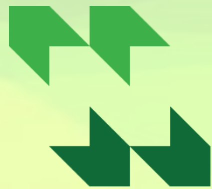

National Investment Services

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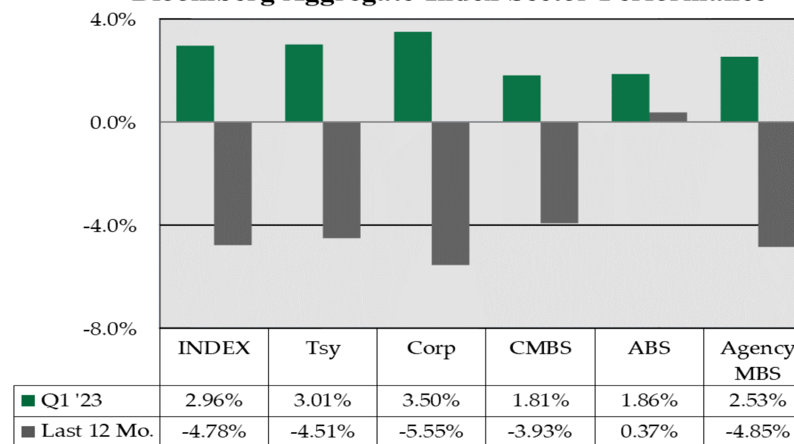
FIRST QUARTER 2023 INVESTMENT REVIEW

FIXED INCOME OVERVIEW

Volatility and uncertainty stemming from the second largest bank failure in U.S. history roiled risk markets in March and spiked interest rate moves in what had been a relatively quiet start to the year. Fortunately, bank regulators put together a safety net that at least stemmed the bleeding in the sector, but the focus would then shift to the possible long-term ramifications of more costly deposits and tighter lending standards. With the market now looking forward to possible easing, the Bloomberg Aggregate Index returned almost 3% this quarter, which is a welcomed change of pace versus the prior year of negative returns. The table below contrasts almost a mirror image of this year's start and that of the last twelve months. All major sectors of the U.S. bond market finished higher this quarter, led by corporate bonds with the lower duration structured sectors finishing up, but not quite as high. U.S. Treasuries also finished up 3%, with the long-end of the curve outperforming as 20+ year Treasuries returned over 6.5%, whereas intermediate Treasuries were up 2.3%. All in all, it was a decent quarter of performance across the fixed income landscape.

ARTICLE HIGHLIGHTS

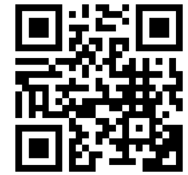
- Fixed income performance is up
- Opportunities in high-yield areas
- How the fears of looming recession affected the Treasury curve
- Recent ISM manufacturing data hints at further slowing
- The Feds' preferred way of measuring inflation
- OPEC+ production cut to oil
- Which sectors look most attractive going into 2Q2023



	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q1 '23	2.96%	3.01%	3.50%	1.81%	1.86%	2.53%
Last 12 Mo.	-4.78%	-4.51%	-5.55%	-3.93%	0.37%	-4.85%

Source: Bloomberg

For the latest on NIS happenings and firm updates



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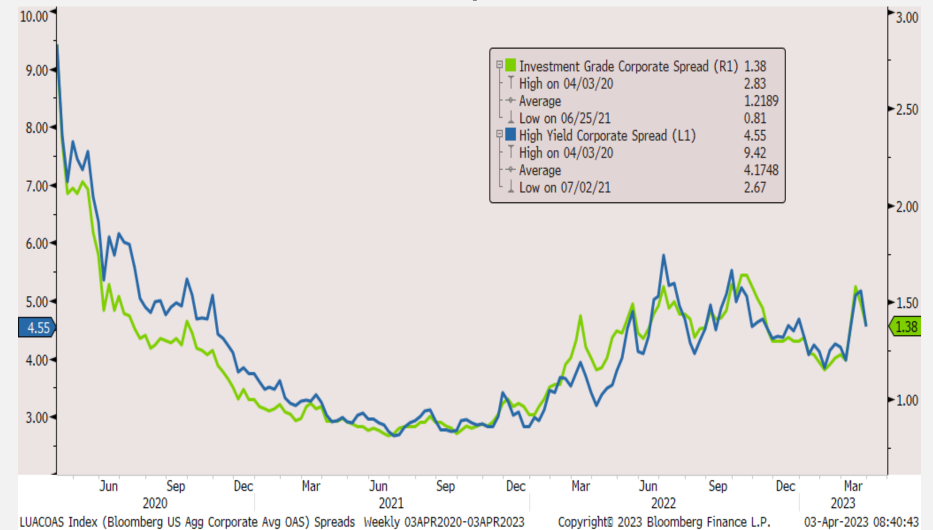
CREDIT SPREADS

Investment grade corporate credit spreads (green line in chart to the right) widened eight (8) basis points (bps.) on the quarter while high yield bonds actually tightened 14 bps. The quarterly statistics do a nice job of hiding some of the volatility that roiled the markets in mid-March as spreads widened 30 and 40 bps., respectively. The investment grade (IG) market seemed relatively worse off as their exposure to bank and finance sectors is a bit more magnified than their high yield (HY) counterparts. The chart below highlights the widening of credit spreads in March and the subsequent late-quarter rally. It is interesting to note the "wides" in both IG and HY did not eclipse what we witnessed last year and that both market segments are trading wide of their three-year averages. We continue to see opportunities in areas of the high yield market like property and casualty insurers, airlines, cable, and other consumer-related leisure sectors. Within our investment-grade portfolios we pared back some of our municipal exposure and deployed some capital into the corporate bond arena, as industrials and utility paper seem relatively cheap.

Credit Spreads



Source: Bloomberg

THE ECONOMY

The outlook for the economy now includes building recession fears being quickly brought forward by the current troubles in the banking industry and concerns in the commercial real estate area. A seemingly good indicator of past trouble has been the inversion (below zero) of the 2 year /10 year Treasury curve (see green line in chart to the right reflecting that this is currently -61). This barometer has preceded each of the last three recessions, and it likely will again, but it is really a matter of timing. So if we look at the behavior of 2-year Treasury yields (blue line), when they roll over and then start moving down quickly, a recession is likely not too far off. We think this is something to watch.

2Yr. UST Yield & 2/10 UST Curve

Source: Bloomberg

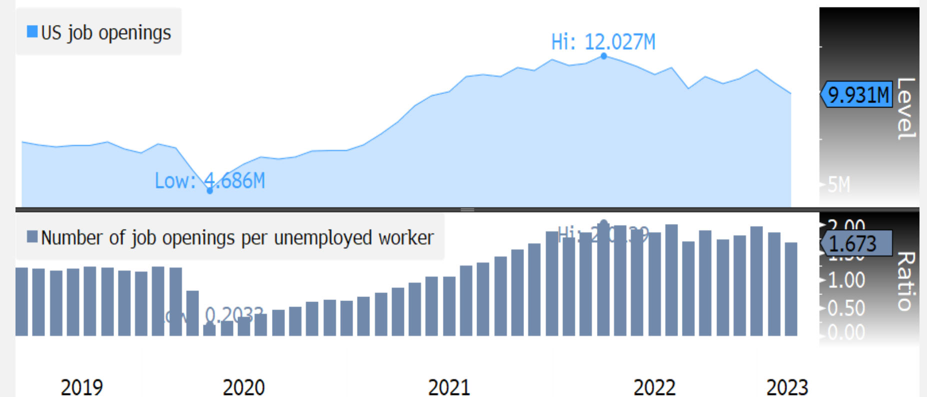
While it seems difficult to envision a recession given what has thus far been a very strong market for labor, we note the pace and magnitude of layoff announcements from very large U.S.-based businesses seem to be on the rise. Ironically, the stock price of these companies also seems to rise when these actions are announced, which no doubt adds fuel to the fire, as it could be seen as a quick way for shareholder gains. The latest company to offer a restructuring is McDonalds Corp., which temporarily shut down (Cont.)

THE ECONOMY

(Cont.) its offices for a week to inform their corporate employees of job reductions and restructuring. We doubt that too many folks there are “lovin’ it.” Additionally, UBS, the large Swiss bank that just took over embroiled Credit Suisse, announced they are letting go of 36,000 employees. The numbers are adding up quickly and are starting to affect job openings, which just ticked under 10 million for the first time since May of 2021.

Businesses seem to be acting in a conservative manner and recent ISM manufacturing data hints at further slowing as new orders and employment components pulled back to levels generally not seen since the depths of the pandemic and in 2009. Fortunately, for job seekers, wages still appear sticky with average hourly earnings at an increase of 4.6% year over year, but off the high 5% readings witnessed a year ago. To the extent wages play a role within the inflation equation, we would have to chalk another up for the elevated side.

Job Openings

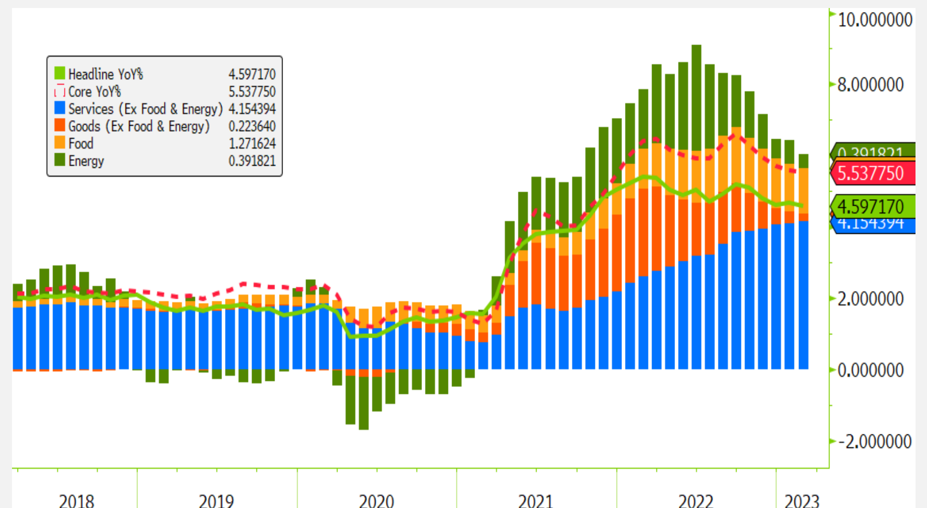


Source: Bureau of Labor Statistics, Bloomberg

INFLATION AND THE FED

The next chart might require the reading glasses, but we think the graphic tells a very interesting story and one which Federal Reserve (the Fed) Governors are probably not too comfortable. The chart breaks down Consumer Price Index (CPI) inflation by its main components while also showing Core CPI, which backs out food and energy because they tend to be volatile. Additionally, we included the Fed’s preferred way of measuring inflation, PCE (personal consumption expenditure deflator, reflected by the green line in the chart to the right, currently 4.59%), which tracks the price changes in goods and services. Unfortunately, just about any way you slice it, inflation does not seem to be coming down as quickly as hoped, due in part to services and food remaining quite high, and it seems these are areas where people do not want to go slowly with their spending. (Cont.)

US CPI Urban Consumers



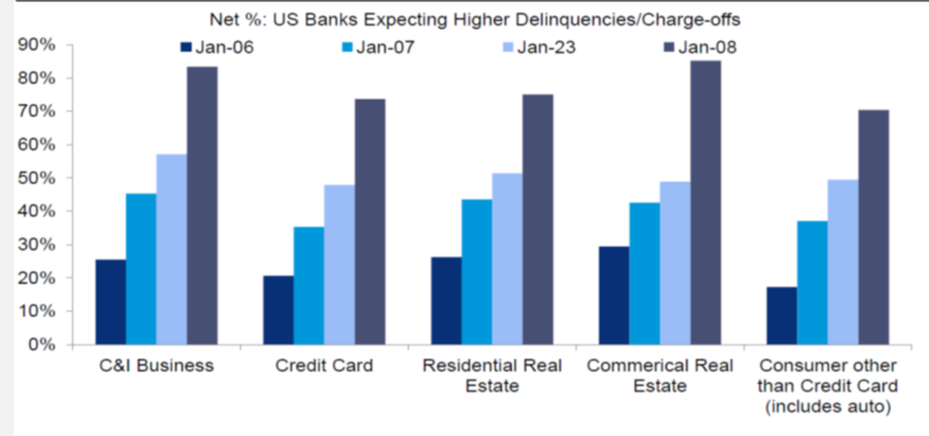
Source: Bureau of Labor Statistics, Bloomberg

INFLATION AND THE FED

(Cont.) Potentially making matters even worse, OPEC+ just announced a 1 million barrel per day production cut to oil. The markets and the Fed might not get the break in energy prices that they thought.

While it seems somewhat hard to believe, it was just over a year ago that the Fed made their first move higher in the Fed Funds Rate, and we are equally surprised that 475 bps. of rate increases have done so little in putting a dent in inflation. It is this delayed effect of higher rates that has us, as well as the financial markets a bit concerned. Inflation tends to pressure corporate margins over time as costs and financing get more and more expensive, and that is if financing is even available. A recent (prior to the banking weakness) Senior Loan Officer survey from the Federal Reserve shows that lending standards were already tightening. Additionally, those surveyed on expected delinquencies and charge-offs estimated levels to be somewhere near those experienced in 2007 and 2008, which was not exactly a time when consumers and businesses were strong.

Senior Loan Officer Opinion Survey



Source: Federal Reserve Bank, Deutsche Bank

SECOND QUARTER 2023 STRATEGY

As worries about future economic growth build and a softening employment market potentially weighs on sentiment, we believe the rates market has put in a top for this cycle. We will work to bring clients' portfolios closer to their benchmark durations across our core mandates while keeping an eye out for opportunities in the high yield markets in appropriate accounts. Our team is constructive on the attractiveness within the overall bond market as "all-in yields" available in corporate bonds are over 5% from investment grade names and 8.5% in high yield. Additionally, our structured team is finding value in legacy MBS, and highly rated auto and credit card benchmark ABS sectors.

Mark R. Anderson, CFA

Chief Strategy Officer

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