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The breakeven spreads and yield cushions are a strong tailwind to fixed income investors over the course of 2023. (UBS)

Fixed Income: December review

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2022 will be remembered by markets as an epic year that saw the most front-loaded, fast-paced Fed hiking cycle in decades; a 40-year high in inflation; the largest jump in the 30-year mortgage rate on record—from 3.1% to the current 6.5%—fueling an affordability crunch and a price correction in the housing market; substantial losses in higher-quality assets; and tightening financial conditions concluding with a severe breakdown in sector correlations that has led to wealth declines.

Although most of the negative total returns in fixed income were fueled by rising interest rates, and it remains our and the consensus expectation that yields will decline over the year, this will not be a straight line.

Our next *Fixed Income Strategist* will be published on 10 January discussing our 2023 outlook and positioning for fixed income.

Volatility in 2023 will not likely rise with the same magnitude as it did in 2022 (over 1.8x the 10-year average), but it is far from collapsing. December, although not the most liquid of months, offered a glimpse to the potential volatility as the 10-year Treasury yield rose 40 basis points from the Federal Reserve's 14 December meeting. Concerns over the Bank of Japan raising its yield cap on Japanese government bonds to 50bps fueled a response by speculative accounts. The expectation of slower growth ahead will be the dominant driver of US Treasury yields, but the decision by the BoJ is another variable that needs to be watched and will keep volatility heightened. While Japanese policymakers said the move was to improve market functioning, traders interpreted it as a step toward the end of the BoJ's yield-curve control policy and thus increased short positions. As a result, the BoJ bought USD 128bn in Japanese government bonds in December —a monthly record—to counter the speculative trade and try to limit the yield rise.

With the one-year US CPI swap priced around 2.5%, the market is eyeing a Fed terminal rate around 5% followed by 40bps of easing in 2023 and 130bps in 2024. Our expectation is that economic growth will slow in the second half of this year alongside declining Treasury yields, but the market may be a bit to optimistic over the magnitude of easing in 2023. We think a higher-for-longer or rising terminal rate remains a risk to the marketplace. As a result, we have incrementally added duration to our fixed income portfolios but are not moving above the intermediate 7-year at this stage until we see a better entry point.

As we know, "this time is different," but historically yields tend to rise in the first quarter of the year—about 57% of the time going back to the early 1960s, averaging a 46bps yield increase. Renewed deal issuance (supply), investors recalibrating risk, and Japan's March year-end calendar have often been the explanation.

The breakeven spreads and yield cushions are a strong tailwind to fixed income investors over the course of 2023. However, the divergence we have seen in bank lending standards versus high yield spreads decoupled this past year-end , and we believe high yield will have a better entry point near the second half of this year.

This leaves our positioning with a least preferred in sectors such as loans and high yield, and a most preferred in short-end investment grade and agency MBS. See next week's *Strategist* for a more in-depth outlook for 2023, including timing and positioning.

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