Portfolio Management Outlook

Balancing Attractive Yields and Tight Spreads

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Tighter monetary policy has weighed on the U.S. economy, but a broad recession has thus far been avoided primarily due to deficit fueled fiscal spending associated with the COVID-19 pandemic. This has created a resilient consumer, helped to fortify corporate balance sheets, and contained more widespread economic weakness, even as high interest rates created a "rolling recession" dynamic. Although expanding economic capacity allowed inflation to fall quickly in 2023 even with strong growth, progress stalled in the first quarter with three consecutive months of elevated prints. The Federal Reserve (Fed) responded by reinforcing a higher-for-longer policy stance that has incited some volatility in the markets. While volatility can be unnerving, we are mindful that the pause phase of the Fed's monetary policy cycle creates an environment that is constructive for fixed income and more specifically for active management in the credit markets.

A common theme across our sector team reports this quarter is that while spreads have been grinding tighter, yields remain high and attractive, particularly relative to post-Global Financial Crisis (GFC) norms. Even as they tighten, spreads in high grade sectors remain wide relative to fundamental risk. Credit fundamentals are healthy overall, but we are still seeing bifurcation between the larger issuers with better access to capital and an ability to pass along higher costs to customers, and smaller and lower quality issuers that are struggling with higher interest expense. We expect growth to moderate in 2024, with increasing dispersion under most scenarios.

Opportunities across fixed income remain broad based, even in categories that we have traditionally underweighted like Agency RMBS. Broadly we are prioritizing high carry and shorter duration instruments. Favored categories include non-Agency RMBS, senior CLOs, commercial ABS, current coupon RMBS, syndicated loans, high quality high yield and certain parts of the investment-grade corporate market. In thinking about spread valuations, the most attractive sectors remain primarily in securitized products, both Agency RMBS and non-Agency structured credit. Even as we take advantage of market conditions to invest at these levels, and the growing new issue pipeline, we are all also maintaining dry powder and taking a high-quality bias for future optionality.

The retracement in yields higher to start the year has cheapened certain parts of the yield curve. We find the front end and belly of the curve look most attractive as Fed easing expectations have been pushed back, which aligns with our longer-term expectation that the curve will bull-steepen as these expectations start to move toward rate cuts.

The current investment environment should reward a balanced approach. Our preferred strategy is to preserve diligent underwriting standards, prioritize carry and maintain diversification across sectors and issuers.

By Anne Walsh, Steve Brown, Adam Bloch, and Evan Serdensky

Investing involves risk, including the possible loss of principal. In general, the value of a fixed-income security falls when interest rates rise and rises when interest rates fall. Longer term bonds are more sensitive to interest rate changes and subject to greater volatility than those with shorter maturities. During periods of declining rates, the interest rates on floating rate securities generally reset downward and their value is unlikely to rise to the same extent as comparable fixed rate securities. High yield and unrated debt securities are at a greater risk of default than investment grade bonds and may be less liquid, which may increase volatility. Investors in asset-backed securities, including mortgage-backed securities and collateralized loan obligations ("CLOs"), generally receive payments that are part interest and part return of principal. These payments may vary based on the rate loans are repaid. Some asset-backed securities may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity and valuation risk. CLOs bear similar risks to investing in loans directly, such as credit, interest rate, counterparty, prepayment, liquidity, and valuation risks. Loans are often below investment grade, may be unrated, and typically offer a fixed or floating interest rate.

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