TOP 5 INSIGHTS

Fixed Income Resiliency

MacKay Shields Fixed Income Team

Fixed Income Top 5 Insights for 2024

1. Economics Trumps Treasury Supply
2. Bonds Outperform Equities
3. Emerging Opportunities in Developing Market Debt
4. Lock in Mortgages in 2024
5. Stressed Credits Fall Out of Favor

As we navigate the intricate financial landscape of 2024, the overarching concerns surrounding the size and scale of the U.S. budget deficit, coupled with the substantial Treasury debt issuance required to address it, continue to captivate the attention of investors.

While the prevailing narrative suggests that these fiscal challenges may fuel interest rate volatility throughout the year, we find ourselves at a juncture where rising term-premia indicate that the market has already largely factored in the deteriorating supply outlook. The outcome of the 2024 U.S. Presidential election is a pivotal variable to watch. Amid these dynamics, we view current yield levels as laying the foundation for robust fixed income returns for the foreseeable future. Moreover, there are distinct opportunities that merit attention.

Emerging markets debt beckons with potential, offering a fresh avenue for investors seeking growth across corporate, hard-currency-sovereign and local-currency debt. Closer to home, agency mortgage-backed securities (MBS) stand as a compelling choice, boasting higher yields than investment-grade corporate debt while, in our view, carrying negligible credit risk. In addition, significantly higher mortgage rates have notably mitigated prepayment risk, reinforcing agency MBS as an attractive proposition. Meanwhile, high yield corporate bonds continue to hold appeal within the higher echelons of credit quality. Lower-rated CCC debt took center stage in 2023. However, deteriorating credit trends suggest that a repeat performance is unlikely.

Investments

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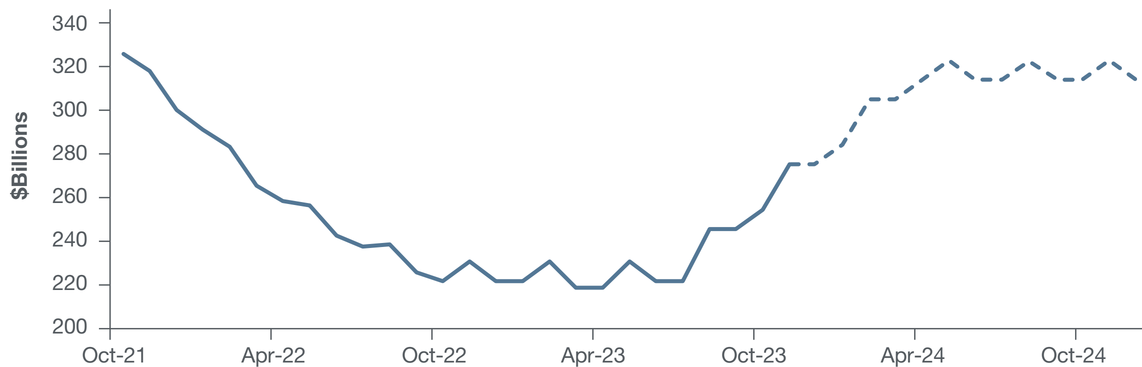
1 Economics Trumps Treasury Supply

Against a backdrop of long-simmering concerns over U.S. debt sustainability, we expect the outlook for deficits and supply to remain a driver of rate-market volatility in 2024, especially around quarterly refunding announcements and longer-dated Treasury auctions. Federal Reserve policy may also contribute to investor hand-wringing over the supply picture, as the central bank's ongoing quantitative tightening operations, or balance sheet run-off of Treasuries and MBS, will add additional supply back into the market likely through the first half of next year. Treasury will also need to offset via issuance the loss of income on the Federal Reserve's securities portfolio, as the central bank continues to fund low-yielding assets with expensive bank reserves. This later dynamic may remain in place for several more years.

Treasury Coupon Issuance, Actual and Forecast



Source: US Treasury Department, Bank of America

Still, we believe that any market volatility related to fiscal news may ultimately prove limited, at least in 2024. First, estimates of the Treasury term premium have risen notably in recent months, suggesting that a worsening supply outlook may already be largely discounted. In addition, we expect some factors that drove the significant increase in the fiscal year 2023 deficit will not repeat, namely, the inflation adjustment to social security outlays and weak capital gains tax revenues. Further, the growth slowdown we anticipate next year should put downward pressure on rates. We suspect this will be a more significant driver of fixed income markets, especially as moderating inflation will open the door to less restrictive monetary policy. Finally, the Treasury Department has already demonstrated sensitivity to market concerns over the supply picture, limiting the increase in long-term Treasury auction sizes in the most recent refunding announcement. We suspect Secretary Yellen will continue with this more flexible approach, within the context of regular and predictable issuance.

One important caveat to our views revolves around the presidential election, and the potential that former President Trump returns to office. This scenario could precipitate a material rise in yields and volatility, as a Trump presidency—especially if it coincides with Republican control of Congress—would dampen any move toward entitlement reform, raise market expectations that the 2017 tax cuts would be extended, and increase the odds that corporate tax increases in the Inflation Reduction Act would be eliminated. Progress on fiscal reform, while clearly not a priority today, would surely be kicked further down the road.

2 Bonds Outperform Equities

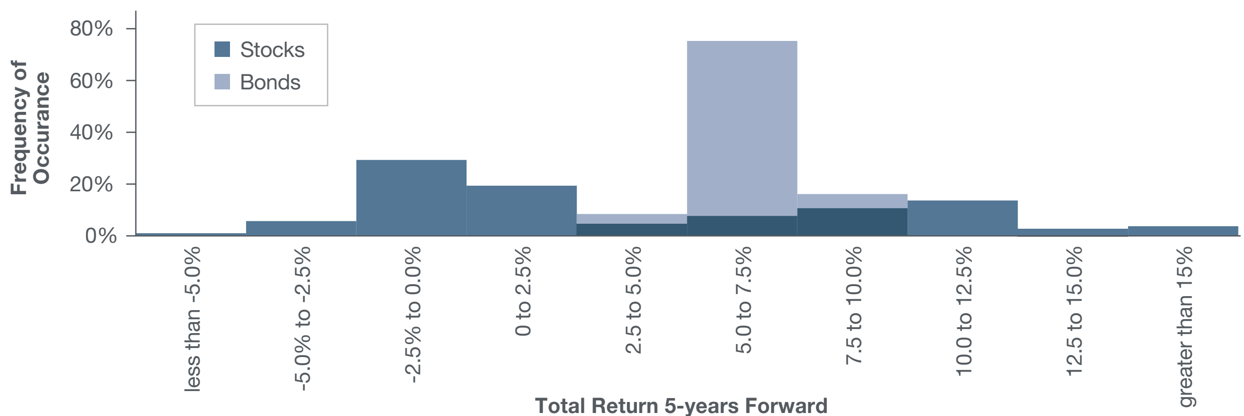
In assessing the potential of investment returns, starting levels of bond yields and equity multiples are very good indicators of potential returns over a medium-term horizon. At present, bond yields are at or near the highest levels since before the Global Financial Crisis. On average, these yields have historically led to outperformance over medium-to-longer-term horizons. This contrasts with current equity valuations, as indicated by the Shiller cyclically-adjusted price/earnings (CAPE) ratio, which historically correlates with underperformance when at current levels.

Equities Expensive Based on CAPE

Source: http://www.econ.yale.edu/~shiller/data.htm

Moreover, the consistency of returns from bonds is noteworthy. Data illustrate a more stable distribution of bond returns compared to equities, enhancing the appeal of fixed income investments. A historical perspective reinforces this view: in the last century, only a few instances, such as during the Great Depression and the dot-com crash, have seen U.S. equities outpacing bonds with yields and multiples at or near current levels.

Current Valuations Favors Bonds Over Stocks



Source: Bloomberg, Shiller date: http://www.econ.yale.edu/~shiller/data.htm, MacKay Shields; Bonds represented by the Bloomberg US Government/Corporate Bond Index from Jan 1973 to Jan 1976 and the Bloomberg US Aggregate bond index from Feb 1976 to Oct 2023. Stocks represented by the S&P 500.

Another key metric we look at is the equity risk premium (ERP), which we calculate as the earnings yield or the inverse of the S&P 500's price/earnings ratio, minus the yield of the 10-year U.S. Treasury note. Currently, the ERP hovers slightly over 1%, a figure comparable to the lows of 2007. This suggests that equity valuations, in relation to bonds, are at an unusually high level, unlikely to be sustained in the long term. This scenario presents a compelling case for prioritizing fixed income over equity in multi-asset portfolios.

Given today's yield levels, we advocate for a stronger focus on fixed income, even when considered independently of equity valuations. Not only does fixed income present attractive return potential, but, in our view, it also offers a buffer in portfolio performance during market downturns, particularly as current dis inflationary trends persist.

3 Emerging Opportunities in Developing Market Debt

From a total return perspective, we believe current yield levels across Emerging Market debt sub-asset classes offer significant positive potential for 2024. As we always advocate, country and issuer selection remain paramount to investment success, and we detect trends of divergence within each sub asset class.

Emerging Market Yields Offer Notable Opportunity

Source: JP Morgan. HC Corporates represented by World, Fixed Income Indices, J.P. Morgan, CEMBI Broad Diversified, Financials Face Constrained Broad Index, All Maturities, Stripped Yield to Maturity. HC Sovereign represented by World, Fixed Income Indices, J.P. Morgan, EMBI Global Diversified, Face Constrained Index, All Maturities, Stripped Yield to Maturity. Local Currency represented by World, Fixed Income Indices, J.P. Morgan, GBI-EM Global Diversified, Index, All Maturities, Yield.

For Emerging Market Hard Currency Corporates, we favor defensive sectors over cyclical sectors. Furthermore, TMT companies (technology, media & telecommunications) in Latin America are facing a tough competitive landscape and a challenging growth-stagnation trend going forward. We are also cautious on the petrochemical sector across regions due to large supply emanating from China, depressing margins for this industry worldwide. Utilities should continue to do well as a defensive sector, and we especially like the Indian renewable energy sector, which remains in growth mode and is well-aligned with the Indian government's clean energy transition objectives. Another area of opportunity, the Macao gaming industry continues to benefit from positive structural changes. The industry has shifted its focus from junket operators to one of premium mass market with higher profit margins. It has also successfully diversified its revenues by expanding into entertainment and attracting a new segment of consumers that are younger and more social media savvy, in addition to the well-established, traditional casino consumers.

Macao

Source: JP Morgan

Within Emerging Market Hard Currency Sovereigns, while investment-grade spreads are not particularly appealing to us, there are selective value opportunities in high yield sovereigns, where we think markets are too pessimistic on default probabilities. Similarly, within Emerging Market Local Currency Sovereigns, we believe high yielders in Latin America and Europe should outperform amid easing inflation and attractive term premia. However, low yielders in Asia may struggle, facing tight interest rate differentials against the U.S. and slower disinflation prospects.

For Emerging Market debt, we believe the theme of divergence across asset classes, regions, countries and sectors will be prevalent, which provides abundant investment opportunities for 2024.

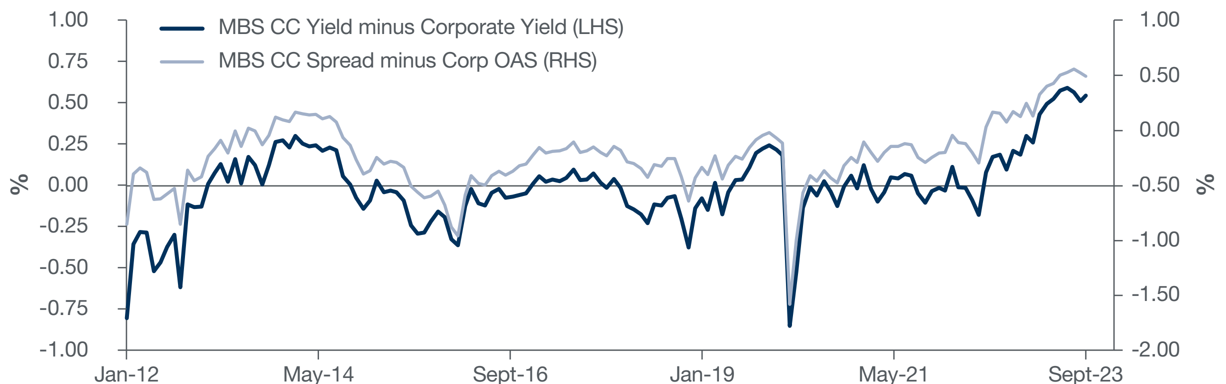
4 Lock in Mortgages in 2024

The attractiveness of U.S. Agency Mortgage-Backed Securities (MBS) is underscored by a convergence of monetary policy shifts and market dynamics. The Federal Reserve's move away from quantitative easing and its rate hikes have significantly widened the spread of agency MBS over U.S. Treasuries. This shift, along with high interest rates and a cooling housing market, has greatly mitigated prepayment risks, enhancing the appeal of agency MBS in the fixed-income market.

A notable factor in this landscape is the market technical pressures related to the banking sector. The FDIC's completion of the sales of agency MBS from the portfolios of Silicon Valley Bank and Signature Bank has alleviated some market pressure, potentially ushering in a period of more stable MBS pricing. There remains approximately $3 billion of agency CMOs that are still to be sold, but we expect these sales to be completed by the end of this year. However, bank demand for MBS has been notably weak, a trend that might see a turnaround should market volatility stabilize. Bank demand may also resurface as loan demand cools in a slowing economy. This potential increase in bank demand for MBS could provide further support to the market, making agency MBS an even more attractive investment.

Contrasting this with the investment-grade corporate bond market, spreads recently touched new lows for the year, not adequately reflecting the broader economic slowdown, heightened market volatility and geopolitical risks. This disconnect suggests that corporate bonds may not be fully pricing in the prevailing economic uncertainties. In contrast, agency MBS, with their higher yields, wider spreads and reduced prepayment risks, appear to offer a more accurate reflection of the current economic environment. This makes them a particularly appealing option for investors seeking stability and yield in an uncertain market. With the technical headwinds from banking sector challenges easing and the prospect of renewed bank interest in MBS, agency MBS are poised to be a key investment choice, offering both relative safety and potential for superior performance in the coming year.

Mortgage-Backed Securities Poised to Outperform



Source: Bloomberg and MacKay Shields as of November 24, 2023. MBS yield reflects the yield on FNMA currency coupon MBS, Corporate Yield is represented by the yield-to-worst on the Bloomberg US Corporate 5-10 Year Index of A or higher credit quality; MBS CC Spread is the currency coupon yield minus the average yield on a 5-year and 10-year US Treasury and the Corp OAS is the option-adjusted spread of the Bloomberg US Corporate 5-10 Year Index of A or higher credit quality.

5 Stressed Credits Fall Out of Favor

At the beginning of 2023, few would have predicted that CCC-rated bonds would have their best year since 2016. As of November 30, 2023, the CCC segment of the ICE BofA US High Yield Index has returned a remarkable 13.7%.

However, we believe it will be difficult for CCCs to continue their strong performance in 2024 versus the higher-quality part of the market.

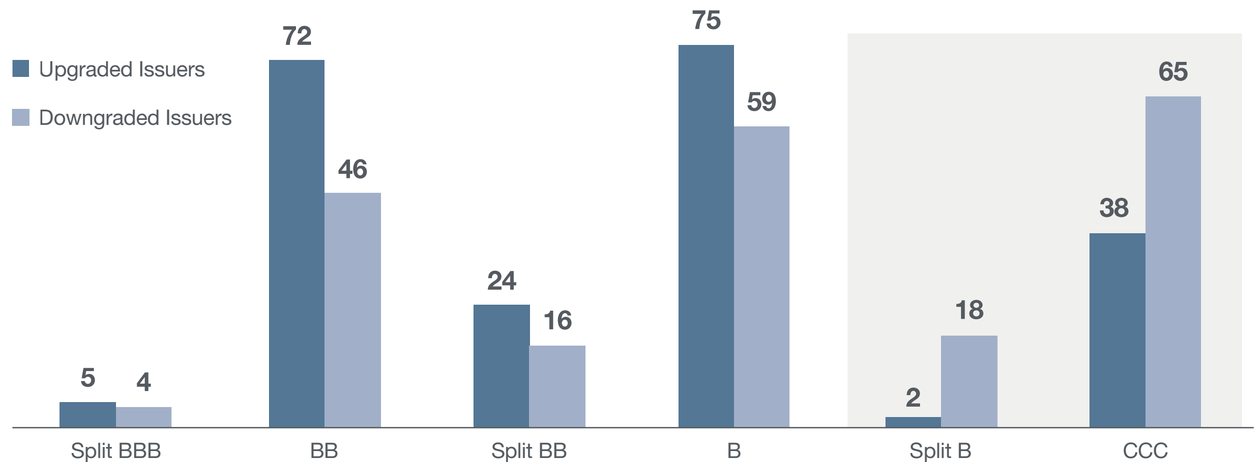
As shown in the chart below from JP Morgan, the "upgrade-to-downgrade" ratio for the high yield market remains above one (i.e., for every $1 of high yield bonds downgraded by credit rating agencies, $1.3 in high yield bonds were upgraded). While this ratio has declined sharply from the 2021 high, it suggests that broad credit trends remain stable.

Last 12 Months U.S. HY Upgrade to Downgrade Ratio (by Par)

Source: JP Morgan. As of September 30, 2023.

Beneath the surface, however, there is a stark difference in credit trends between CCC issuers and the rest of the high yield market. As seen in the chart below, so far in 2023, the number of CCC issuers downgraded (65) have significantly outnumbered the number upgraded (38). On the other hand, both BB and B issuers have continued to more frequently experience upgrades than downgrades.

Number of Issuer Upgrades and Downgrades YTD to September 2023



Source: JP Morgan. As of September 30, 2023.

It is important to note that CCCs represent only 11% of the market, and we believe the credit outlook for high yield remains strong. The quality of high yield bonds has improved significantly in the past decade. The ICE BofA US High Yield Index is now comprised of 51% BBs (on a par value basis) at the end of 2022, up from 43% at the end of 2011. High yield issuers today are generally publicly traded companies—69%, according to JP Morgan. Even if the U.S. economy heads into a recession, it is unlikely that default rates spike far above historical norms.

Source Information

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ICE BofA US High Yield Index
The ICE BofA US High Yield Index tracks the performance of U.S. dollar-denominated, below-investment-grade, corporate debt publicly issued in the U.S. domestic market. The ICE BofA US High Yield Index tracks the performance of U.S. dollar-denominated, below-investment-grade, corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have a below-investment-grade rating (based on an average of Moody's, S&P and Fitch) and an investment-grade-rated country of risk (based on an average of Moody's, S&P and Fitch foreign-currency, long-term, sovereign debt ratings). In addition, qualifying securities must have at least one year remaining term to final maturity, a fixed-coupon schedule and a minimum amount outstanding of $100 million. Original issue zero-coupon bonds, "global" securities (debt issued simultaneously in the Eurobond and U. S. domestic bond markets), 144a securities and pay-in-kind securities, including toggle notes, qualify for inclusion in the Index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed-rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating-rate security. DRD-eligible and defaulted securities are excluded from the Index.

S&P 500 Index
The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

JPMorgan EMBI Global Diversified Index
JPMorgan EMBI Global Diversified Index is an unmanaged, market-capitalization weighted, total-return index tracking the traded market for U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

JP Morgan Government Bond–Emerging Market Index
JPMorgan GBI-EM Global Diversified (GBI-EM) series, launched in June 2005, is the first comprehensive global emerging markets index of EM local government bond debt. There are three root versions of the GBI-EM with a Diversified overlay for each version; GBI-EM Broad / GBI-EM Broad Diversified, the GBI-EM Global / GBI-EM Global and the GBI-EM / GBI-EM Diversified.

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