CIO maintains their slower growth outlook into 2H23 and continues to have agency MBS and IG corporates as their most preferred allocation. (UBS)

Fixed income: Carry conscious

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While the UBS Chief Investment Office (CIO) maintains the overall up-in-quality bias within their portfolio, they do not believe rates will move materially lower, given the easing priced in and rising recession expectations over the near term, to mitigate the loss in yields between loans and IG corporates.

March witnessed a large flight-to-quality bid as concerns over stability in the financial sector pushed the 10-year Treasury yield to slightly below the lower end of our forecast range, at 3.3%, hitting 3.25% during pockets of vulnerability. That 3.25% was also the prior tightening cycle peak witnessed in 2018. We have advocated being longer on interest rate risk since the beginning of this year and added to our exposure at the end of February when the 10-year yield hit 3.97%. While we continue to think the 10-year will end the year near 3.25%, our expectation is for the Federal Reserve to raise rates one more time—in May, by 25 basis points—then shift to a pause.

The difficulty with the current assessment is that when we look at historical 10-year yield trends moving closer to the Fed's terminal rate dating back to the early 1980s, in some instances yields have trended lower, and in others they have trended higher up to the time the Fed pauses. However, once the Fed pauses, every time since 1984, the 10-year yield has declined, awaiting the next phase of monetary policy—i.e., an easing.

Historically, the first easing has occurred between six and seven months after the Fed pauses. However, given the instability witnessed in March—and the competing narratives over a soft or hard landing—volatility has heightened, and what would normally occur post-pause has been pushed forward. The market has moved the first Fed easing from seven months to a mere two months after the pause, while the 10-year yield has fallen 100bps from the 2022 high of 4.25% reached in October to the 3.25%witnessed last Thursday. Our near-term range in 10-year yield now resides between 3.25% and 3.75%, with the expectation of lower yields in 2H23.

Although we remain with a bullish tilt on interest rates, we do anticipate more stability in the near term, accompanied by a decline in volatility. Within our fixed income portfolio, we have had a least preferred in high yield (HY) and in senior loans versus investment grade (IG) corporates and agency MBS. Our least preferred in loans versus IG corporates was initiated on 20 October when the 10-year yield was at 4.23%. We have guided investors with our view of 10-year yield ranges, which have worked well in deciding when to lock in yields and when not to chase an illiquid, volatile market.

With the market reaching the lower end of our yield range, we are trimming some of our incremental long positioning. With loans being a floating-rate asset class, and IG corporates' duration at seven years, this performance will be dominated by the move in interest rates versus spread compression. While we maintain the overall up-in-quality bias within our portfolio, we do not believe rates will move materially lower, given the easing priced in and rising recession expectations over the near term, to mitigate the loss in yields between loans and IG corporates. We therefore move to neutral on senior loans and take our profit.

We maintain our slower growth outlook into 2H23 and continue to have agency MBS and IG corporates as our most preferred allocation.

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Content is a product of the Chief Investment Office (CIO).

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