UBS

The Bond Bulletin

What's happening in fixed income markets

UBS Asset Management I November 2023

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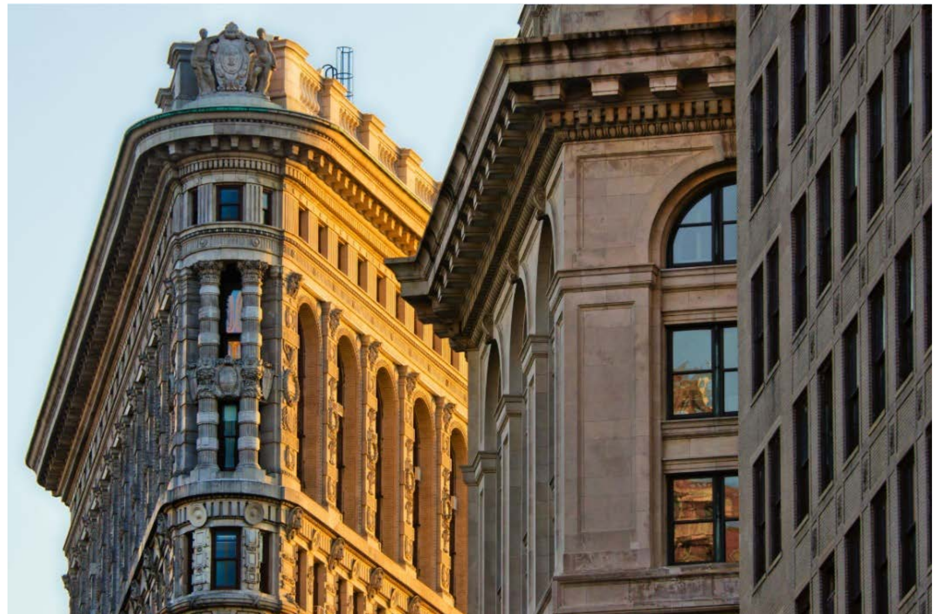

Highlights

In October US municipal bond prices down 085%, down 2.22% YTD

- Weak flow data when paired with weak supply isn't that bad. Its effect on the market can be rather muted. However, that wasn't the case in October with munis
- Not only was this the third consecutive down month for municipals but it maintains the streak of negative returns in October for the 4th straight year
- Yields took the record highs they experienced the previous month and surpassed them

US corp investment grade total returns down 1.25% in October, US high yield down 1.25%

- YTD total return for US investment grade down 1.86%, US high yield up 4.58% at month end
- The Fed paused at the November meeting, and implied a longer pause might be warranted at this time. This was viewed as a dovish signal by the Fed and risk assets rallied on the news
- In October, risk markets have taken a turn to the downside as markets fully embrace the higher for longer narrative as economic data continues to be resilient

Fixed income month in review

In October, good news on the US economy and the relentless rise in long term bond yields continued placing additional pressure on risk assets. The US labor market remained tight. We saw stronger than expected 3Q23 GDP growth, resilient consumer spending and strong corporate earnings which all pointed to unexpected strength in the US economy. Fixed income returns were driven by both wider corporate spreads and the increase in US Treasury yields. US Investment-grade and high yield closed the month at a spread level of +129bps and +439bps, 8bps and 39bps wider, respectively. For October 2023, the total return for US investment grade credit was down 1.87%, while US high yield was down 1.25%. Year-to-date ending October 2023, the total return for US investment grade and US high yield are -1.86% and 4.58%, respectively.

The yield on the 2-year US Treasury rose 5bps to 5.09%, while the 10-year and 30-year yields rose 36bps and 39bps to 4.93% and 5.09%, respectively. The US Treasury curve maintained its bear steepening bias; the result of stronger economic data during the month that caused the market to reprice the duration of the Fed's terminal rate – higher for longer. For the month, the total return for the US Treasury index was down 1.21% with the long-end (20yr+ posting a negative 5.47% return) underperforming the short-end (3-5yr posting a negative 0.28% return). In October, we saw the continuation of the 2yr vs 10yr US treasury curve inversion reversing course moving from a peak inversion of -108 bps reached on July 7th to an inversion of -16bps at month end. Post October, the inversion is now -38 bps November 15th, 2023).

In terms of commodities, the Bloomberg Commodity Index[1] finished modestly lower on the month as a retreat in oil prices and industrial metals offset strength in precious metals. Gold futures had their best month since July 2020 as the outbreak of war between Hamas and Israel fueled demand for the haven asset. Oil futures slumped at the start of the month, and retraced some of those losses following Hamas' attack on Israel before sliding once again to end October down 8.3%. Industrial metals also fell as continued weakness in global manufacturing offset some green shoots out of China. Gold futures rose 7.9%, with all of those gains coming after Hamas' attack on Israel.

Macro outlook

The US economy continued to mostly surprise to the upside in October, notably on the labor market and consumption. Demand for labor remains robust. The September non-farm payrolls report showed job growth of 336,000, nearly double the consensus estimate. Job openings unexpectedly rose to 9.6 million, breaking a string of declines. Initial jobless claims also remained very low throughout the course of the month, though continuing claims are edging higher. However, wage metrics point to some labor market cooling. Average hourly earnings rose just 0.2% month-on-month in September, and the private wages and salaries component of the Employment Cost Index (excluding incentive paid) decelerated to an annualized growth rate of 3.8% quarter-on-quarter, which is close to levels that could be consistent with 2% inflation. Retail sales rose far more than expected, with the control group (which goes into GDP calculations) up 0.6% month-on-month in September, versus the 0.1% increase projected by analysts.

The September CPI report modestly surprised to the upside, with headline rising 0.4% month-on-month and core up 0.32%. Shelter inflation drove the hotter than expected print, and while there is a broad consensus that this will trend lower going forward, the timing and magnitude of this deceleration is more uncertain. Core PCE inflation, which is the Federal Reserve's preferred gauge of underlying price pressures, also came in modestly above expectations on a monthly basis. However, the annual rate of inflation is already in line with what US monetary policymakers expect for the fourth quarter compared to the same period in 2022.

[1]See last page for further information

Municipal fixed income

Performance Backdrop

Threats of perceived weakness among global Treasury buyers and inflation worries forced the Bloomberg US municipal index[1] lower for a 3rd straight month recording a -0.85% return for the month of October. Not only was this the third consecutive down month for municipals but it maintains the streak of negative returns in October for the 4th straight year. The under-performance this month pushes the index down -2.22% for the year and has us yearning to turn the clocks back in November. November has posted a positive return in 20 of the past 29 years and posted a record return last year. Another bright spot given the recent selloff is that we are seeing yields in municipal bonds we haven't seen in almost a decade which could lead to buyers picking their head up before 2023 is out.

Outflows marred the municipal market again in the month of October according to Lipper reporting municipal funds. We started off the month with some weakness from September as the weekly and monthly reporters saw -$1.3Bn in outflows for the week ending October 4th. We received no break as the outflows persisted with $735Mm leaving mutual funds for the week ending October 11th, $297Mm in outflows for the week ending October 18th, and $935Mm in outflows for the week of October 25th. The negative trend finished out the month with the worst week in October as we saw $1.5Bn leave for the week ending November 1st. The only bright spot when you look at YTD data which show outflows of $8.7Bn are the mixed data with open end mutual funds losing $15.5Bn YTD while Municipal ETFs have added $6.7Bn.

Weak flow data when paired with weak supply isn't that bad. Its effect on the market can be rather muted. However, that wasn't the case in October as weak flow data was paired with the largest supply of the year. October saw $41.54Bn in municipal primary supply outpacing August's big month of $40.71Bn new issues. October's supply was a 48% increase over October 2022. This strength in issuers coming to market has helped push year-to-date issuance higher. For the year we have seen $324.8Bn in issuance which is a moderate 4% decrease over 2022 YTD.

The headwinds created by positive net supply (supply outpacing maturities, coupon and calls), a Fed that is battling inflation and higher Treasury rates led the municipal yield curve in October to experience another month of bear flattening. According to TM3 data the two-year was off 1 bps, the five-year was 10 bps higher and yields on the 10-year and 30-year were off 16 bps and 23 bps, respectively.

The municipal market's willingness to follow the direction of Treasuries paired with the supply/demand imbalance led munis to lag Treasuries throughout the month. According to Bloomberg data all muni/Treasury yield ratios finished the month of October higher for a 2nd straight month with the exception of the 30-year, which was slightly lower. The two-year cheapened the most and finished at 74% after starting the month at 72%. The five-year ratio moved from 71.77% to 72.54% and the 10-year moved a mere 0.6% from 73.6% to 74.2%. The one spot where municipals were able to maintain strength vs. Treasuries existed in the long end as the 30-year ration tightened from 91.5% to 90.05%.

A deeper dive into performance reveals the following:

The best performing areas of the curve in October were the one-year (1-2) which generated a positive return of 0.28% followed by the three-year (2-4) which returned 0.13%. The one-year maintains the lone bright spot with a positive return YTD of 1.32%. The worst performing areas of the index were the long bond (22+) which returned -1.98% and the 20-year (17-22) at -1.48%. The underperformance of the long bond and the 20-year area in October extends the losses for the two worst performing spots YTD at -3.58% on the 20 year and -3.96% on the long bond.

Within the investment grade realm AAA paper performed the best with a return of -0.60% for October ahead of the AA category returning a -0.80%. The worst performer for the month was BBB paper which returned -1.41% compared to the -1.02% return for single-A. Year to date BBBs had been the strongest but lost ground this month posting -1.64% YTD just behind the best performer single A's at -1.59%. AAA names are the worst performers for the year at -2.93% and AA paper has returned -2.36%.

High yield and taxable munis were off in October. Municipal high yield fared better off than taxable munis with a return of -1.60% vs. -2.05%. Year to date, high yield munis are down -1.60% while taxable munis have posted a negative return of -1.19%.

For the month, revenue bonds under-performed general obligation bonds to the tune of -0.98% vs. a -0.66%. The best performing sectors for October and for a 3rd straight month were pre-refunded bonds which returned 0.15% followed by the electric sector, a distant 2nd, returning -0.63%. The worst performer for the 2nd straight month was The hospital bond sector which returned -1.59% and behind that driving the index lower was the Transportation sector returning -1.06%. The best performers YTD are the tobacco bonds at 0.14% and resource recovery, with a return of -0.23%.

VRDNS continue to record elevated levels in October topping out at a 4.19% yield, unable to surpass the highs in September of 4.31%, but averaging slightly higher at a 3.71% for the month and a 3.27% YTD.

In conclusion, yields took the record highs they experienced the previous month and surpassed them. These new higher levels continue to offer attractive options for income focused investors. As we approached the end of the month those buyers looking to compare municipal AA State GO paper to their taxable counterparts may be enticed by Taxable Equivalent yields around 6.25% in the 10 year space. We are entering a period of net negative supply in November and December where we see approximately $7Bn more in

[1]See last page for further information

maturities, coupons and calls than we see on the expected new issue calendar. This is seen as supportive for municipal rates and should provide us with a decent headwind as we look to finish out 2023.

Taxable fixed income

Taxable fixed income performance

US corporate investment grade total return (as measured by the Bloomberg US Corporate Bond Index)[1] posted a -1.87% return for the month of October. There was performance dispersion across ratings and maturities for investment grade issuers. BBB-rated credit returned -1.84% for the month relative to AA-rated credit at -2.05%. From a maturity standpoint, three-to-five–year maturities were down 0.49%, while 10+ year maturities were down 4.20%. Investment-grade spreads widened 8bps in October from 121bps to 129bps. During the first half of 2023, the average investment-grade spread was 133 bp with a wide of 163 bps (3/15/2023) and a tight of 115 bps (2/6/2023). For context, the average investment grade spread in 2022 was 134 bps with a wide of 165 bps (10/12/2022) and a tight of 91 bps (1/5/2022). At the sector level, the best performers were E&P, oil field services, wirelines, supranationals and automotive, while gaming, airlines, life insurance, transportation services and railroads underperformed.

US short duration high yield (as measured by the ICE BofA 1-3 year BB-B Cash Pay High Yield Constrained Index)[1] returned -0.43% for October. During the month, the OAS for the index widened 60 bps to close at a level of 363 bps. Both double B credits and single B issuers widened 47 bps and 80 bps, respectively, in October. Translating spread widening to performance across the major ratings buckets for the short-dated high yield index, BB's were down 0.16%, while B's were down 0.71%. On a total return basis and for the broader high yield index, BB's were down -0.69%, B's were down 1.31%, and CCC's were down 3.49%. In October most sectors were down, the best performing sectors were independents (0.05%), supermarkets (flat), aerospace/defense (-0.16%), leisure (-0.19%), and brokerage asset manager exchanges (-0.33%). Laggards on a relative basis were pharmaceuticals (-3.47%), airlines (-3.38%), packaging (-3.02%), wireless (-2.49%), and transportation services (-2.31%).

Emerging market sovereign bonds (as measured by the J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI Global Diversified)[1] and EM corporate bonds (as measured by the J.P. Morgan Corporate Emerging Markets Bond Index Diversified (CEMBI Diversified)[1] returned -1.35% and -1.29%, respectively, during October. The year-to-date return of the EMBI Global Diversified Index[1] and the CEMBI Diversified Index[1] and the reached 0.39% and 1.50%, respectively, over the period. Over the month, the OAS for the sovereign index widened by 5 bps to 436 bps and the corporate OAS widened 11 bps for the month to 341 bps. During the month and with respect to sovereign issuers, high-yield issuers outperformed their investment-grade counterparts in October, as the EMBI Global Diversified IG returned -2.08%, while the HY cohort of the index posted a -0.62% return over the month. On the corporate side and during the month of October, high-yield issuers outperformed the investment-grade ones in October, as the IG cohort of the Index returned -1.30%, while their HY counterparts posted a -1.28% return over the month. All sectors ended down on the month, with the index's best performers being Diversified (-0.18%), Financial (-0.37%) and Infrastructure (-0.64%) while the bottom three were Real Estate (-3.57%), Pulp & Paper (-3.35%), and Metals & Mining (-2.77%).

Taxable fixed income market update

The investment grade corporate market has started to regain its footing again after the recent rise in Treasury yields. The November Fed meeting was viewed as dovish by investors and we saw 10 year Treasury yields fall from a peak of 5.00% to the current level of 4.60% in a span of 3 weeks. After a few weeks of cash outflows for the asset class, we have seen inflows resume again as investors are getting more comfortable that we are close to the peak in interest rates. Unfortunately, this doesn't change the fact that macro drivers will be bumpy as the interest rate scenario of higher for longer plays out in 2024. Uncertainty in regards to: How much does economic growth slow in 2024, how fast does it slow, and how sticky will inflation be as it trends downward will keep volatility elevated in the Treasury market. As this unfolds over the next year, we believe it will provide investors many opportunities to capture positive total returns within investment grade credit. Attractive all in yields of roughly 6% which we haven't seen since the global financial crisis. The release of third quarter earnings announcements that continued to show corporate fundamentals among investment grade issuers as well positioned for a slowing economic environment. Finally, market expectations that we are approaching the peak in the Fed rate hike cycle is supportive for investment grade credit. Historically, investment grade corporate bonds perform well after the end of the rate hike cycle. The resiliency in economic growth continues to support corporate fundamentals as well as an environment of low unemployment, and solid wage growth. This type of backdrop keeps credit in the sweet spot as long as the soft landing scenario continues to play out as expected.

In terms of the high yield market and for a majority of the last twelve months, high yield spreads have been moving in an 80 bps range (480 bp to 400 bp) with majority of the time spending within a narrower band of 415 bp to 475 bp. Since the end of March and to Tuesday's close (10/31), high yield spreads have compressed 14 bps to 413 bp which is 39bps from the 1 year tight of 374 bps (1yr spread wide of 518 bps,

[1]See last page for further information

tight of 374 bps, average 430 bps and a standard deviation of 33 bps).

The softer landing narrative has gain momentum which has propelled all risk assets to outperform through July. In October much like September, risk markets have taken a turn to the downside as markets fully embrace the higher for longer narrative as economic data continues to be resilient. Concerns are growing over the potential need to see something 'break' in the market in order for Powell to put the interest rate engine in reverse and for cuts to happen. Current Fed Funds Futures (WIRP) is reflecting the view that a Fed cut will not happen until Q2 '24. As a result, we have seen rates retrace through July's highs (2007 prior to this) with 5's and 10's pushing out +25bps and +36bps respectively to 4.85% and 4.93%.

The high yield new issuance calendar continues to be supportive from a technical supply/demand standpoint although we did see issuance pick up once the debt ceiling agreement was reached (as we expected). Portfolio manager cash levels remain elevated but have been reduced from their highs as recent risk on tone drove reinvestment back into cash bonds. October new issuance volume was $10.5bn bringing the year-to-date new issuance total to $153.9bn. Year-to-date new issuance on a year-over-year basis was up 51.6% from the $101.5bn reported as of October 2022. The high yield universe however shrank by around 10% in 2022 driven by less new issue supply, down around 80% compared to the previous year, as well as a strong year for upgrades as rising stars outnumbered fallen angels by a ratio of 12:1. Our expectation for 2023 is for the high yield universe to shrink between 8% to 10% driven by another anemic new issue calendar.

While high yield fundamentals are likely to deteriorate going forward, investors should keep in mind we are normalizing off of an exceptional period. Interest coverage ratios are at record highs and leverage is at a decade low, so even in a weaker economy, these metrics provide some cushion. Companies are well equipped to weather the uncertainty with their strong balance sheets. They also have plenty of time to come up with solutions to deal with their outstanding debt as there is not much coming due for another two years. It's not until 2025 that we see a pick-up in debt coming due. This is one of the main reasons why we expect default rates to remain manageable in the low 3% range compared to historical averages of 4.3%. That said, we believe volatility will continue and we expect dispersion amongst credits to increase, especially for lower quality credits as economic growth slows and uncertainty increases. Participants remain focused on down side risk and the implications for global growth.

Taxable fixed income strategy

The Fed paused its hiking cycle at the June meeting, but forecast two additional hikes over the remainder of the year. At the July meeting, the Fed delivered the first of its 2 forecasted hikes with a 25bp increase. This put the Fed funds rate in the 5.25% to 5.50% range. The Fed paused at the November meeting, and implied a longer pause might be warranted at this time. This was viewed as a dovish signal by the Fed and risk assets rallied on the news. We continue to believe corporate bonds are attractive from both an income/carry, and total return perspective. We have moved to a neutral position in the front-end of the credit curve, and are overweight the intermediate part of the credit curve, (5-10 years). Overall, corporate fundamentals remain stable as low unemployment and strong wages have offset tightening financial conditions. This Fed rate hike cycle, which began in March 2022, has seen 10 straight hikes with a current Fed funds rate in the 5.25% to 5.50% range. The Fed paused at the June meeting, but projected two additional rate hikes, delivering the first of its two forecasted hikes at the July meeting. The Fed has remained on pause since the July meeting, but left the door open to tighten policy further if appropriate.

In terms of sectors and for our active investment-grade strategies, we are overweight the financial sector, as we believe the sector offers attractive relative value. The banking sector has maintained solid fundamentals, and capital levels remain strong. We are maintaining our overweight to US money center banks, and have an overweight to large US regional banks.

We remain overweight the utility sector as we added exposure to take advantage of attractive new issue concessions. We remain underweight issuers that have poor ESG scores. We remain underweight the industrial sector, but we are overweight the energy sector as fundamentals within the sector remain strong. We have moved to a neutral position in the technology sector as valuations have become more attractive. We are underweight the non-cyclical sector, but within the non-cyclical sector we continue to favor healthcare & pharmaceuticals. We remain overweight the telecom, media and cable sectors.

From a credit curve perspective, we are neutral the short-end of the credit curve (2-4 yrs.), and are overweight the intermediate part of the credit curve (5-10 yrs.). We continue to take advantage of the new issuance calendar to add exposure into the portfolios with a focus on certain sectors within industrials.

In our high yield portfolios, we prefer to be closer to neutral with a bias to slightly longer duration given how far rates have moved already and remain up in credit quality while looking for idiosyncratic opportunities to present themselves as the weakening fundamental credit story plays out going into the second half of 2023. For lower quality credits we are targeting shorter maturity bonds and continue to remain focused on credit selection as tighter financial policy works its way through the economy and to borrowers. Demand for high yield cash bonds should remain supported as investors are sitting on high cash balances, while the size of the high yield market is expected to shrink given both rising stars and light new issue supply.

From an industry perspective, we continue to add and to rotate names within the energy space. The backdrop for this sector remains sound as corporate discipline over recent years has led to stronger balance sheets for most issuers. Away from energy, we remain underweight telecom and cable due to higher financing needs and/or tight spreads. We have allowed our

[1]See last page for further information

healthcare exposure to drift lower leaving us with an underweight as we see the sector trading riches which historically have been more defensive in nature supporting our higher quality liquid bias. From a ratings perspective, we have a quality bias with a focus on fundamentally-driven security selection. We are currently overweight BB-rated credit relative to B in our short duration high yield SMAs. We have been holding onto our rising stars as we still see them offering attractive risk adjusted returns. In terms of maturity focus, while we have been investing primarily in the two-to-four–year part of the curve we are looking to put cash to work in longer dated positions to take advantage of higher rates.

In our emerging market ladder portfolios, we have no direct exposure (sovereign, corporate and quasi-sovereign) to Russia or Ukraine. From a regional perspective, we are seeing attractive relative value opportunities in Latin America especially in markets such as Brazil, Mexico, Panama, Peru, Turkey and Uruguay. We continue to prefer sovereigns to quasi-sovereigns and corporates. Within corporates, we have allocations to the energy, basic materials and industrial sectors.

Outlook

The yield curve once again offered decided bear-steepening in October as the bond market acknowledged the extent the Fed may able to retain a higher policy rate for longer while fears of meaningful, nearer term recession remained misplaced. Stubborn signs of labor's resilience were uninterrupted, with sideways moves in initial jobless claims figures, after a strong non-farm payroll release that began the month. US inflation surprise metrics rose as CPI, and other price measures, generally indicated continued persistence even if secular disinflation remained unchallenged. Lastly, the market perceived state of the US consumer remained intact in October, as Q3 release of consumption rose to 4.0% spurring GDP to report a preliminary rise of 4.9% annualized.

Without an FOMC meeting, market participants parsed Fed speak for new signs of policy intentions, at least during the first weeks of October before the black out period commenced. Universally, participants suggested that retaining a higher policy rate for longer would remain prudent toward constraining inflationary impulses over the medium and long terms, even if participants may have quibbled over the precision of the terminal fed funds rate.

Against this backdrop, we remain of the belief that rates remain likely rangebound as we look forward. Spreads increased among credit markets in October, lending to negative excess returns. We continue to posit an imminent, deep economic downturn in the US remains remote, but tight valuations and challenges on both the technical and fundamentals pictures still suggest remaining defensive is sound practice.

Municipal Fixed Income	Taxable Fixed Income	US Multi sector	SMA Fixed Income Advisory
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[1]See last page for further information

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The Bloomberg Commodity Index is designed to provide liquid and diversified exposure to commodities via futures contracts.

The Bloomberg US Municipal Bond Index includes investment grade, tax-exempt and fixed-rate bonds with long-term maturities (greater than two years) selected from issues larger than $50 million. The index is unmanaged and does not reflect the deduction of any fees or expenses. The index returns reflect all items of income, gain, loss and the reinvestment of dividends and other income.

The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The ICE BofA 1-3 year BB-B Cash Pay High Yield Constrained Index tracks the performance of non-investment-grade corporate bonds with a remaining term to final maturity less than three years and rated BB-B and limit individual issuer concentrations to 2%.

J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI Global Diversified) tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities. It limits the weights of constituent countries with larger debt stocks by only including specified of their debt outstanding**.**

J.P. Morgan Corporate Emerging Markets Bond Index Diversified (CEMBI Diversified) tracks total returns of US dollar-denominated debt instruments issued by corporate entities in emerging market countries.

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