First quarter 2023 outlook

Better weather ahead for taxable fixed income

Anders Persson
CIO of Global Fixed Income

Tony Rodriguez
Head of Fixed Income Strategy

While 2022 was terrible for the financial markets, every cloud has a silver lining. Rate hikes are nearly finished, inflation is moderating and the economic outlook appears less dire. More importantly, yields are much higher, and yields are the primary driver of fixed income returns over time. We continue to favor non-Treasury spread sectors, with an up-in-quality bias. We like senior loans, preferred securities, high yield credit and emerging markets debt.

KEY TAKEAWAYS:

- The slowing economic environment and potential for wider credit spreads demand prudence and diversification.
- Anticipated rate declines, along with higher starting yields, create an attractive outlook for bonds.
- We continue to favor spread sectors and credit risk in asset allocation, with an up-in-quality bias within asset classes.

SAY GOODBYE TO LOW YIELDS AND WEAK RETURNS

An encouraging feature of today's bond market is its higher yields. While getting there was painful, the forecast for fixed income has significantly improved. Because income, not price return, has dominated bond market returns over time,[1] higher starting yields have frequently resulted in higher returns the following year.

***Higher starting yields** have frequently resulted in **higher returns** the following year.*

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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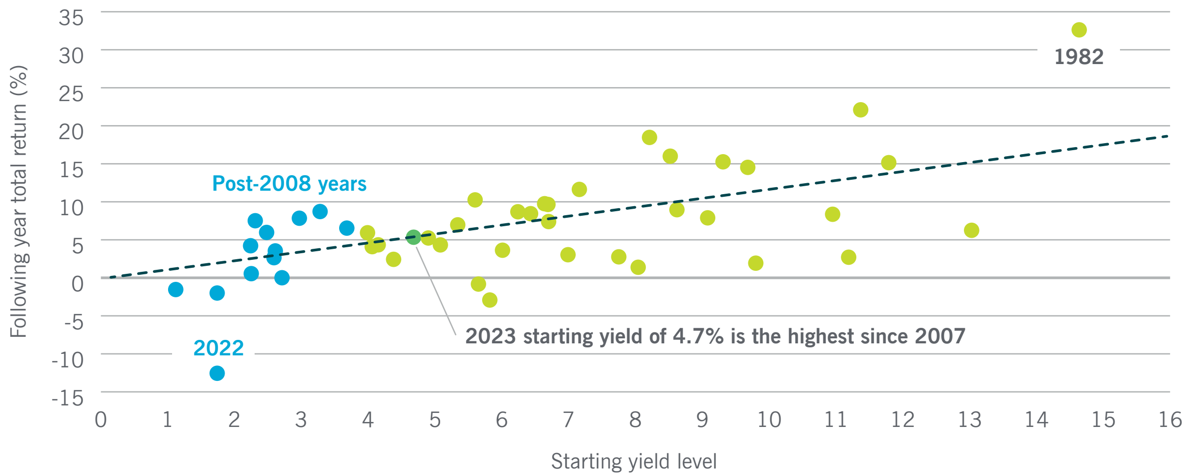
Figure 1: Higher starting yields have led to higher bond market total returns

Bloomberg U.S. Aggregate Bond Index

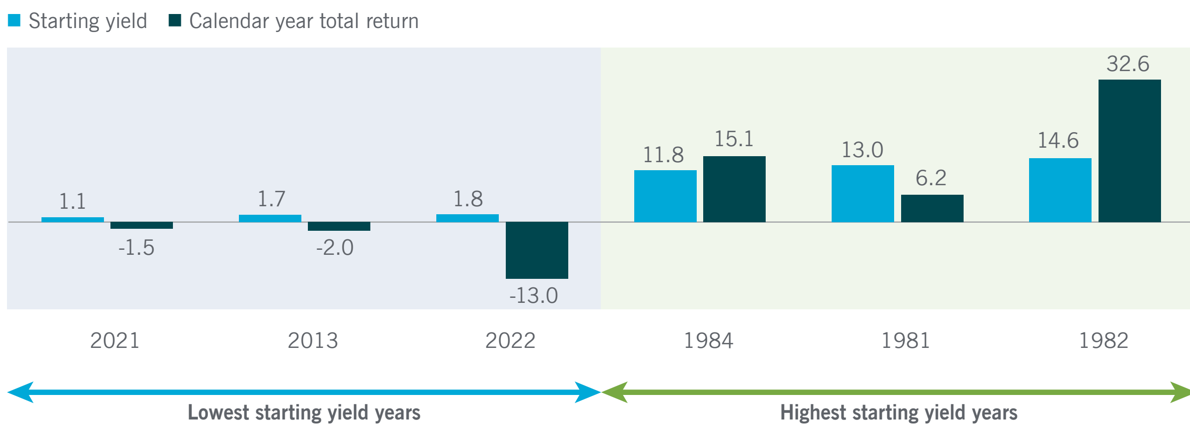


Data source: Bloomberg, L.P., 01 Jan 1977 – 31 Dec 2022. **Performance data shown represents past performance and does not predict or guarantee future results.** Starting yield is the yield-to-worst at the beginning of the calendar year. Following year total return is the total return for that entire calendar year.

Examining years with the highest and lowest starting yields provides better insight into this trend. Years with the lowest starting yield had negative returns, while years starting with the highest yields more often had positive returns. Of course, yields are not the only factor that affects returns, but their contribution can be significant.

Figure 2: Three years with highest starting yields had positive returns

Highest and lowest starting year yields (%)



Data source: Bloomberg, L.P., 01 Jan 1977 – 31 Dec 2022. **Performance data shown represents past performance and does not predict or guarantee future results.** Starting yield is the yield-to-worst at the beginning of the calendar year and following year total return is the total return for that entire calendar year.

The Bloomberg U.S. Aggregate Bond Index is starting 2023 at a yield of 4.7%, the highest level since before the 2008 financial crisis. In addition, consensus market forecasts are expecting the 10-year Treasury yield to fall 25 bps to 3.50% this year,[2] creating potential price return opportunities. (When interest rates decline, bond prices increase, and vice versa.) We believe the anticipated rate decline, along with the higher starting yield, creates an attractive outlook for bonds this year.

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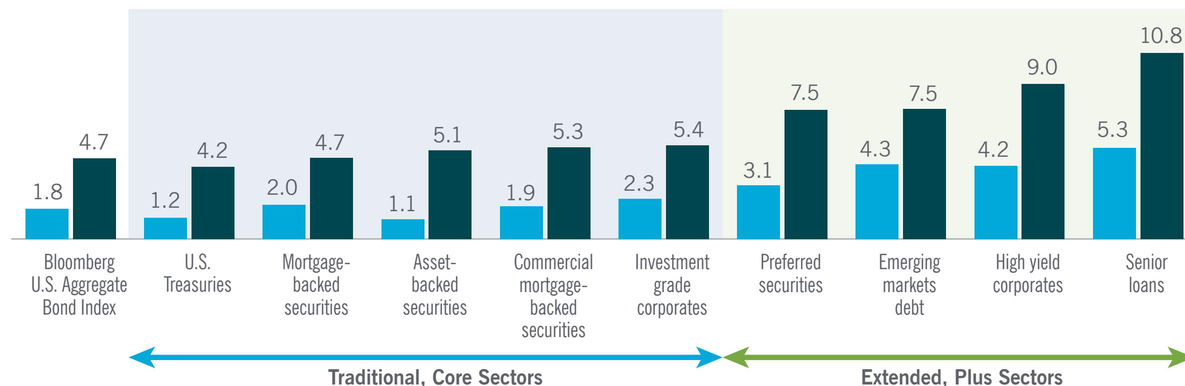
Figure 3: Start-of-year yields are attractive

Yield-to-worst (%)



Data sources: Bloomberg, L.P., Credit Suisse. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: broad bond market:** Bloomberg U.S. Aggregate Bond Index; **U.S. Treasuries:** Bloomberg U.S. Treasury Index; **mortgage-backed securities:** Bloomberg U.S. MBS Index; **commercial mortgage-backed securities:** Bloomberg CMBS Index; **asset-backed securities:** Bloomberg ABS Bond Index; **investment grade corporates:** Bloomberg U.S. Investment Grade Corporate Index; **emerging markets debt:** Bloomberg EM USD Aggregate Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield corporates:** Bloomberg U.S. HY 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index.

CONSIDER ACTIVELY MANAGED CORE AND MULTISECTOR PORTFOLIOS

While the yields on credit-oriented sectors are extremely attractive, the slowing economic environment and potential for wider credit spreads demand prudence and diversification. Using multisector portfolios, active managers can blend opportunities from the more conservative core sectors with smaller allocations of the higher return potential plus sectors. They can also actively manage credit risk and create an up-in-quality bias across the entire portfolio to help reduce risk.

Consider these ideas for fixed income allocations:

Short-term bond funds. The lower duration profile reduces the impact of rates changes on portfolio returns while still benefiting from a wide array of sectors. These funds typically combine higher-quality, short-duration sectors — like U.S. Treasuries, asset-backed securities and mortgage-backed securities — with smaller amounts of higher yielding sectors, such as high yield corporates and emerging markets debt. Note that yields on short-term bond funds are near the level of longer duration strategies, making them even more attractive.

Multisector bond funds. The additional yield potential can help offset price declines due to rising rates. The funds augment a base of diversified higher-quality sectors with larger allocations (typically up to 50%) to below investment grade securities. This approach offers more yield potential than core plus, in return for greater potential volatility.

Core plus funds. The ability to actively adjust allocations to lower-quality segments may increase yield while balancing overall risk. These funds combine a larger portion of higher-quality sectors — like U.S. Treasuries, mortgage-backed securities and investment grade corporates — with smaller allocations (typically up to 30%) to lower-quality sectors, such as high yield corporates, senior loans and emerging markets debt.

Core/core impact with small amounts of plus sector exposure. These funds focus on higher-quality sectors to maintain return profiles similar to the broad bond market with a low correlation to equities. Core strategies with the flexibility to add small amounts (0% to 10%) of lower-quality sectors can be particularly attractive. Core strategies with an impact investing mandate add the diversification of responsible investing themes.

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OUTLOOK

Fed hikes to slow, but credit spreads may widen

We continue to expect growth to moderate to a below-trend pace. We see heightened risks of recession in the U.S. and Europe this year, though the magnitude of a downturn should be mild by historical standards. Job growth, which has remained very strong in recent months, is likely to decelerate in the coming quarters. Inflation has likely peaked, but will remain too high relative to central banks' targets throughout 2023. This will drag on consumer spending and prompt further central bank tightening.

We expect the Fed to return to 25 bps hikes at the first three meetings of 2023. The European Central Bank is also likely to continue raising rates, though the overall level of rates in Europe should remain lower than in the U.S.

In China, policymakers will likely continue pivoting toward reopening and economic policy support. We expect the 10-year U.S. Treasury yield to reach 3.60% by the end of the first quarter and 3.25% by year end.

We continue to favor spread sectors and credit risk in asset allocation, with an up-in-quality bias within asset classes. We believe credit spreads should widen in the coming months, likely presenting more attractive entry points for risk taking. We do not see much further upside for long-end yields. Higher interest rates should benefit floating-rate asset classes like loans, while shorter-duration segments of high yield credit and emerging markets should also be insulated. Preferred securities continue to benefit from the overall health of the U.S. banking sector, which responds positively to rising rates.

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Endnotes

1 Data source: Bloomberg, L.P. Since index inception (31 Jan 1976 – 31 Dec 2022), 100% of the Bloomberg U.S. Aggregate Bond Index's annualized total return was derived from coupon return (as opposed to price appreciation).

2 Data source: Bloomberg, L.P., 31 Dec 2022.

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