Allspring

MARKETING COMMUNICATION

Income Generator

Beyond the Inflection Point

GEORGE BORY, CFA

+ Chief Investment Strategist, Fixed Income

The Federal Reserve (Fed) delivered a dovish hike in March as it broadened its objectives to simultaneously fight a two-pronged attack against persistent pressures from inflation and market instability due to pressures in the banking system. This event likely signals an inflection point in the global interest rate cycle and will have repercussions for fixed income investors around the world.

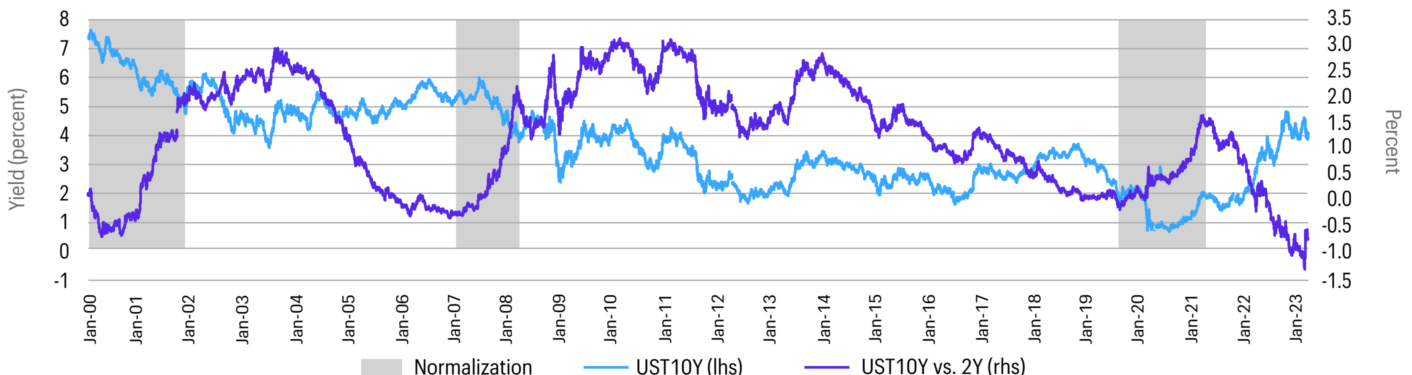
Fixed income investors should consider the following:

- Yield-curve normalization → add duration
- Maximize yield → income remains the primary driver of fixed income returns
- Stay up in quality → use high-quality credit to reduce risk
- Global yield → swap to the USD from non-USD currencies
- Munis for stability → reduce volatility with municipal bonds

Fallout from volatility across the banking sector will likely mark an **inflection point in policymakers' current tightening cycle.** Significant unrealized losses in bond portfolios around the world are bubbling to the surface, as evidenced by the collapse of Silicon Valley Bank (SVB). Subsequent policy responses from regulators in the U.S. and Europe to manage the collateral damage suggest the one-dimensional fight against inflation must broaden out to simultaneously calm nerves and restore confidence in the financial system. This shift in focus, while not unprecedented, is a tall order.

The Fed and other global policymakers have multiple tools at their disposal to affect the economy and financial system, but their primary tool is liquidity. Additional liquidity helps stimulate growth and can restore functionality in the financial system when it's under stress, while less liquidity tends to constrain demand and curb inflation. The trade-off between these two dynamics creates conflicts.

YIELD-CURVE NORMALIZATION



Source: Bloomberg LLC

Currently, regulators' inflation-fighting credentials are very much at risk. Core inflation in the U.S. is running at approximately 5.5%, well above the Fed's 2.0% target. Europe faces the same challenge with core inflation at 5.6% (6.2% in the U.K.). With base interest rates in the U.S., EU, and U.K. at 5.00%, 3.50%, and 4.25%, respectively, rates are still below core inflation in all three regions. It's clear that policymakers still need to hike rates to contain inflation. However, the pace is likely to change as fallout in the banking system contributes to tighter financial conditions and further evidence of an economic slowdown emerges.

This is a challenging time for policymakers, and the risk of a policy "mistake" is on the rise. Recession risks are rising, and it's notoriously difficult for policymakers to know when policy is tight enough. However, given the pernicious nature of inflation and the apparent "stickiness" it presents in this particular cycle, it's likely policymakers will err on the side of overtightening to ensure they don't repeat the mistakes of the 1970s.

Bond investors should look ahead and position for upcoming changes in market dynamics. Bond yields are likely to consolidate around current levels but trend lower over time as growth falls and inflation moderates. Yield curves should steepen but remain inverted as tight policy gnaws at economic growth and constrains inflation. Credit spreads will likely come under more pressure, with more segmentation across the market as weak credits are exposed and strong credits thrive. To be fair, credit investors already repriced some credit market weakness in a violent, but fairly orderly, manner in the first quarter of 2023. However, this may not be enough, as current levels of credit spreads suggest an economic backdrop of sluggish, uninspired growth—but not a recession.

The upshot is the relatively high starting point of yields, which should buffer against future volatility and help generate attractive returns. Indeed, year-to-date U.S. bond returns (as of March 31, 2023) are 1.5% to 3.5% across different segments of the market and points along the yield curve. This performance stands in the face of the U.S. Treasury 2-year note's yield swing of more than 100 basis points (bps; 100 bps equal 1.00%) over the same period.

We've positioned for this outcome and believe our commitment to active management and diversified risk management should help quantify and appropriate scale risk and volatility throughout this period. This, in turn, should generate attractive risk-adjusted returns.

Allspring's active investment process in fixed income rests on making diversified investment decisions across rates; curves; ratings; sectors; and, most importantly, securities. To position portfolios for the next phase in the economic cycle, we lay out five specific investment themes to help fixed income investors navigate these shifting markets.

Investment themes for bond investors

IDENTIFYING "NORMAL"

Typically, the yield curve "normalizes" after a period of rate hikes that caused the yield curve to invert (when short-dated yields are higher than long-dated yields). During normalization, yields along the yield curve tend to fall, and yields at the short (front) end of the curve tend to fall faster than yields at the long (back) end of the curve. Anticipating this shift and positioning portfolios for it are notoriously difficult. However, once the shift occurs, it tends to last a while.

Three early signals for a possible turn in the fixed income market include:

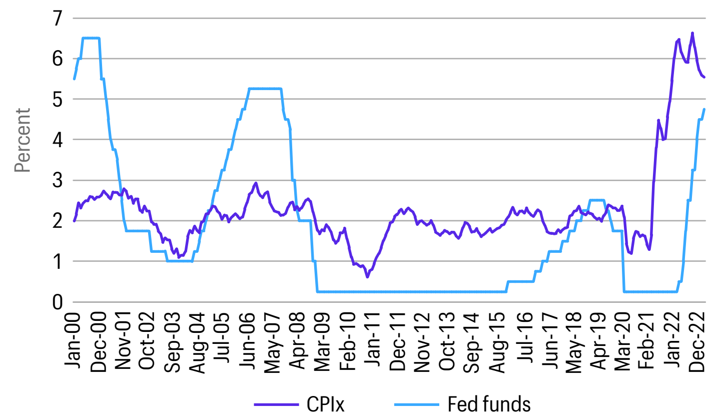
1. Fed funds rates are higher than the rate of core inflation (Chart 1).

2. U.S. Treasury 5-year yields peak and start to decline.

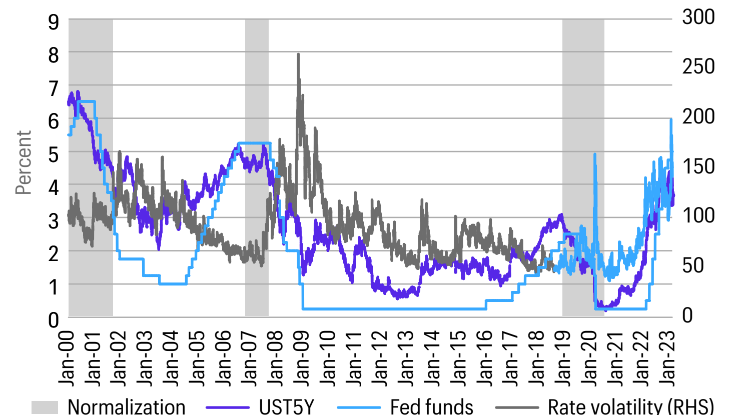
3. Interest rate volatility spikes (Chart 2).

When these three conditions are met, the simple strategy of extending duration can be beneficial to portfolios.

INFLATION & MONETARY POLICY



RATES & VOLATILITY



Source: Bloomberg LLC

Yield-curve normalization: Add duration

With the Fed much closer to the end of the rate-tightening cycle than to its beginning, fixed income investors should start to position for the eventual normalization of the yield curve. This includes extending duration and positioning for a steeper curve. To be fair, the yield curve has already started to shift as higher prices at the front end of the curve outpace the long end. Nevertheless, adding duration at the front end of the curve should benefit portfolios as bond yields are expected to fall over time. It will take time and won't be a straight line lower as temperamental inflation trends and fickle policymakers conspire to make for a bumpy ride. But patient investors should benefit as tighter policy takes hold. The optimal spot on the yield curve appears to be five-year maturities. This should generate enough duration to capture the early stages of a shift in policy while also protecting against a false dawn.

Maximize yield

Income remains the primary driver of returns for any fixed income portfolio. As such, maximizing income per unit of risk remains the most critical investment decision to generate efficient returns. Currently, income is most attractive at the front end of the curve due to the shape of the yield curve. This is particularly true in the lower-rated segments of the corporate credit and structured product markets. Investments in this segment of the market should benefit from the dichotomy of an inverted yield curve and steep credit curve.

Move up in quality

The prospect of slower economic growth suggests an up-in-quality bias should persist as monetary policy remains restrictive and fiscal support appears unlikely anytime soon. In addition, broad credit fundamentals have started to erode across corporate credit markets. Leverage is creeping higher, interest coverage is declining, and default rates are on the rise. However, the trends are NOT universal and are coming off very strong levels. In a post-COVID-19 economy characterized by strong nominal growth, weak real growth, and persistent inflation, there will be winners and losers across the corporate landscape. Quality will likely outperform growth for the foreseeable future. Pricing power, cost controls, strong cash flow generation, conservative balance sheets, financial flexibility, and spending power should be the winning characteristics. Credit spreads have started to price in some of the weakness and offer attractive opportunities to find value. But with U.S. investment-grade and high yield bond average credit spreads at roughly 150 bps and 500 bps, respectively, investors are being compensated for slow/sluggish growth but not a recession.

Beyond corporate credit, yields and spreads of low-credit-risk, high-liquidity 2- to 10-year bonds appear attractively priced as these sectors are cheap for technical rather than fundamental reasons and provide return potential while offering resiliency in the event of a weaker-than-expected economic downturn. This includes government debt, asset-backed securities, mortgage-backed securities, and other structured products.

Municipals offer stability

A combination of healthy fundamentals and very strong technicals should support municipals and provide a buffer against broad market volatility. Muni fundamentals are in good shape, but munis aren't immune to cyclical trends. If the economy slows down, muni credit spreads will widen. However, muni revenue streams (taxes) tend to hold up better than the cyclical earnings of companies—at least initially. For example, property taxes go up much faster than they go down. Furthermore, public services, such as water and sewer systems, are significantly less affected by cyclical factors compared with a typical industrial company.

Many municipalities across America are still basking in the glow of the $5 trillion stimulus check written by the federal government during COVID-19. Much of that money was paid directly to states and municipalities and should preserve fundamentals for the foreseeable future. As for technicals: When yields go up, the value of the tax exemption of municipal bonds goes up, too. This helps boost demand as prices fall and buffers market volatility.

Global yield: Swap to USD from non-USD

In this environment, recession risks are high, yet credit spreads are fair. In Europe, fixed income investors can generate income while macro risks clarify, ensure quality to protect portfolios against disappointing growth, and preserve liquidity to access when better opportunities arise. European government debt swapped to the USD provides all three. Over the past 18 months (as of March 31, 2023), five-year French OAT yields rose from negative 50 bps to nearly 3.25%. But swapped to the USD, the yield boosts an additional 150 bps, to around 4.75%. In USD terms, that's comparable to five-year USD BBB credit yields. Short-maturity EUR credit provides similar risk/return characteristics to capture attractive cross-currency yield.

Bonus idea

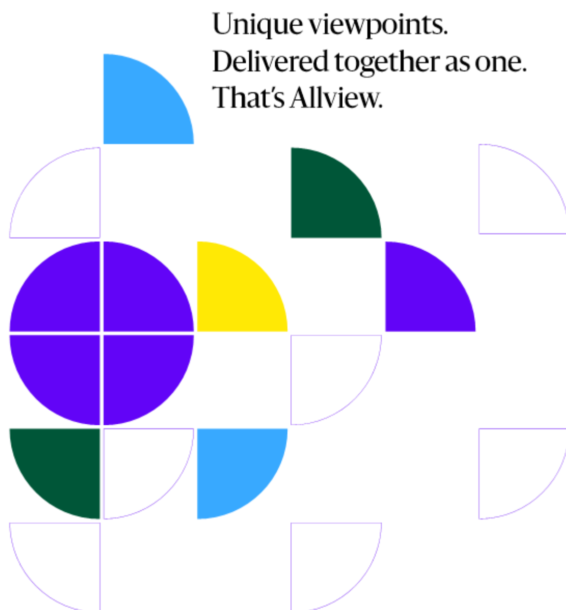
MAXIMUM YIELD, MAXIMUM DURATION

	WEIGHT	YIELD TO WORST	DURATION
ICE BofA 1–3 Year BB US Cash Pay Index	50%	7.2%	1.7
Bloomberg Muni High Yield Index	50%	5.7%	8.3
Weighted average	100%	6.5%	5.0
Expected annual return	6%–12%, depending on yield-curve shifts		

Source: Bloomberg LLC

Investment rationale: High income from short-duration securities provides a steady stream of **inflation-beating cash flow** that can be reinvested as investors move through time. There's some credit risk, but active management can help avoid defaults and manage downside. **Munis** provide a counterbalance to cyclical exposure in corporates and are attractively priced at this point in the cycle. **Long duration should benefit from a decline in inflation over a longer period of time** and provides a capital gain kicker if rates decline by 20 to 30 bps. Plus, bonds are broadly supported by a still-hawkish Fed.

Additional benefit: For those worried about shenanigans in Washington D.C. and issues surrounding the debt ceiling, this theme avoids U.S. Treasuries but stays invested in areas of the fixed income market that we believe should benefit if investors move away from U.S. Treasuries to avoid volatility.



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- To discuss sustainable investing solutions, contact Henrietta Pacquement, head of Sustainability, and Jamie Newton, deputy head of Sustainability, at **henrietta.pacquement@allspringglobal.com** and **jamie.newton@allspringglobal.com**.

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