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Fourth Quarter 2022 Fixed-Income Sector Views

From the Desk of the Global CIO

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Duration could again be a tailwind for returns.

This Global CIO Outlook is excerpted from the Fourth Quarter 2022 Fixed-Income Sector Views.

While the path to get us here has been painful, yields for investment-grade assets are in the 5–6 percent range.[1] In more speculative grade assets, which tend to be more cyclically sensitive and carry more credit risk, we are seeing yields in the 8–10 percent range.[2] These levels have the potential to meet the return objectives of pension plans, insurance companies, or other investors that may have been sitting on the sidelines—or taking undue risk within fixed income in a reach for yield. The message from our sector teams is that it is now possible for many investors to potentially generate the income they require without taking excessive credit or duration risk.

One of the most compelling points for credit right now is the starting health of corporate borrowers as the downturn begins. Corporate issuers have been able to borrow cheaply for a long period of time, which enabled them to lower their cost of capital and improve their debt service and leverage ratios. This means that they should have a greater ability to absorb a higher cost of interest and a degradation of earnings that will come from a recession. In structured credit, rising home prices over the past few years have lowered loan-to-value ratios for borrowers, which is credit-positive for mortgage-backed securities.

As always, we have to be mindful with credit selection and maintain a healthy amount of defensive skepticism in our allocations, particularly with the Federal Reserve (Fed) still hiking and a recession looming (if it isn't already here), but our risk appetite is relatively strong right now. Our conviction is strengthened by the historically wide spreads and low dollar prices available in the market.

While credit spreads may widen more from here, history shows that peaks in credit spreads are often transient and short-lived. Market timers might find it productive to wait for a spike in credit spreads, but investors risk missing the opportunity to add investment-grade credit at historically cheap levels relative to U.S. Treasury securities. We believe current high-yield spreads of 450 basis points are compensating investors

1. Bloomberg U.S. Corporate Bond Index as of 9.30.2022.
2. Bloomberg U.S. Corporate High-Yield Index as of 9.30.2022.

for a market-implied default rate of 4.5 percent, which is significantly above the current default rate of 1.1 percent and above our expectation for a rate of 3.5 percent next year. However, if our expectation that a 2023 recession stretches into 2024 comes to pass, we believe defaults should rise to 7 percent. This would suggest that high yield may be susceptible to further deterioration should signs of a prolonged recession emerge. Additionally, defaults, especially for investment-grade and higher quality below investment-grade debt, are not likely to reach the peaks of prior cycles due to the extended period of financial repression that has enabled companies to lock in long-term rates at low levels and, more recently, to improve their balance sheets, which may reduce the impact that rising rates will have on corporate cash flows. Nevertheless, attractive yields may provide an income cushion that could reduce the impact if spreads should widen from here. We believe long-term investors are being compensated to take that risk.

The future is all that matters to investors, and these market conditions have the potential to offer good compensation for the range of risks that we see, as well as a relatively high starting point for total returns going forward. Duration has been everyone's enemy this year. We appreciate that it has driven down absolute returns for investors across the fixed-income universe—and it probably will for a while longer. But if the Fed is close to slowing the pace of rate hikes, as we expect, then the terminal rate for this cycle will also come closer into view and duration could again be a tailwind for returns.