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Portfolio Management Outlook

Opportunity in Fixed Income Rises With Uncertainty

Mounting headwinds are spooking many investors, creating attractive entry points.

The first quarter edition of our Fixed-Income Sector Views was posted on Feb. 22, 2023. Less than three weeks later markets faced down an unexpected banking crisis that has continued to permeate. We are not in the business of predicting black swans but we are in the business of preparing our portfolios for a range of outcomes, and as we headed into the week of Silicon Valley Bank's (SVB) downfall we were already positioning for late-cycle market activity, a time when unwanted market surprises are more likely to occur. For several quarters we have been rotating portfolios to be more defensive by reducing certain exposure and increasing credit quality, conservative positioning that we believe will continue to help our clients weather the storm. With the subsequent fall of additional banks in the United States, and of global systemically important bank Credit Suisse, we are reminded that the SVB episode was not an isolated, idiosyncratic incident. It also shined a light on one of the most fundamental tenets of investing—the importance of diversification, whether at the sector or the issuer level.

Markets are still facing uncertainties regarding the impact of the Federal Reserve's (Fed) aggressive rate hikes and quantitative tightening, a potential economic slowdown, and the likelihood of other unforeseen consequences of financial disintermediation. However, it remains one of the most attractive times in the post-GFC era to be invested in U.S. fixed income, particularly relative to other more volatile asset classes. With continued elevated yields and spreads, debt holders are taking a greater share of the economics than equity holders and this trend seems unlikely to end soon. This portends continued opportunities across credit and more negotiating leverage for creditors to influence pricing and terms.

Throughout this edition of Fixed-Income Sector Views, our Sector teams acknowledge the many headwinds facing credit investors, including rising default and downgrade risk, the decline in new issuance volume in many sectors, and signs of pre-recession weakening in corporate and municipal credit performance. Markets like these represent opportunity for active fixed-income asset managers. For example, we are taking advantage of any moves higher in Treasury yields at the short end of the yield curve and are positioning for greater spread dispersion between sectors and across the quality spectrum. While the risk of defaults is rising in corporate credit on an aggregate basis, some issuers and sectors may be oversold, creating potentially attractive entry points from a portfolio perspective. The same is true in structured credit, where certain commercial ABS sectors continue to offer discounted dollar prices and wider spreads compared to similarly rated corporate credit alternatives.

With high yields available on relatively lower risk assets within credit, it is a good time to be defensive and maintain elevated levels of liquidity. This posture is designed to help protect our portfolios against late-cycle uncertainty, and position us to be rewarded as a provider of capital down the road.

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