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Hobson's choice for the Fed: What does it mean for fixed income portfolios?

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The UBS Chief Investment Office (CIO) reflects on recent economic data and what it means for fixed income portfolios.

Hobson's choice is defined as a free choice in which only one thing is offered, or the necessity of accepting one of two or more equally objectionable alternatives. We have often described the path of the Federal Reserve over the last several months of 2022 as a policy trade-off, not necessarily a policy error. Bringing down inflation at the cost of creating demand destruction and slowing growth has been in the purview of the Fed for the past six months.

As witnessed from Wednesday's data releases, retail sales, industrial production, and supplier prices all provided further support for investors who believe that US economic growth is decelerating. In addition, the Atlanta Fed's GDPNow index for the fourth quarter of 2022 fell to 3.49% from 4.07%—not a small number, but mainly driven by inventory levels. One small bright spot was the uptick in the index of US homebuilders' confidence; still, it indicated that more builders view market conditions as poor rather than good. Meanwhile, manufacturing has been on the decline for several months, and given that the US is a service-driven economy, the spotlight on consumer headwinds may be occurring faster than anticipated. The US economic surprise index is trending to the downside, while the European surprise index is moving to the highest levels not seen since July 2021.

Ten-year US Treasury yields have rallied 50 basis points since end-2022 and 90bps from the 24 October closing peak (4.25%). Our longer-term view for 10-year Treasury yields remains bullish, and we do anticipate continued slowing in growth as consumers' real income turns negative and the days of heightened spending begin to slow. However, raising the victory flag that the Fed will pause and reverse as quickly as the market anticipates may be a bit too early. The Fed's "one team, one dream" mantra may be decoupling as Fed officials continue to send mixed signals to investors on the

amount of future rate hikes. That said, no one has yet to express too much optimism about inflation or the potential for a rate cut in 2023.

Positioning

Our fixed income portfolios entered 2022 with higher embedded interest rate risk and a barbel approach which resulted in a preference to the 4–5-year area of the yield curve. Our "belly" exposure is due to our belief that the end of the Fed hiking cycle is soon upon us. Although we have not concluded that the Fed will pursue a material policy shift in 2H23, the pause will be a tailwind to the 5-year area of the curve.

We maintain our curve positioning and look to an approximate range of 3.4–3.9% in the short term, trending lower later in the year to 3%. With the lower range being met so quickly, alongside loosening financial conditions and the market's dovish path, we have been reducing interest rate risk in the short term while maintaining a bias toward higher-quality sectors such as investment grade corporates (1–3-year and 7–10-year) alongside agency MBS versus higher embedded credit sectors such as loans and high yield. We look to increase our interest rate risk with outright longs within nominal or real rates when the market trends toward near the upper level. It is a long year, and we are only 19 days in.

The outperformance of spread product to start the year is beyond impressive. The IG corporate index is now at 129bps, a level not seen since April 2022. The recent weekly inflow into IG mutual funds (USD 6.5 billion) was the largest weekly increase in two years and a welcome change from the USD 130 billion outflow witnessed in 2022. Support for the sector is also shown by the recent divergence in spread compression from the recent lower equity valuations and widening CDX spread. We continue to favor IG, but at 129bps, we do not anticipate more than 10–15bps of spread compression and will rely on the carry component to generate returns over the remainder of the year.

The performances in lower-quality credit, senior loans, preferreds, and high yield have been the main beneficiary of the market's perception of a pivoting Fed. HY spreads are nearly 60bps tighter to start the year, and the year-to-date HY supply of USD 11 billion—the highest supply for a month since April—has been easily absorbed as the nearly USD 5 trillion in money market funds look to reallocate to higher yielding sectors amid growing confidence in a soft landing. We caution against chasing yields, particularly due to the tighter spreads alongside the wide opportunity set offered to earn carry, while maintaining higher credit quality as the economy slows into 2H23, with the expectation of a Fed rescue that may be further out than what is currently priced in.

2023 has just begun, and although we expect yields to decline over the longer term (3%), we take some of our incremental interest rate risk off the table and wait for a better entry point (top of recent range) to initiate outright longs in longer-term Treasuries. We believe risk premiums in lower credit product will widen over the next few months, and we maintain a least preferred allocation.

Read the original blog Fixed income update: Hobson's choice 20 January 2023.

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