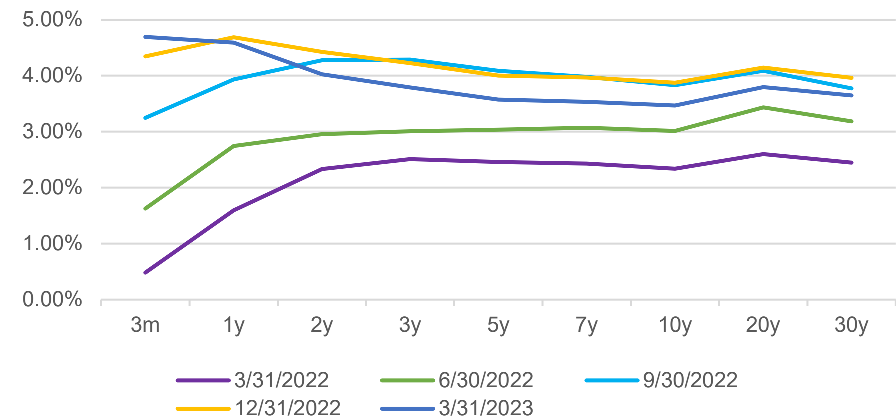
Exhibit 1: Treasury Yields declined in the first quarter of 2023



Source: Bloomberg.

Rates across the U.S. Treasury yield curve decreased for the quarter except for the 3-month rates, leading to a deeper inversion of the yield curve for the quarter. The 3-month yield, which is highly sensitive to the movement of the Fed funds rate, rose from 4.34% to 4.69%, a level 1.23% higher than the 10-year yields (see Exhibit 2). The 30-year bond yield, which is more sensitive to changes in long-term economic prospects, decreased from 3.96% to 3.65%.

Exhibit 2: U.S. Treasury Yields Curve



Source: Bloomberg.

At current yield levels, fixed income can provide an appealing balance between generating attractive income and hedging against economic downturns. We believe that bonds are attractive now due to various factors, including higher yields relative to historical levels, the Fed closer to the end of the hiking cycle, growing recession risks, and duration switching from a headwind to a tailwind. In this newsletter, we highlight three key recent developments that inform our outlook:

1. Fed closer to the end of the hiking cycle

In its March meeting, the FOMC lifted the target range for the Fed funds rate by another 25 basis points to 4.75% to 5% to continue to tame stubbornly high inflation among turbulence in the banking sector. However, we believe we are now closer to the end of the rate hiking cycle for at least the following reasons: 1) The Fed's guidance shows that the median projection for the Fed funds rate will peak at 5.1%, implying that the policymakers believe an additional 25pbs hike would be sufficiently restrictive, 2) The Fed's March statement replaced its previous statement, "ongoing increases in the target range will likely be appropriate" with "some additional policy firming may be appropriate" – taken by the market as a dovish shift, and 3) We believe the

recent development in the banking sector is likely to result in tighter credit conditions, which would work to slow economic growth and eventually affect inflation. As a result, the Fed might need to do less tightening for its monetary policy.

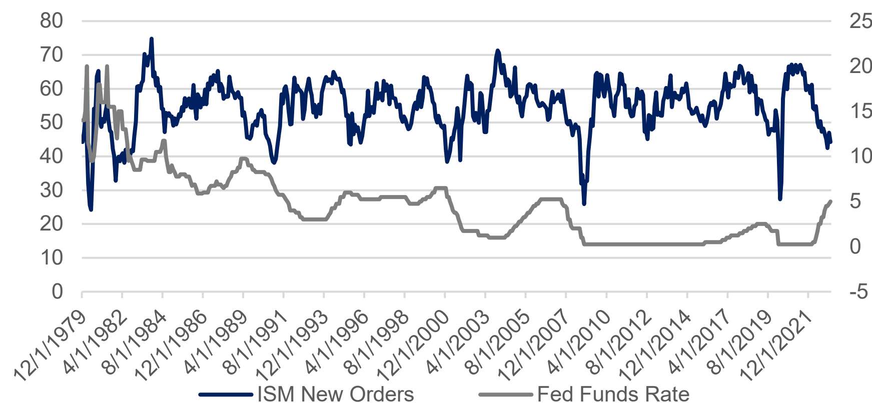
Meanwhile, we believe that the markets are overly optimistic by pricing in four rate cuts this year. We see a new phase of taming inflation ahead: less fighting proactively but no easing. Since inflation is still very high and we believe it will only moderate slowly, any actions to reduce rates will likely occur with a lag. Ultimately, policy easing will require tangible evidence of sustained declines in inflation and depend on the trade-off between inflation risks and financial stability.

2. Probability of recession has risen

Our base view is that a mild recession will likely occur in the U.S. over the next 12-18 months. The yield curve inversion has become deeper during the quarter, and the inverted yield curve is generally considered as a good leading indicator that signals recession risk (as shown in Exhibit 2).

This economic cycle is unique: the central banks are usually expected to come to the rescue by cutting rates with slower economic growth, but not this time. It is unusual for the Fed to raise interest rates when the manufacturing sector is in contraction. Exhibit 3 displays ISM manufacturing new orders versus the Fed funds rate from 1980. Historically, it is rare for the Fed to continue hiking when the new orders component is below the neutral level of 50. However, this time, the Fed continues to hike when new orders are contracting, as the Fed needs GDP growth to be below its potential for a period to tame persistent inflation.

Exhibit 3: ISM manufacturing New Orders versus the Fed Funds Rates (from 12/31/1979 to 03/31/2023)



Source: Bloomberg.

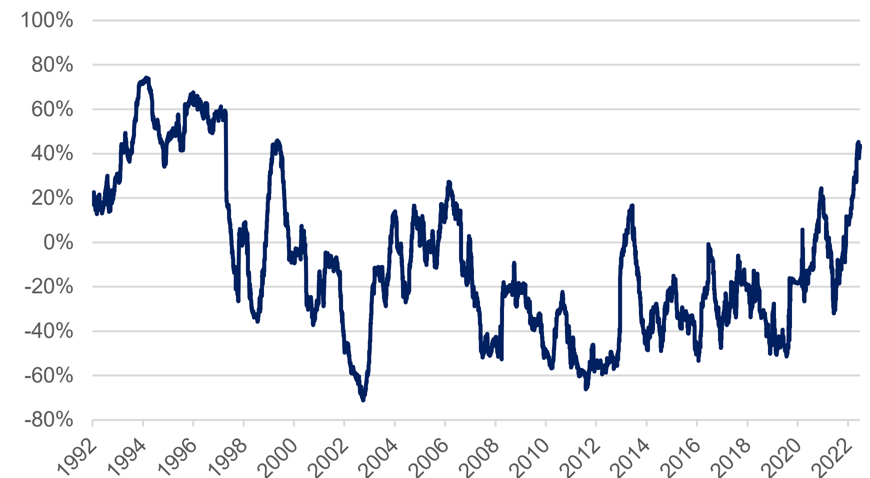
The banking sector turmoil that developed over the past month could also prove to be a headwind for economic activity. While we believe that the recent events are unlikely to escalate into a systematic banking crisis, they might lead to a pullback in credit growth which can be a meaningful drag on overall economic growth. Banks with less than $250bn in assets accounted for 70% of loan growth last year and 80% of the outstanding commercial real estate bank loans, indicating the impact that recent bank failures may have on the economic landscape.

Several factors are likely to limit the downturn to a mild recession, including strong consumer and corporate finance and potential reacceleration of real income due to moderating inflation and labor scarcity. However, a mild recession could be a headwind for equity markets and a more favorable environment for high-quality bonds, which should provide investors with good diversification potential.

3. Bonds-equities correlation is shifting

As we have anticipated, the traditional negative correlation between stocks and bonds resumed in the first quarter of this year, enhancing the role of high-quality fixed income as reliable hedging against risky assets. The traditional 60/40 balanced stock/bond portfolio suffered in 2022 as both stocks and bonds declined simultaneously. Exhibit 4 illustrates that over the last 20 years, returns of the S&P 500 and U.S. Aggregate Bond Index were usually negatively correlated, while 2022's strong positive correlation was relatively rare over that period.

Exhibit 4: Rolling 6-month correlations of S&P 500 and U.S. Aggregate Bond daily returns (from 1992 to 2022)



Source: Bloomberg.

With moderating inflation, peaking policy rate, and recent stress in the financial markets, the correlation has shifted back to a more traditionally negative one. On March 10, the collapse of SVB sent global equity markets lower, with S&P 500 down by 1.4%. On that day, lower growth expectations and risk-off sentiment led to a sharp drop in treasury yields and a rally in bond indexes. The correlation between the S&P 500 and the U.S. Aggregate Bond Index returns was -0.7 since March 9, a stark contrast to the positive correlation last year.

While the correlation between stock and bond performance can be influenced by confounding variables, empirical research has demonstrated that it is dependent on both inflation risks and monetary policy stability. During periods of high inflation uncertainty and quick Fed policy evolvement, stocks and bonds tend to move together. This finding helps to explain the strong positive correlation between equity and bond returns in 2022 with aggressive rate hikes from the Fed. On the other hand, correlations are much lower when inflation is moderate and Fed policy is relatively stable. As we move away from the regime of high inflation and extreme Fed actions in 2023, we believe that the stock/bond correlation will revert to a relationship more historically typical, reinforcing the diversification role of high-quality fixed income.

Investment Implications

With higher yields, a potential Fed pause and a likely economic downturn in 2023, we continue to see a compelling case for investing in fixed income. For YTD ending March 31, 2023, our Tactical Income strategy returned 2.2% net of fees, slightly underperforming the U.S. Aggregate Bond Index and the Global Aggregated Bond Index by 0.7% and 0.8%, respectively.

We are beginning to extend duration in our tactical portfolios and are neutral for duration in less tactical portfolios. For treasuries, we added short-term (SHY) and intermediate-term government bonds (IEF) for their attractive yields. 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 favor high-quality corporate bonds as they tend to perform better than equities in economic downturns and mild recessions. In the meantime, the banking sector turmoil reinforces our cautious approaches toward lower-rated corporate credit, such as high-yield bonds and senior bank loans. We trimmed our position in Invesco Senior Loan ETF (BKLN). We continue to believe that investing in a wide variety of assets can further help investors meet their income needs in this environment and have kept our exposure to alternative asset markets.

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