

Top 5 Fixed Income Market Insights for 2022: Mid-year Update

Transition Leads to Opportunity

Consistent with MacKay’s Global Fixed Income forecast in our 2022 Insights, the taxable fixed income markets are undergoing a transformational shift away from an extended period of ultra-low interest rates and accommodative financial conditions to an environment of higher interest rates, tighter credit conditions and heightened volatility.

While transitions typically create uncertainty and weaken investor sentiment, they can also lead to unique opportunities. Today, we believe fixed income valuations are meaningfully more attractive and current yields have greatly improved the income profiles for investors. While investors have endured unprecedented drawdowns from the bond markets in 2022, in our view the future holds compelling opportunities.

Theme	Rationale	Portfolio in Action	Mid-Year Status
1 EXPECT MORE VOLATILITY ON THE SHORT END	<p>As the Federal Reserve adjusts to a tighter monetary policy, we expect rates on shorter maturity bonds to move higher from current levels. Both the timing and magnitude of the move may prompt increased volatility in shorter-maturing bonds relative to longer-maturing bonds. Should Federal Open Market Committee (FOMC) rate hikes happen sooner than anticipated or more aggressively than projected, the yield curve is likely to flatten as investors weigh the risks of a more proactive Fed inducing a slowdown. Moderating inflation may shrink the yield differential between longer and shorter maturities. We are decreasing allocations to short-term debt to reduce the risk that a flattening yield curve poses.</p>	<p>Based on the view that the Fed would need to adjust monetary policy more rapidly, portfolios were positioned to be underweight short maturities in favor of longer maturities. Looking ahead, the yield curve has repriced future expectations for short term rates.</p> <p>Yields on short and intermediate maturities have risen more than longer maturity bonds, flattening the overall yield curve. We have reduced our curve flattening positions and shifted to intermediate maturities where we see better risk adjusted returns.</p>	<p>ON TARGET</p> <p>Volatility on short maturities have increased significantly during the first half of 2022 based on market expectations for a faster pace by the Federal Reserve to normalize rates. This has also led to a significant flattening of the yield curve as yields on short maturities have risen more than longer maturity bonds.</p>

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<p>2 CORPORATE CREDIT: CATCH A "RISING STAR"</p>	<p>We see 2022 as a year of positive ratings trajectories that will result in a higher volume of "rising stars" or companies upgraded to an investment grade rating (BBB-/Baa3 or higher). During the pandemic-induced volatility in 2020 the credit markets experienced approximately \$200 billion in "fallen angels" or companies whose credit rating was reduced from investment grade to junk status (BB+/Baa1 or lower). In 2021, the downgrade trend reversed as "rising stars" outpaced fallen angels by 2-to-1, according to data from JPMorgan. We expect this trend to continue into 2022 and beyond as more companies continue to de-lever, increase free cash flow and improve their balance sheets as the economic expansion enters its second full year.</p>	<p>Portfolios that permit sub-investment grade debt were positioned in select BB rated credits that we believed were rising star candidates or whose ratings trajectory was pointing to investment grade status. Included in this cohort were several issuers that were upgraded in 2022. These are names that bring in new buyers from the investment grade market, thus resulting in spread compression.</p>	<p>ON TARGET The corporate credit markets have already experienced \$61 billion in rising stars through the first five months of the year, according to data provided by Goldman Sachs. These upgrades have been most prevalent in the energy, healthcare and food & beverage sectors of the market. In the energy markets alone JPMorgan is forecasting another \$90 billion in rising stars over the next 18 months.</p>
<p>3 DON'T COUNT CONSUMER OUT</p>	<p>U.S. consumers continue to be a bright spot in the economic recovery and remain poised to power future economic activity. Thanks to generous fiscal stimulus and a tight labor market, consumers are flush with savings and confidence remains high. We expect consumer spending to remain strong in this coming year. Two key metrics - the household obligation ratio and household debt to net worth - have fallen to their lowest levels in 40 years, suggesting consumers also have room to pay down debt. Investors in securitized credit card debt and auto loans are likely to see rapid repayments.</p>	<p>We favored asset-backed securities with more of a focus on consumer oriented collateral such as auto, credit card and time share receivables.</p> <p>Concerns around lower income consumers have led us to adjust our investment approach and focus more on the top of the capital stack for new deals originated in 2022. However, we remain focused on adding down in the capital stack in seasoned securitizations.</p> <p>Additionally, as yields have risen AAA assets have cheapened, providing unique opportunities to add these high quality assets to portfolios.</p>	<p>MIXED We are seeing a bifurcation between lower income consumers and the higher end cohorts. This tends to be typical during economic slowdowns given that inflation represents a tax that is more punitive for low to moderate income households. The consumer still represents more than two-thirds of the US economy, so trends in spending and confidence warrant close attention.</p>
<p>4 A NEW INFLATION REGIME</p>	<p>Rising wages and housing costs suggest higher inflation in the years ahead; capital spending on renewable energy and carbon-neutral initiatives will likely be inflationary longer-term. Thus, we think it is unlikely that inflation returns to pre-COVID-19 levels, despite productivity improvements gained by businesses and reductions in supply chain bottlenecks.</p>	<p>Remained defensive to neutral on interest rate risk in the portfolios.</p> <p>Positive real yields, an inflation fighting Fed and intermediate yields greater than the neutral rate have led us to increase interest rate exposures in portfolios.</p>	<p>MIXED The near-term inflation environment has turned out to be even stronger than we anticipated, prompting the Fed to bring forward policy tightening considerably. Despite this policy shift, inflation will likely remain well above the Fed's two percent objective at least through the end of next year, even as growth slows to below trend. Ultimately, we believe the Fed will win the battle against inflation.</p>

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<p>5 HOUSING MARKET ROLLS ON</p>	<p>We expect the supply/demand imbalance in housing to support price increases in 2022. Housing prices have exceeded expectations as limited supply and competition met multi-generational demand. COVID-19 and the advent of hybrid work has meaningfully altered housing preferences.</p> <p>Low inventories, particularly in the fastest growing cities, are likely to persist with little identifiable new sources coming to the market in the near term. Since the Global Financial Crisis, underwriting standards have improved as evidenced by average Fair Isaac Corporation (FICO) scores increasing and loan to value ratios declining. Importantly, lenders also no longer offer affordability loans such as pay option adjustable-rate mortgages. Rising prices for underlying assets coupled with strong underwriting standards should generally support mortgage-related debt instruments.</p>	<p>We adopted a two-prong strategy to be underweight prepayment risk and overweight residential credit risk. The management of prepayment risk was evidenced through a significant underweight to agency mortgage pass-through securities favored by the Federal Reserve as part of its quantitative easing program. The Fed being the largest buyer in the market coupled with historically low interest rates, we felt these securities offered little value. Conversely, we rotated into residential mortgage credit such as Single Family Rentals (SFRs) and Credit Risk Transfer (CRT) securities. We believed these securities would provide attractive risk-adjusted total return potential owed to the strength of the borrower and favorable housing market fundamentals.</p>	<p>ON TARGET</p> <p>Although recent data suggests a softening in the housing market, including new and pending existing home sales coupled with meaningfully higher mortgage rates, the housing market has remained relatively robust during the first half of 2022. The dearth of supply relative to the demand for homes from first-time home buyers and second home purchasers continues to support housing prices despite lower affordability. While spreads on agency passthroughs have widened, residential mortgage credit has fared worse due to heavy supply.</p> <p>As we enter the second half of the year, we have started to slowly add prepayment risk back into portfolios at wider spreads, while staying active in residential mortgage credit, specifically in seasoned securitizations, given strong credit fundamentals and expectations for ratings upgrades.</p>

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