The fixed income and equity markets have now heard Chair Powell loud and clear. Rising rates, widening spreads, and demand for a higher risk premium now set the tone for fixed income investors. The sense of uncertainty remains heightened, with sentiment akin to what we saw in June when rates rose abruptly and equity prices declined.

Fixed income investors are now painfully aware of what happens when you combine one of the most rapid tightening cycles in history with historically low levels of nominal Treasury yields: double-digit negative returns. Given the lower interest rates heading into 2022 (1.50% on the 10-year), the carry (yield) earned was not enough to offset the rapid price declines triggered by rising rates, which peaked 200bp higher this past June. Despite the disheartening results, we foresee selective opportunities ahead.

One driver of our cautious optimism relates to the path of US interest rates. Although we entered 2022 with a bearish tone and positioned ourselves for higher yields, the magnitude and velocity of the move surprised most investors and contributed to a surge in volatility. Sentiment has shifted three times in nine months. First, higher yields and lower stock prices followed the Fed’s dismissal of the word “transitory” from its lexicon and the belated acknowledgment that inflation was likely to be persistent. Recession fears followed, leading to lower yields and higher stock prices on the misplaced expectation of a quick reversal in monetary policy. More recently, in the wake of Jay Powell’s warning that pain is on the horizon, we are amid a return to higher yields and lower stocks as the market re-prices to a more aggressive Fed. It has been quite a ride.

The most recent shift in market sentiment has occurred with one meaningful exception: the removal of the “Fed put”! The rates market has now priced out over 50bp of Fed eases in 2023, alongside increasing the 2023 terminal fed fund rate to ~3.9%, which is meaningful to future performance of fixed income.
We have advised investors start to add interest rate risk near our upper band of 3.25%, with full overweight between 3.25% and 3.5%. The US market has repriced the Fed terminal rate, alongside the increase in quantitative tightening to USD 95 billion this month while acknowledging the likelihood that September is set to become a record month for rate hikes with most major central banks delivering large moves (ECB and FOMC priced in for the likelihood of 75bp).

Forecasting the exact peak in yields has been a challenge in 2022, as the threat of persistently higher inflation is yet to be known. However, the recent front loading of rate hikes combined with the lagged impact of rising borrowing costs to both the consumer and corporation.

How we are allocated:
We remain invested in short-end corporates, where the yield earned is currently over 4%, while the break-even spread cushion remains near the 2018 year-end level of 44bp. We view this sector as a prudent cash alternative while the carry and lower interest rate risk will contribute to total return over the next several months. Alongside this higher quality theme, we also remain with a preferred allocation to the Agency MBS market. The higher quality and the widest spread level in over a decade - current coupon MBS reaching 150bp spread to Treasury - represents value within a sector with nearly zero credit risk and ample liquidity.

We closed out our preference for preferred securities versus US Treasury allocation in August and are now neutral on the sector. As we discussed, the rise and inversion of the real yield curve is a point of concern for risk assets, and we prefer moving up in quality when adding outright risk and chose to lower credit risk given the magnitude of spread compression in July.

We would not add outright credit risk and remain cautious with ‘down in quality’ allocations as the current spread offered to investors does not appear cheap (e.g., high yield at 508bp is only 38bp away from its long-term average spread of 546bp). However, the 8.6% yield earned in HY is the highest cushion to rising interest rates in over 5-years. We would not add high yield versus Treasuries or cash in a fixed income portfolio because that would result in an outright increase in credit risk at potentially the wrong time. But substituting HY for senior loans would not materially alter the credit risk of the overall portfolio. Given the outperformance in senior loans versus HY in 2022, and the risk that fund flows to that asset class may dissipate, we believe substituting HY for leveraged loans in a larger portfolio is a sensible course.

Loans have generated a positive total return of 1.6% in August, marking the strongest two-month stretch of gains (+3.7%) since June 2020. With year-to-date performance of loans only -9bp versus the -11% in high yield, we believe shifting to HY versus loans is an attractive opportunity without increasing credit risk, combined with shifting from floating to fixed yields as interest rates hover near 3.25%.

For more, reach out to your UBS Financial Advisor for a copy of September’s Fixed Income Strategist: Can you hear me now?

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This content is a product of the UBS Chief Investment Office.