INSIGHTS & PERSPECTIVES
from MacKay Shields Global Credit Team

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Bonds Are Back to Being Bonds

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Bonds are back to being bonds in 2023, as we believe higher income will drive investment grade returns. Investment grade bond yields are now at 13 year highs hovering around 5%, which provide investors with more downside protection from a slowing economy and wider credit spreads. We maintain that the currently inverted Treasury curve makes the front-end of the investment grade market the most attractive risk-reward opportunity. As the economy slows into 2023, front-end Treasury yields could slip. We believe investors should consider taking action before the window narrows.

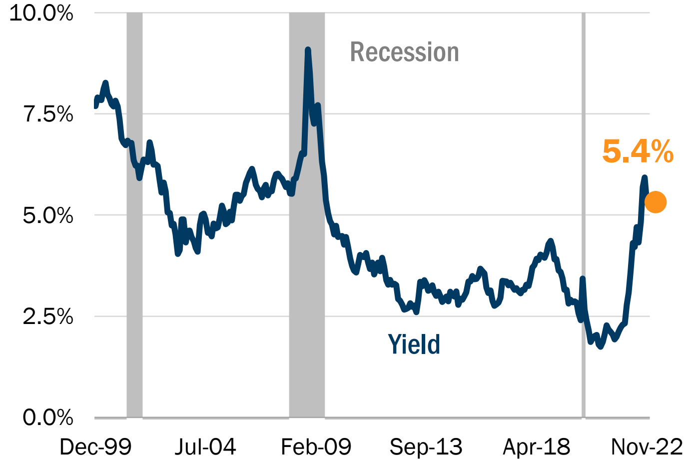
Bonds Behaved Like Equities in 2022

Bond investors in 2022 were reminded that bonds' returns are driven both by coupon and price, but the price return component matters most in a rising interest rate environment.

The sizable and rapid increase in interest rates pushed through by the Federal Reserve in 2022 as it tackled generational high inflation led to the front end of the Treasury yield curve to rise by over 300 basis points.

As a result, bond prices fell as yields reset to higher levels; the yield on the Bloomberg Corporate Index rose from a near record low of 2% in early 2022 to over 5% in late 2022 (interest rates and bond prices move in opposite directions). Simply put, investors will remember 2022 as the year when the income component of holding a bond was unable to offset the lower price moves from rising interest rates. For the full year, corporate bond indices ended down low to mid-double digits, with price declines driving the vast bulk of the negative return.

FIGURE 1: INVESTMENT GRADE YIELDS | 13 YEAR HIGHS



Data as of December 1, 2022
Source: Bloomberg Corporate Index and BEA. It is not possible to invest directly in an index. See disclosures for index descriptions.

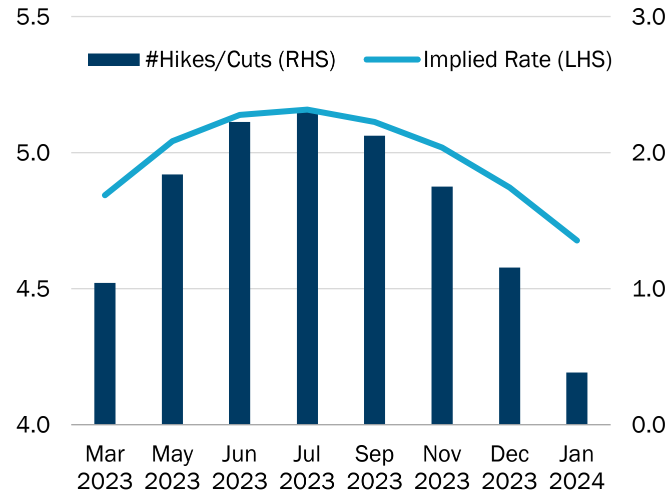
As a decade of low interest rates came to a rapid end, bonds did not act like bonds, but more like equities.

Bonds Are Back to Being Bonds in 2023; Income Dominates

However, things look remarkably different in 2023. Bonds are back to being bonds, with total returns expected to be driven predominantly by coupon and not by price returns.

Today's higher interest rates mean higher yields on corporate bonds. The current yield on the Bloomberg Corporate Bond Index is now around 5%, close to levels last seen almost 13 years ago. Moreover, the current index yield is above the peak yields of the recent recessions and spread widening periods of 2020, 2018, 2016 and 2013.

FIGURE 2: MARKET EXPECTS FEDERAL RESERVE TO CUT INTEREST RATES BY FALL 2023



Source: Bloomberg

With yields at 5%, investors are now being paid to own corporate bonds, as the relatively high yield component in our view provides attractive cushion from widening credit spreads should the economy slow.

After the experience of 2022 and against a backdrop of slowing economic growth, political uncertainties across geographies and elevated energy supply worries, investors are right to be wary. However, these concerns are likely to impact more volatile assets classes such as equities where returns may be more episodic and the carry-like returns in the mid-single digits expected of bonds are less certain.

Exploit the Inverted Treasury Curve

We believe now is the time for investors to add income and yield to their investment portfolios to take advantage of the currently inverted Treasury curve.

The US Treasury curve is at its most inverted level in the last 40 years. This may not endure.

The Federal Reserve is likely closer to the end of its tightening cycle today than it was this time last year. We certainly expect the Federal Reserve to increase interest rates a couple more times this year, though in smaller increments, as it is still reluctant to signal that its tightening job is done and inflation is tamed.

Treasury yields could peak in the middle part of this year as the Federal Reserve completes its tightening objectives. The focus will then shift to how long interest rates remain at those levels and how the economy reacts to tightened financial conditions.

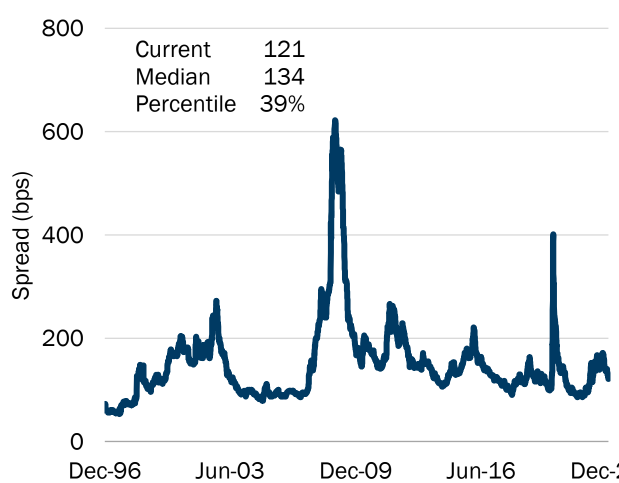
We believe the economy is and will react to higher interest rates. In fact, we believe the economy will slow during the latter half 2023 and the Federal Reserve could subsequently consider reducing interest rates. Certainly, the market is pricing such a scenario with interest cuts occurring in the second half of 2023.

Against the backdrop of now elevated front end Treasury yields, we maintain investors should consider adding corporate bonds on account of the currently high yields.

Investors Are Being Paid to Be Defensive

Our base case is that the economy slows as we go through 2023. For credit investors that means credit spreads will likely widen. Currently, investment grade credit spreads appear almost indifferent to pricing in a recession. BBB-corporate spreads are toward the mid-point of their historical range. This is in contrast to the inverted Treasury curve which has typically been taken as a signal for a forthcoming recession.

FIGURE 3: INVESTMENT GRADE SPREADS



Source: ICE Data, MacKay Shields. Index: ICE BofA US Corporate Index. It is not possible to invest directly in an index. See disclosures for index descriptions.

Credit spreads are simply too low for a recession, but yields are not. While yields are typically are the main driver for investment grade credit, credit spreads can and do go wider in a recession.

We expect credit spreads to widen over the course of 2023 as slowing economic growth weighs on corporate profitability and both consumers and corporations feel tightening financial conditions.

In this environment, investors need to be paid to own investment grade credit ahead of a recession. We believe shorter maturity bonds offer the best risk-reward opportunities to

- Exploit the inverted US Treasury curve
- Protect from economic weakness
- Defend against higher yields and widening credit spreads
- Capitalize on short periods pulling to par

The sweet spot resides in the 3- and 5-year part of the investment grade corporate bond yield curve. These tenors benefit from elevated front-end Treasury yields but also have less credit spread sensitivity as part of their total yield.

In contrast, longer duration bonds suffer from

- Longer spread duration – more events can happen over the life of the bonds
- Vulnerability to yield curve steepening from widening credit spreads
- Limited yield advantage vs. shorter dated bonds

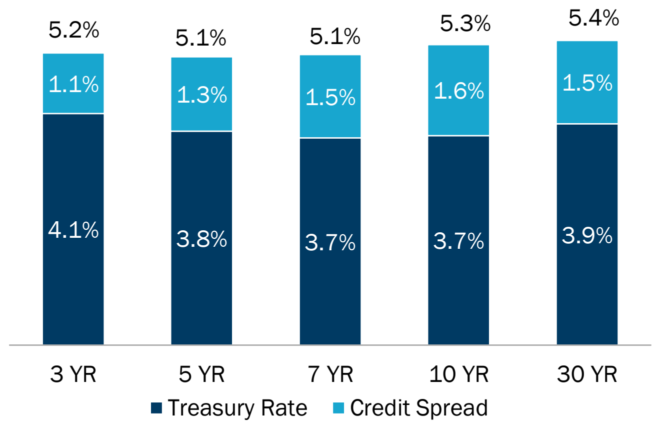
Not All Bonds Are Equal: Focus on the Front-End Sweet Spot

We believe looking at bonds from another perspective also makes front-end bonds a compelling investment.

Front-end bonds hold more attraction when looked at from a bond breakeven perspective. A bond's breakeven measures how much its yield can rise before the total return (price plus income) is erased over a 12 month period (technically is it calculated as a bond's yield dividend by its duration).

Bonds in the 3-and 5-year buckets of the Bloomberg Corporate Index would need to see their yields increase by 240bps and 130bps, respectively, before their annual total returns are negative. Putting that into context, yields on these bonds would need to rise from 5.2% and 5.1% to 7.4% and 6.4%, respectively.

FIGURE 4: SHORT MATURITY BONDS OFFER INCOME AND LESS RISK



As of January 10, 2023
Source: J.P. Morgan US Liquid Index (JULI). It is not possible to invest directly in an index. See disclosures for index descriptions.

How realistic is that possibility? Let's look at things at the overall investment grade corporate index level and focus on the 7-year maturity bucket. Credit spreads would need to move out 90bps to around 240bps before total annual returns turn negative. Investment grade corporate index credit spreads are in the mid-40th percentile and would need to move toward the 90th percentile for this to occur. In other words, only 10% of the time have credit spreads been wider. Furthermore, spreads would need to remain there for a year. More likely in such a scenario, a large economic shock has occurred or a very hard-landing taken place, and the Federal Reserve would look to react by reducing interest rates and hence bring yields lower/bond prices higher.

Our point here is that current high yields on investment grade bonds offer more protection to investors from spread widening. Elevated front-end Treasury yields can enhance that protection. Investors are currently being paid to own investment grade credit even in the face of a slowing economy and the prospect of widening credit spreads. In our view the best protection is found in the front-end part of the corporate credit yield curve.

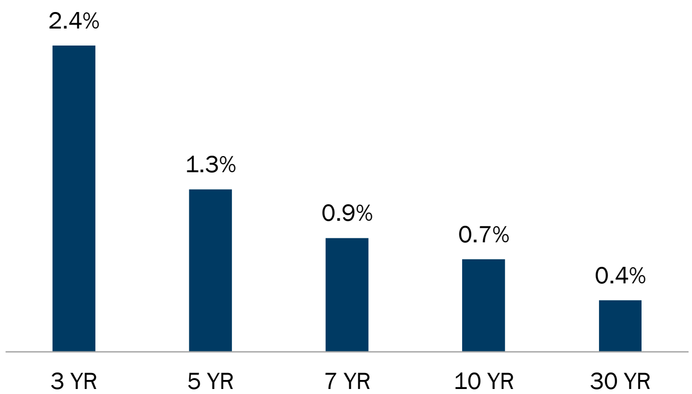
Investment Process Guides Risk Posture

Bonds have an asymmetric return profile: all the upside of par instruments and all the downside of equity. Knowing that and having a systematic process to identify and price risk can help ensure outsized and unappreciated risks are not taken.

A key tenet of our investment process is combining macro-economic risk assessment with industry and individual company selection.

By understanding where we are and where we are likely going in the economic cycle, and favoring industries and companies that are cyclically best positioned, we believe we can protect against spread widening in a slowing economy and exploit spread tightening in a recovery economy.

FIGURE 5: SHORT MATURITY BONDS CAN PROVIDE BETTER DOWNSIDE PROTECTION



Breakeven yields as of January 10, 2023.
Source: J.P. Morgan US Liquid Index (JULI). It is not possible to invest directly in an index. See disclosures for index descriptions.

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