Assessing the Entry Point for Fixed Income

Fixed Income in 2024—Lessons from History

Specialty Fixed Income

For the first time in a long time, rising yields have made bonds a much more powerful part of the asset allocator's toolkit. How should asset allocators be thinking about the role of fixed income in portfolios?

Entry Points Matter

Mathematically, when investors buy in at a higher yield, the coupon income can cushion them against significant capital losses. To put this in perspective, we looked at points in history when yields were around their recent levels, and then looked at the range of return outcomes of the relevant indices (Figure 1).

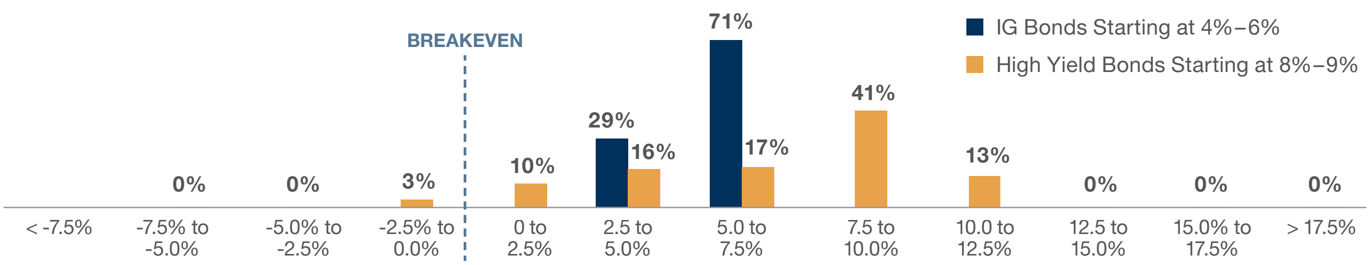
Over the long term, we looked at every month where investment-grade bonds were yielding 4% - 6% and plotted the annualized total return over the next 5 years. In all cases, total returns were positive, and in 71% of the observations, index returns were 5% - 7.5% a year.

Turning to the U.S. high yield index[1], we looked at months when bonds were yielding 8% - 9%. As might be expected in a more volatile asset class, outcomes were somewhat more dispersed. More than 70% of the time the index returned 5% or more and in 13% of cases returned double-digit gains. Losses occurred in just 3% of observations.

The Opportunity in High Yield

Investors can often reduce overall portfolio volatility and reduce downside risks by allocating to high yield from other assets such as equities. Today, while overall yields remain attractive, spreads have tightened considerably since hitting 6% in July 2022. With that in mind, we recommend a relatively defensive stance in high yield, focusing on the higher-quality part of the market.

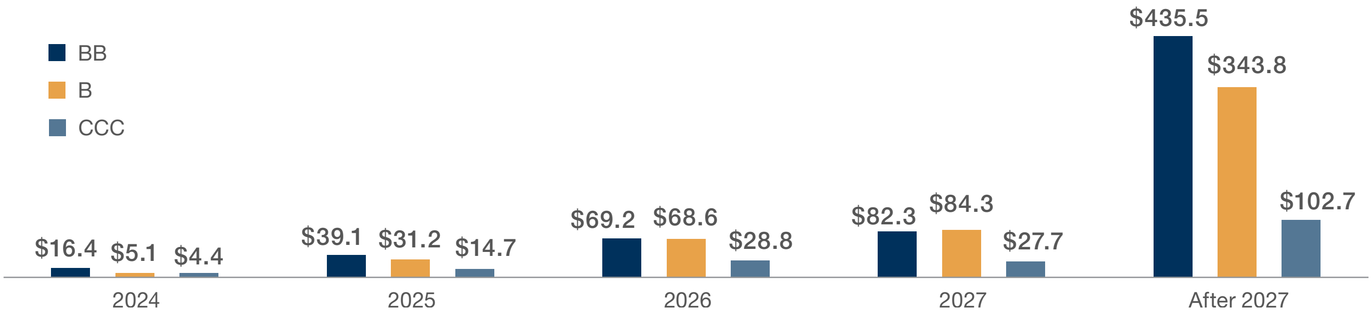
Figure 1: Annualized returns over 5-year holding periods | distribution of monthly observations



Data from January 1973 to December 2023. Investment-grade bonds = Bloomberg Gov/Credit from 1973-1975; Bloomberg US Aggregate from 1976-Present. High-yield bonds = Bloomberg High Yield Corporate Index: 1983 – Present. Source: Bloomberg L.P. and MacKay Shields. It is not possible to invest directly in an index. **Past performance is not a reliable indicator of future performance.**

1. Bloomberg High Yield Corporate Index

Figure 2. Majority of lowest-rates bonds mature after 2026 | $BN



Data as of January 31, 2024
Source: ICE Data

Although overall high yield credit trends remain stable, with low historical leverage and higher interest coverage ratios, CCC issuers have diverged from the rest of the market. In 2023 we saw a continued upgrade trend for the BB-B part of the market, but there was a faster pace of downgrades among low single-B and CCC-rated issuers. This was partly due to the impact of higher financing costs for more levered companies, and issuers in some sectors such as telecoms and media are facing secular pressures.

The U.S. High Yield Maturity Wall

Against that backdrop, how concerned should investors be about approaching maturity walls, where companies will need to refinance maturing debt at higher interest rates?

Roughly US$110 billion worth of U.S. high yield bonds are coming due in 2024 and 2025. At about 8% of the market, we think this volume is manageable, particularly given continued strong investor demand for credit. That said, demand in the primary market has mostly been for BBs and single-Bs. For example, of the roughly US$180 billion in new deals last year, only about 1% was in CCC's according to JPMorgan.

The good news is that most of the bonds coming due imminently are higher-quality credits (Figure 2). The bulk of the CCC maturities are after 2026, offering some runway for more levered companies to refinance.

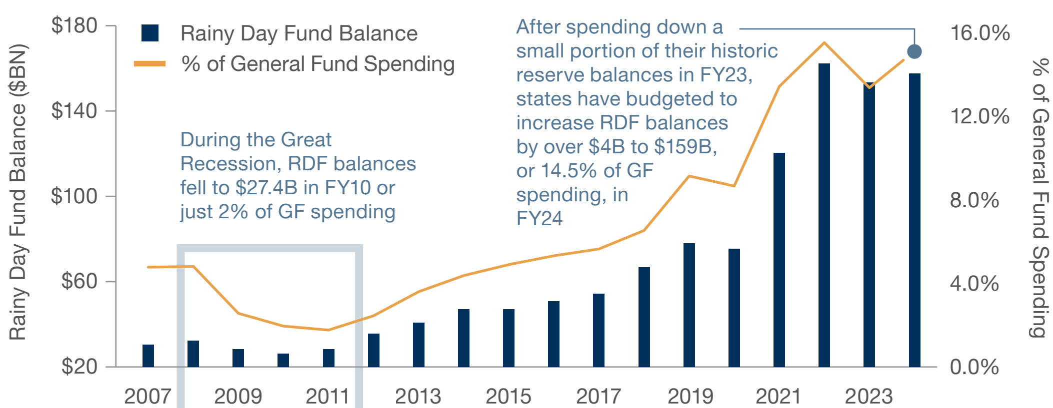
We don't expect significant defaults in the high yield market. Default rates may move closer to their long-term averages of 3% to 4% but, barring a severe macroeconomic event, we don't see them going much higher.

Potential for Seismic Shifts in the Municipal Market

We believe we could see investment flows shift back to the municipal bond market this year as the interest-rate cycle starts to turn, and this should support valuations. Overall, we think municipals could be a strong late-cycle asset class solution.

In terms of the broad credit fundamentals, we believe municipal issuers should remain resilient, even in an economic slowdown scenario. Revenue streams among state governments are diverse; we have seen broad-based replenishment of rainy-day funds, and municipal revenue collections hit an all-time high last year (Figure 3).

Figure 3. States continue to grow their reserve levels



States **more than doubled** reserve levels since FY20 (+$82 billion)

States are projected to close fiscal year 2024 with **$159 billion** in reserves, second only to FY22 levels of $164B

Source: NASBO Fiscal Survey of States, Spring 2023

In terms of credit quality, given that municipal issuers have the flexibility to raise revenues and even cut expenses when they need to, it gives them the latitude to stay relatively stable.

This year we changed our asset allocation guidance to a slight high yield overweight relative to investment grade, to 70:30 rather than the 80:20 we'd consider neutral for the average moderate municipal bond investor. One reason is that we think spreads in general are somewhat more attractive in the high yield space.

Second, if investment flows do pick up, we think a reversal could benefit some of the high yield segments more.

Finally, organizational changes among players in the high yield municipal landscape may result in changes in their strategy and philosophy in terms of what types of bonds they want to buy. For example, in recent years we saw a tendency to chase yield that wasn't always in line with the fundamentals. If somewhat indiscriminate buying turns to equally indiscriminate selling, this could create some attractive relative value opportunities for active security selection.

Meanwhile, in the taxable municipal market, we expect to see institutional demand rebound this year, especially from international buyers as yield curves normalize, and some of the currency hurdles in terms of hedging costs diminish.

What Are the Risks?

While entry points look attractive in several fixed-income sectors, we live in uncertain times. Looking to the future, what could go wrong with our thesis?

One negative scenario would be a reacceleration of inflation, causing interest rates to rise further. However, given current yield levels, rates would need to rise significantly to result in a capital loss.

A second scenario would be a severe hard landing. This would cause credit spreads to widen, corporates would underperform Treasuries and high yield would typically underperform investment grade. That said, history suggests in that scenario, credit would still outperform equities.

Overall, on a risk-adjusted basis, we believe fixed income remains an attractive and potentially resilient option in a late cycle environment.

Bloomberg U.S. Government/Credit Bond Index
The Bloomberg US Government/Credit Bond Index is a broad-based flagship benchmark that measures the non-securitized component of the US Aggregate Index. It includes investment grade, US dollar-denominated, fixed-rate Treasuries, government-related and corporate securities.

Bloomberg US Aggregate Bond Index
The Bloomberg US Aggregate Bond Index is a broad-based index that measures the investment-grade, US dollar-denominated, fixed-rate taxable bond market, including Treasurys, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities, with maturities of at least one year. Index results assume the reinvestment of all capital gain and dividend distributions.

Bloomberg US Corporate High Yield Bond Index
The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on EM country definition, are excluded.

Source information

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