

# Fixed Income Perspectives: Stepping Off the Inflation Hamster Wheel

Don't get caught up in the month-to-month inflation watch—bonds are well positioned across a range of different economic and interest rate outcomes.



**Matt Toms**  
Global Chief  
Investment Officer

The October CPI report showed a broad slowdown in inflation, which lifted risk assets and fueled optimism that the Federal Reserve may not implement additional rate hikes. As the journey toward economic stability continues, our view remains the same: While the easing of inflation is a positive sign, the path to rate cuts remains contingent on sustained economic indicators, especially in the labor market.

The coming months will help determine whether this trend is a transient relief or a steady course towards a balanced economy. However, the good news for bond investors is that they don't have to stay glued to monthly CPI prints and Fed policy meetings. We believe it's more important for investors to take a step back and look at the longer-term picture.

The table below shows three scenarios of rising or falling interest rates, using the Bloomberg U.S. Aggregate Index:

	Scenario 1: Breakeven	Scenario 2: 20yr high	Scenario 3: Crisis
	Bond yields could rise 1% from current levels and investors would still come out even, with income fully offsetting the decline in price.	If bond yields rose to a 20-year high of 5.9%, income would still exceed the decline in price, giving a total return of just over 2%.	If the economy sours and the Fed cuts rates, a 2% decline in yields would mean a 15%+ total return through a combination of price gain and income.
A. Starting yield	5.30%	5.30%	5.30%
B. Yield change	1.02%	0.60%	-2.00%
C. New yield (A+B)	6.32%	5.90%	3.30%
D. Price return	-6.32%	-3.71%	12.36%
E. Total return (C+D)	0.00%	2.19%	15.66%

As of 11/15/23. Source: Bloomberg, Voya IM. For illustrative purposes only. Calculations are based on the Bloomberg U.S. Aggregate Bond Index current duration of 6.2 years and assume immediate parallel shift in yield curve (with the new yield then earned for the 12-month period). Bonds pose a higher risk than Treasury bills, which are guaranteed as to the timely payment of principal and interest. **Investors cannot invest directly in an index.**

## Bond market outlook

### Investment grade

Overall, investment grade issuers are showing better-than-expected earnings for 3Q 2023.

### Agency RMBS

October prepayment speeds are anticipated to decrease marginally, reflecting the ongoing slowdown in the housing market and dampened refinancing activity.

### High yield

The market remains concerned about future corporate margins due to diminishing pricing power and rising labor costs.

### Securitized credit

The ABS sector is set to cool in the near term after outperforming other areas of fixed income year to date.

### Senior loans

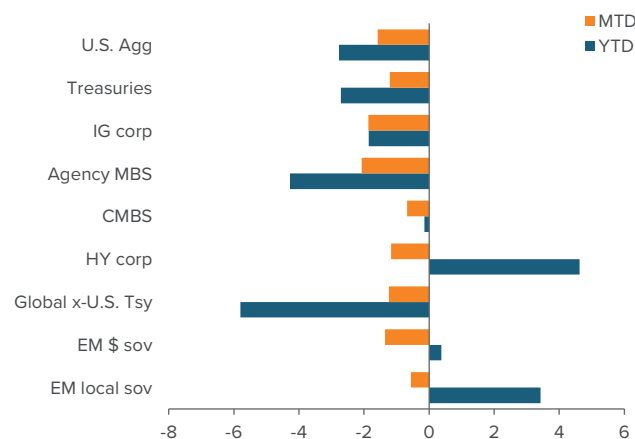
We retain our cautious stance and are underweight cyclical sectors and those dependent on discretionary consumer spending.

### Emerging markets

EM corporate fundamentals remain resilient, and corporate financial policy remains prudent.

## Rates, spreads and yields

### Fixed income sector total returns as of October 31



		31-Oct	30-Sep	1yr Low	1yr High
Yields (%)	U.S. 2yr	5.06	5.05	3.77	5.22
	U.S. 10yr	4.93	4.57	3.31	4.99
	GER 10yr	2.81	2.84	1.78	2.97
	JPN 10yr	0.95	0.77	0.24	0.95
	EM local sovereign	6.85	6.76	6.24	7.44
Spreads (bp)	IG corp	129	121	112	163
	Agency MBS	75	66	36	82
	CMBS	234	222	165	235
	HY corp	437	394	366	516
	HY x-energy corp	455	409	379	529
	EM \$ sovereign	436	431	398	543

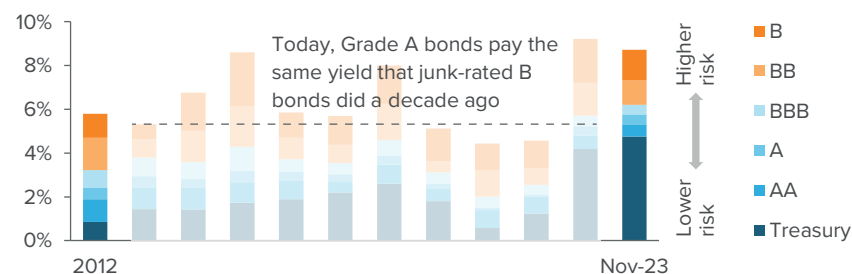
As of 10/31/23. Source: Bloomberg, J.P. Morgan, Voya IM. Past performance is no guarantee of future results.

## Quality remains in the spotlight

The rise in bond yields since 2021 means investors today can get significantly higher yields relative to the credit risk of a bond issuer. With high-quality bonds now offering attractive income, investors no longer need to turn to risky, low-quality bonds for yield (Exhibit 1).

### Exhibit 1. Today's bonds offer more yield for less risk

U.S. bond yields by credit quality



As of 11/15/23. Source: Bloomberg Index Services Ltd., Voya IM. Treasury: Bloomberg U.S. Treasury Index. Yields by credit quality: Bloomberg U.S. Corporate Aa, A and Baa subindices and the Bloomberg U.S. High Yield Corporate 2% Issuer Cap Ba and B subindices. Bonds pose a higher risk than Treasury bills, which are guaranteed as to the timely payment of principal and interest. Credit ratings are an assessment of the risk of default of a company or country. The higher the credit quality (or rating), the lower the perceived risk of default. AAA rated are the highest; D rated are the lowest. Ratings below BBB are classified as non-investment grade, or junk, and are considered to be riskier. Past performance does not guarantee future results.

## Sector outlooks

### Investment grade corporates

- Third-quarter earnings were generally supportive, especially for regional banks, which saw muted deposit outflows. Overall, investment grade (IG) issuers are showing better-than-expected earnings for 3Q 2023, with a 7% earnings surprise and a 0.9% sales surprise. Corporate earnings were even stronger when excluding the financials and energy sectors.
- October saw \$83 billion in supply, slightly below the average, with negative flows persisting due to rate movements, adding pressure on the technical aspect of the IG market.
- Ford's upgrade was the largest "rising star" event in history, moving \$42 billion in bonds to the IG index. Overall, fundamentals remain resilient, supporting IG spreads, but vigilance is needed regarding potential stress from higher rates.

### High yield corporates

- Higher Treasury yields and equity market weakness in October led to wider high yield spreads. This was especially true in the lower-quality end of the high yield market, which was hurt by earnings misses and weak guidance.
- Looking ahead, the market remains concerned about future corporate margins due to diminishing pricing power and rising labor costs. This, coupled with weaker earnings growth and higher interest costs, is expected to impact credit quality, leading to an increase in defaults and credit stress.
- We are overweight builders/building products, health care/pharma and energy (E&P). We are underweight technology, utilities and financials.

### Senior loans

- Senior loan returns were flat for the month amid uncertainty surrounding a prolonged period of higher interest rates—the asset class is still outperforming other fixed income classes year to date.
- There was a decrease in primary market issuance compared with September, with a few opportunistic transactions. CLO issuance continued to offer support, despite retail flows turning negative.
- We retain our cautious stance and are underweight cyclical sectors and those dependent on discretionary consumer spending.

### Agency mortgages

- Net issuance projections have been revised down to approximately \$500 billion for the year, mainly due to reduced organic net supply from slower home activity and refinancing.
- Bank demand has been erratic, influenced by new regulatory updates, slower deposit growth, and declining commercial and industrial loan demand. Money manager demand is expected to closely follow market volatility and fund flows.
- October prepayment speeds are anticipated to decrease marginally, reflecting the ongoing slowdown in the housing market and dampened refinancing activity.

### Securitized credit

- **CLOs:** While the income-producing attribute of CLOs will drive value as the Fed continues and eventually completes its hiking regime, the accompanying acceleration in the aging of the economic cycle brings credit risk associated with a potential recession.
- **CMBS:** Less well sponsored properties, particularly offices, should cause the broader CMBS sector to underperform, despite strength from multi-family, industrial, retail and hotel properties.
- **ABS:** The sector is set to cool in the near term after outperforming other areas of fixed income year to date. Longer term, we continue to favor the sector for its exposure to the U.S. consumer, diverse mix of sub sectors, wide array of forms of consumer credit, and robust structures.
- **Non-agency RMBS:** The sector appears poised to rally in the near term amid strong fundamentals and a broader risk-on market.

### Emerging market debt

- While China's latest policy response appears to have stabilized the country's economic activity, next year's growth is likely to slow, as the housing sector and private sector confidence remain negative.
- Inflation continues to moderate across most countries. However, market-implied terminal rates have repriced upwards due to higher developed market yields and a stronger U.S. dollar.
- Corporate fundamentals remain resilient, overall, and financial policy remains prudent.

### A note about risk

The principal risks are generally those attributable to bond investing. All investments in bonds are subject to market risks as well as issuer, credit, prepayment, extension, and other risks. The value of an investment is not guaranteed and will fluctuate. Market risk is the risk that securities may decline in value due to factors affecting the securities markets or particular industries. Bonds have fixed principal and return if held to maturity but may fluctuate in the interim. Generally, when interest rates rise, bond prices fall. Bonds with longer maturities tend to be more sensitive to changes in interest rates. Issuer risk is the risk that the value of a security may decline for reasons specific to the issuer, such as changes in its financial condition.

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