Portfolio Management Outlook

Portfolio Positioning in an Opportune Market

Valuations have reset after a historically volatile year.

The emerging theme from our Sector Teams in this edition of Fixed Income Sector Views is that the market has come around to the view that the Fed's hiking cycle is nearing its end. This is an important and bullish transition in investor psychology and has led asset allocators to rethink their exposure to fixed income. After a year of aggressive rate hikes, a radical reshaping of the yield curve and volatile credit markets, the headwinds to fixed-income performance from 2022 are subsiding.

Contributing to this change in market perception is better news on inflation and the step-down in the size of rate increases at the last two Federal Open Market Committee (FOMC) meetings. As our Macroeconomic and Investment Research Group reports, falling core goods prices, slowing wage growth, improving supply chains, and a cooler rental market should keep inflation on a downward trend. While future Fed policy is uncertain and the risk of recession is rising, fixed income can again add both income and correlation benefits to a diversified portfolio.

As active fixed-income managers, our job is to anticipate market developments so that we can avoid problems and seize opportunities when possible. In the second and third quarters, credit risk across all sectors was attractively priced as quickly moving markets were offering historically wide spreads and attractive yields.

The subsequent recovery in credit has been disproportionate and has led to some dispersion among credit sectors. This presents a compelling opportunity for some opportunistic repositioning. Most attractive to us are the dislocations in higher quality structured credit, where spreads remain historically wide relative to corporate credit. In addition to wide spreads, the significantly discounted dollar prices offer attractive convexity and total return potential. Our strategies have broadly continued to add to this exposure while also using recent strength to lighten up in more cyclically sensitive categories of credit.

We remain positioned to benefit from tighter spreads and a normalizing of credit curve relationships, but are mindful of the risk of a reversal of the recent strength and a longer term weakening of credit fundamentals. Both risks call for active sector allocation, overweighting higher quality credit, disciplined security selection, and maintaining sufficient dry powder to allow for future flexibility.

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