Active Fixed Income Outlook 3Q 2023: Yield Is Your Friend

While the U.S. Federal Reserve (Fed) remains hawkish, the backdrop of falling inflation and slowing economic growth should limit further increases in long-term interest rates

Higher yields provide a cushion against an uncertain macroeconomic environment

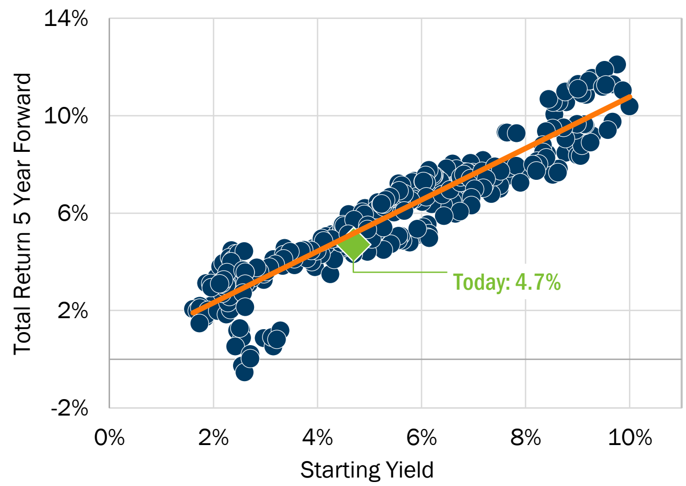
We believe active management and a focus on higher-quality sectors will be key factors in the third quarter.

Looking Ahead

While there are still challenges in the global economic backdrop, including Fed policy and economic uncertainty, we believe the opportunity set for fixed income is compelling today. Higher bond yields mean higher return expectations across the board.

Indeed, starting yield is a good indicator of total return for a bond over a medium to longer horizon. As yields rise the potential for a stronger total return also moves up as can be seen in the exhibit below. Here we measure the total return of the Bloomberg U.S. Aggregate Bond Index five years forward and compare that to the yield at the start of those same five years. As you can see, there is a high correlation between the starting yield and the realized future total return. Today's yield is 4.7%, slightly off the highs reached in October 2022, but more than four times the yield from three years ago in the midst of the COVID-19 pandemic and among the highest levels in more than a decade.

FIGURE 1: INITIAL CONDITIONS MATTER



It is not possible to invest directly in an index. Please see disclosures for information related to comparisons to an index and index descriptions.
Past performance is not indicative of future results.
Source: Bloomberg and MacKay Shields. Data from January 1, 1987 to June 26, 2023.

Approach: Guidance

DURATION
Long duration bias as we believe interest rates are at or near cycle peaks

YIELD CURVE
Inverted yield curve = favor intermediate maturities

SPREADS
Favor agency mortgages, commercial mortgage-backed securities and high quality corporates

VOLATILITY
Gradual normalization to lower levels

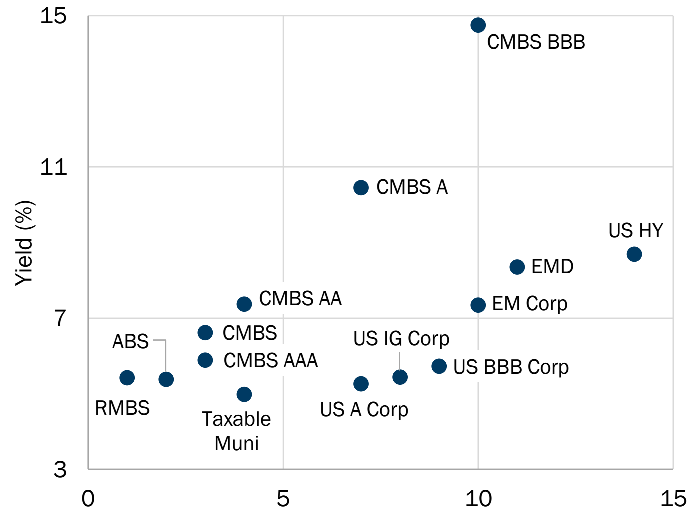
ASSET ALLOCATION
Up-in-quality bias

Periods of elevated bond market volatility typically create pockets of dislocation across certain segments of the market. With economic uncertainty top of mind for investors, we view the opportunity best in higher quality segments of the market, such as residential mortgage-backed securities (RMBS), asset-backed securities (ABS) and investment grade corporate bonds.

Of note, commercial mortgage-backed securities (CMBS) appear disproportionally attractive today. This is primarily due to the challenging environment created by the work-from-home trend that reduced occupancy rates, higher interest rates and stress in the banking sector resulting in limited credit availability. While the negative outlook for office space has driven spreads in the CMBS market much wider, office accounts for less than 20% of outstanding commercial real estate debt.

Outside of office, fundamentals remain strong and there should be room for rents to rise so long as a severe recession can be avoided. For example, multi-family properties enjoy strong demand as high home prices and high mortgage rates make home ownership prohibitively expensive for many people. In addition, continued growth in e-commerce is driving demand for warehouse space. Even within the office sector, we are seeing opportunities in select properties that can retain tenants and sustain rents. Accordingly, we believe opportunity exists for risk-aware investors to take advantage of the current dislocation and considerable yield and total return upside potential to portfolios.

FIGURE 2: HIGHER QUALITY ASSETS OFFER GENEROUS RISK-ADJUSTED YIELDS



Please see disclosures for index descriptions.
US IG Corp: Bloomberg US Corporate Total Return Index Value; US A Corp: Bloomberg A Corporate Total Return Index Value; US BBB Corp: Bloomberg Baa Corporate Total Return Index Value; US HY: Bloomberg US Corporate High Yield Total Return; ABS: Bloomberg US Agg ABS Total Return Value Unhedged USD; Euro IG: Bloomberg Pan European Aggregate Corporate TR Index Value Un; EMD: J.P. Morgan - EMBIG Diversified Yield to Worst; EM Corp: J.P. Morgan CEMBI Broad Div Yield to Worst; MBS: 30Y FNCL Par Coupon; CMBS: Bloomberg Non-Agency CMBS Total Return Index Value Unhedged USD; CMBS AAA: Bloomberg Non-Agency Investment Grade CMBS: Aaa Total Return Unhedged; CMBS AA: Bloomberg Non-Agency Investment Grade CMBS: Aa; Taxable Muni: Bloomberg Municipal Index Taxable Bonds Total Return Index Value.
Source: Bloomberg and JP Morgan. Past performance is not indicative of future results. It is not possible to invest directly in an index.

IMPORTANT DISCLOSURE

DEFINITIONS

Active Management: Active management is the use of a human element, such as a single manager, co-managers or a team of managers, to actively manage a fund's portfolio. Active management strategies typically have higher fees than passive management.
Duration: Duration can measure how long it takes, in years, for an investor to be repaid a bond's price by the bond's total cash flows.
Spreads: The difference of gap that exists between two prices, rates, or yields.
Yield Curve: A line that plots yields of bonds having equal credit quality but different maturity dates.

COMPARISONS TO AN INDEX

Comparisons to a financial index are provided for illustrative purposes only. Comparisons to an index are subject to limitations because portfolio holdings, volatility and other portfolio characteristics may differ materially from the index. Unlike an index, individual portfolios are actively managed and may also include derivatives. There is no guarantee that any of the securities in an index are contained in any managed portfolio. The performance of an index may assume reinvestment of dividends and income, or follow other index-specific methodologies and criteria, but does not reflect the impact of fees, applicable taxes or trading costs which, unlike an index, may reduce the returns of a managed portfolio. Investors cannot invest in an index. Because of these differences, the performance of an index should not be relied upon as an accurate measure of comparison.

INDEX DESCRIPTIONS

The following indices may be referred to in this document:

BLOOMBERG U.S. AGGREGATE BOND INDEX

The Bloomberg U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. Must have at least one year to final maturity regardless of call features. Must have at least $300 million par amount outstanding. Must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Must be dollar-denominated and non-convertible.

BLOOMBERG US CORPORATE TOTAL RETURN VALUE UNHEDGED USD

The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers

BLOOMBERG BAA US CORPORATE INDEX

The Bloomberg Baa Corporate Index measures the Baa-rated, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

BLOOMBERG US TAXABLE MUNICIPAL BOND INDEX

The Bloomberg U.S. Taxable Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term taxable bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies if all three rate the bond: Moody's, S&P, and Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate and must be at least one year from their maturity date. Remarketed issues (unless converted to fixed rate), bonds with floating rates, and derivatives, are excluded from the benchmark.

BLOOMBERG US CORPORATE HIGH YIELD TOTAL RETURN INDEX VALUE UNHEDGED USD

A component of the US Corp High Yield Index that is designed to track a more liquid component of the USD-denominated, high yield, fixed-rate corporate bond market. The US High Yield VLI uses the same eligibility criteria as the US Corp High Yield Index, but includes only bonds that have a minimum amount outstanding of USD500mn and less than five years from issue date.

BLOOMBERG PAN-EUROPEAN AGGREGATE INDEX

Covers eligible investment grade securities from the entire European continent. The primary component is the Bloomberg Euro-Aggregate Index. In addition, the Bloomberg Pan-European Aggregate Index includes eligible securities denominated in British pounds (GBP), Swedish krona (SEK), Danish krone (DKK), Norwegian krone (NOK), Czech koruna (CZK), Hungarian forint (HUF), Polish zloty (PLN), Slovenian Tolar (SIT), Slovakian koruna (SKK), and Swiss franc (CHF). Apart from the currency constraint, the inclusion rules for the Pan-European Index are identical to those of the Bloomberg Euro-Aggregate Index.

BLOOMBERG NON-AGENCY INVESTMENT GRADE CMBS INDEX

The Bloomberg Non-Agency Investment Grade CMBS Index measures the market of conduit and fusion CMBS deals with a minimum current deal size of $300 million that are rated investment grade or higher using the middle rating of Moody's, S&P, and Fitch after dropping the highest and lowest available ratings.

J.P. MORGAN EMBI GLOBAL DIVERSIFIED INDEX

The J.P. Morgan EMBI Global Diversified Index (EMBIG) tracks liquid, US Dollar emerging market fixed and floating-rate debt instruments issued by sovereign and quasi-sovereign entities.

J.P. MORGAN CEMBI BROAD DIVERSIFIED CORE INDEX

The J.P. Morgan CEMBI Broad Diversified Core Index (CEMBI CORE) tracks the performance of US dollar-denominated bonds issued by emerging market corporate entities.

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