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Restoring the Foundation in Fixed Income — December 2022

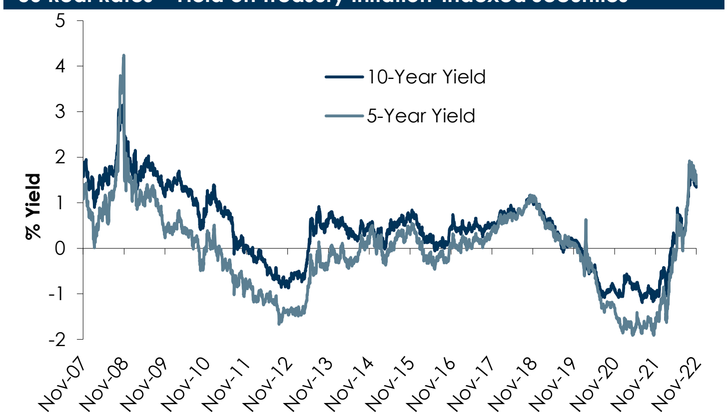
- **Rate hikes have driven 10-Year US Treasury yields up to levels not seen since 2011**
- **Meaningful yields on high quality fixed income assets should reset investor expectations for fixed-income returns**
- **Markets are currently pricing credit risk premiums well below historic peak levels**

What's happened with rates?

Following more than a decade of low rates, Fed rate hikes in 2022 have pushed nominal yields up to levels investors haven't experienced since the years immediately following the Global Financial Crisis. Rising rates have delivered historic losses to rate-sensitive assets in traditional fixed income portfolios. This repricing of rates has implications for how investors think about their portfolios going forward.

The 10-Year US Treasury yield recently closed on November 30th at 3.61%, a level that prior to this year was last breached in 2011. Inflation expectations and monetary policy have driven nominal rates higher. Importantly, we have also seen an increase in real rates (i.e. the amount of yield earned in excess of inflation) as investor's long-term inflation expectations have remained well contained in the second half of the year. Since early March, real yield, as approximated by the yield on 10-year Treasury Inflation-Protected Securities, has increased by about 2.4%.

US Real Rates - Yield on Treasury Inflation-Indexed Securities



Source: ACG Research, Federal Reserve Bank of St. Louis, Data as of 11/30/2022

10-year real yields are now higher than they were 85% of the time over the last 15 years. A similar comparison for 5-year real yields shows 5-year rates are higher than they were 96% of the time during the same period.

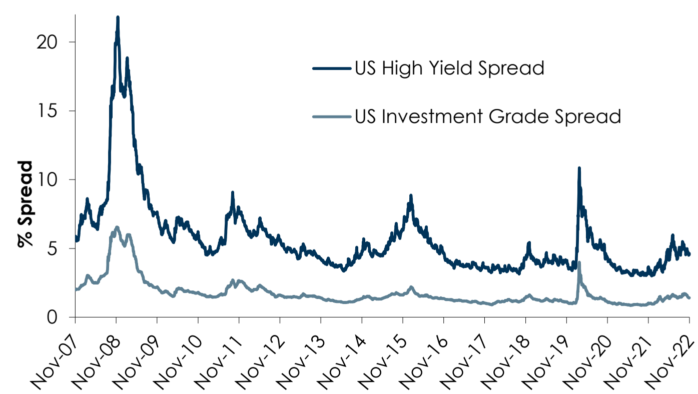
What do higher rates mean for my portfolio?

Higher yields make high quality fixed income a more attractive component of the portfolio. As yield rises, so does the expected future return on traditional fixed income assets. While 2022 results have so far delivered sizeable losses to investors, the fixed income market is now set up to provide a more meaningful contribution to portfolio results going forward. The reset in real yields means investors are now being more richly compensated for taking interest rate risk. This creates an opportunity for investors looking to reduce risk amid uncertainty around a potential 2023 recession. While often viewed as an unexciting part of the portfolio, higher rates have made high quality fixed income a relatively more attractive asset-class compared with the start of the year. Higher-yielding assets help to provide a buffer against volatility by providing an offset to losses elsewhere.

Are credit markets adequately pricing risk?

Unfortunately, credit spreads do not look as attractive on a historic basis as Treasury yields. As the Fed seeks to lower inflation through monetary policy, tightening financial conditions have the potential to create headwinds for economic growth. A higher cost of capital may result in some weaker corporate credit issuers facing balance sheet difficulty, especially if economic fundamentals start to erode. A number of credit managers have positioned their portfolios more defensively with the view that credit markets are not adequately compensating investors for 2023 recession risk. Credit spread, i.e. the premium paid to investors for taking credit risk, is underwhelming in both the investment-grade and high-yield markets.

US Corporate Spreads - Investment-Grade & High Yield



Source: ACG Research, Ice Data Indices, Federal Reserve Bank of St. Louis, Data as of 11/30/2022.

Both high-yield and investment-grade spreads currently sit below their 15-year median values. Over that period, spreads have been lower than current values just 41% and 44% of the time respectively. Even setting aside the extremes of the Global Financial Crisis, a quick glance at the chart above shows spread levels are currently well below several of the largest post-2008 spread widening events. Some arguments have been put forth to justify lower spreads, notably that credit indices now contain less risky assets than they had historically. Even a 200 basis point adjustment to spreads to account for this would still leave us with spreads below the previous peaks. With a handicap to historic US high yield spreads of 200 basis points, the current high yield spread would still be 200 – 400 basis points below the peak of the three largest spread widenings since 2010. If spreads were to widen further, it would have a negative impact on the performance of an investor's existing bond holdings.

ACG's Position

We often describe core fixed income as the "ballast" of a portfolio, but with higher rates, it doesn't need to be an anchor. It is important for investors to reevaluate their asset allocation mix during periods of elevated volatility to ensure their portfolio is still set up to deliver optimal results. While the picture on credit is less clear, with the repricing in the rates market, investors should consider whether core fixed income deserves a larger share of their overall asset allocation mix.

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