

Fixed Income Perspectives: **Don't Wait for Rate Cuts to Allocate to Bonds**

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Recent inflation data reinforces base case

Navigating the delicate balance between economic growth, inflation and monetary policy remains at the forefront of financial discussions. Throughout this year, our base case has been that inflation will take its time to taper off due to unprecedented tightness in the labor market. In our view, the Fed will likely be hesitant to cut rates until inflation is closer to its 2% target or there's a more significant rise in unemployment.

Recent inflation data reinforces our view. In August, core CPI increased by 4.3%. That's lower than July's figure, but still well above 2%.

We previously highlighted the recent disinflationary pressures stemming from a downshift in consumer spending, tightened credit standards and higher borrowing costs. The tension among these economic levers, in addition to the resilience of private sector balance sheets and strategic investments in supply chain restructuring and labor-saving technologies, suggests that inflation will continue this slow pace of decline.

Don't wait to allocate to bonds

As the market continues to digest the September Fed meeting, history shows that the best entry points for bonds are often [before the Fed starts cutting rates](#). During the last four rate-hike cycles, the peak point in the 10-year Treasury bond yield has occurred before the Fed began cutting rates. Because bond prices rise when yields fall, investors who held out for rate cuts to start may have actually left money on the table. Increasing allocations to longer-term bonds now may help mitigate the opportunity cost associated with staying on the sidelines in cash for too long.



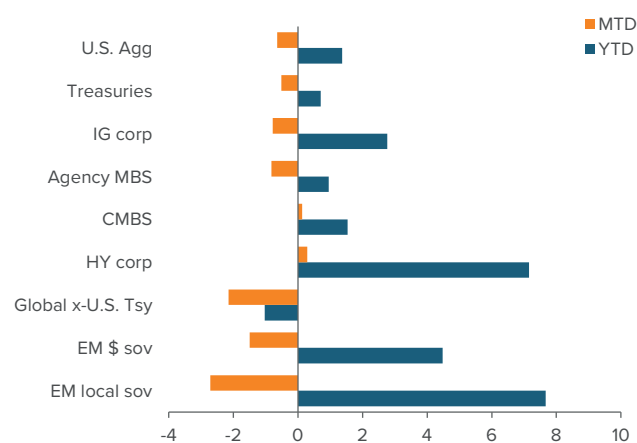
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Bond market outlook

Investment grade	High yield	Senior loans	Agency RMBS	Securitized credit	Emerging markets
Fundamentals likely bottomed in 2Q. This has kept spreads at fair levels, while all-in yields continue to attract demand.	Despite spread compression, lower-quality assets appear cheaper than higher-quality ones (but come with increased downside risk).	We expect technicals to remain supportive in the near term due to persistent CLO creation, moderating retail outflows, and still light new-issue supply volume.	As the Fed possibly takes a breather and mortgage fund inflows continue, mortgage performance is expected to strengthen this fall.	Our outlook has firmed a bit, as a pickup in both primary and secondary market activity should support securitized market “beta” in the near term.	The EM growth outlook has improved, excluding China. Meanwhile, EM corporate fundamentals largely remain steady, even as commodity-driven businesses grapple with commodity price fluctuations.

Rates, spreads and yields

Fixed income sector total returns as of August 31



		31-Aug	30-Jun	1Y Low	1Y High
Yields (%)	U.S. 2Y	4.85	4.87	3.40	5.07
	U.S. 10Y	4.11	3.84	3.19	4.34
	GER 10Y	2.47	2.39	1.53	2.75
	JPN 10Y	0.65	0.40	0.22	0.67
	EM local sovereign	6.39	6.32	6.24	7.63
Spreads (bp)	IG corp	118	123	112	165
	Agency MBS	53	52	36	88
	CMBS	221	230	159	235
	HY corp	372	390	367	561
	HY x-energy corp	386	400	379	581
	EM \$ sovereign	422	432	398	578

As of 08/31/23. Sources: Bloomberg, J.P. Morgan and Voya Investment Management. Past performance is no guarantee of future results.

Sector outlooks

Investment grade corporates

- Investment grade spreads widened to +118 basis points in August due to seasonal illiquidity and equity selloffs. Supply was down at \$69 billion, 23% below the 4-year average, and higher rates led to a negative total return for the month.
- Earnings pressure was concentrated in the energy, materials and health care sectors, while bank earnings remained robust, boosting investor confidence in the banking sector.
- We remain overweight in telecommunications, utilities and technology, and we have a neutral weight in energy. We continue to see opportunities in banking.

High yield corporates

- The high yield market remained mostly stagnant in August, reflecting the balance between resilient U.S. growth and better-than-expected earnings. This led to spread compression across different quality levels.
- BB spreads are tight compared to BBBs, restricting the overall upside for the high yield sector. Despite spread compression, lower-quality assets appear cheaper than higher-quality ones (but come with increased downside risk).
- The portfolio leans overweight towards builders/building products, specialty retailers and energy (E&P), and is underweight in cable/wireline, financials and technology.

Senior loans

- Supported by healthy technicals and a historically high level of interest carry, performance in the loan market remained resilient in August. We expect technicals to remain supportive in the near term due to persistent CLO creation, moderating retail outflows, and still light new-issue supply volumes.
- While corporate fundamentals are intact, they could become more challenged in the second half of 2023. Key concerns are centered around the impact on cash flows and coverage ratios for weaker and lower-rated credit profiles in a “higher for longer” interest rate environment, given the notable pickup in borrowing costs on a sequential/LTM basis.
- In addition, we expect dispersion in performance among borrowers to remain a theme and pockets of stress to emerge as the cycle matures. As such, our focus will be on security selection and finding pockets of value in a continuously dispersed market.

Agency MBS

- Many local indicators are favorable for MBS, including the conclusion of FDIC liquidations, the weakening of housing seasonal trends, the nearing end of the Fed’s tightening cycle, and appealing spreads.
- The Fed remains in “runoff” mode, while REIT demand is expected to increase in 2H23. Bank demand has been erratic due to new regulation proposals, slower deposit growth and slowing C&I loan demand.
- As the Fed possibly takes a breather and mortgage fund inflows continue, mortgage performance is expected to strengthen this fall. Supply predictions remain low, volatility is expected to stay in check, and rates are anticipated to find a new range, likely attracting more investors.

Securitized credit

- **CLOs:** While the income producing attribute of CLOs remains attractive as the Fed continues its hiking regime, the aging of the economic cycle introduces credit risk. This weakens the medium-term outlook for CLOs given the more leveraged nature of their underlying collateral.
- **ABS:** We continue to overweight ABS, which provides access to a diverse mix of sub sectors, access to the U.S. consumer, and robust structures with relatively short spread durations.
- **CMBS:** CMBS cheapness remains evident, and non-benchmark sectors offer compelling relative value. That said, tighter lending conditions should increase defaults from less committed borrowers.
- **Non-agency RMBS:** Accumulated HPA, demographics, exceptionally tight housing supply and rising wages are the dominant supportive forces helping mortgage credit (and housing more broadly).

Emerging market debt

- The Chinese recovery has stalled, resulting in some pessimism regarding emerging market (EM) and global growth in recent months.
- Inflation is stabilizing in many EM countries. Numerous EM central banks have wrapped up their tightening stances, leading to rate cuts due to softer developed market inflation, potential Fed pausing and a stable U.S. dollar.
- Elevated political risks are palpable in Latin America, from Brazil’s governmental transitions and Chile’s constitutional overhauls to Colombia’s left-leaning leadership and Argentina and Ecuador’s upcoming elections.
- EM corporate fundamentals largely remain steady, even as commodity-driven businesses grapple with commodity price fluctuations. Ongoing government interventions have led to persistent gross margin pressures, preventing companies from transferring full inflation costs.

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