Fixed Income Perspectives: Themes for 1H23: The economy's moment of truth

As we enter the new year, attention will shift from inflation to the economy and the effects of tighter Federal Reserve policy.

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Bond yields dropped dramatically in November, and signs of receding inflation are mounting. The Fed has raised rates at the fastest pace in generations, no doubt contributing to the improving inflation picture. Below are our key takeaways on the looming questions regarding the impact of the aggressive interest rate hikes on the economy and financial markets.

1 Global growth is under pressure on multiple fronts

The cumulative effects of central bank tightening, energy supply disruption and the fading impact of COVID stimulus will push global growth below potential and threaten recession in several key economies. The effects of rationed energy supply and high prices on industrial activity will force the Eurozone into recession in 1H23. The United States should fare better, and companies may be more likely to hold on to workers in a slowing economy, with tight labor supply fresh in their minds. A delay in layoffs could set up a narrow but improbable path for avoiding a recession. Renewed fiscal support and gradual relaxation of zero-Covid policies make China the only potential upside counterbalance, but any meaningful offset will not be apparent until the second half of the year.

2 Inflation peaking globally but still too hot for comfort

Although inflation has peaked, the cost of goods, labor and financing remain uncomfortably high. European inflation is likely to remain elevated, as low unemployment and government subsidies to reduce energy costs should support consumer spending. On the other side of the Atlantic, inflation in the US appears to be on the decline, helped by lower housing costs and falling goods prices. Nonetheless, a strong US labor market likely will keep wages elevated and inflation above target.

3 Central banks becoming less synchronous; Fed in no rush to cut rates

As we near the end of hiking cycles, we expect central bank policies to diverge globally, driven by regional differences in growth and inflation. The European Central Bank will prioritize growth, since energy, the primary driver of inflation, is outside its control. In the US, falling inflation should allow the Fed to pause once it's convinced that nominal rates are higher than expected inflation. Unless the US dips into a deep recession, however, we don't expect the Fed to cut rates until labor markets rebalance and inflation data shows signs of settling below 3%. The Bank of Japan, on the other hand, is steadfast in maintaining its policy of near-zero rates.

4 The emerging market outlook is gradually improving

The outlook for emerging markets should improve gradually as global food and energy bottlenecks clear and US dollar strength eases, leading to the end of EM central bank rate hikes. High debt loads and populist fiscal policies will continue to weigh on many EM economies. But those with stable political structures, low labor costs and proximity to consumers in developed markets should benefit from the realignment of global supply chains.

5 Rate volatility recedes as market's focus shifts to fundamentals and recession risk

Interest rate volatility will recede as central banks move beyond peak hawkishness, although higher rates will linger globally. Markets will pivot from pricing interest rate risk to pricing fundamental risk, potentially with recessions scattered around the globe. This shift in rate expectations should favor market segments with embedded duration risk and sensitivity to rate volatility. By contrast, fixed income instruments tied to economic growth may underperform. In general, we expect wider yield spreads and lower equity valuations before the economic cycle bottoms.

Bond market summary

Investment grade

Spreads tightened significantly this past month. We continue to favor high-quality issuers over the lower end of the IG credit spectrum.

High yield

Though spreads have been tightening, the sector is pricing in only a mild recession and strong fundamentals should lead to a lower default cycle.

Senior loans

We prefer loans to stronger borrowers given our concerns about a vulnerable economy and numerous corporate headwinds.

Agency RMBS

We remain overweight RMBS on lower extension risk and attractive valuations.

Securitized credit

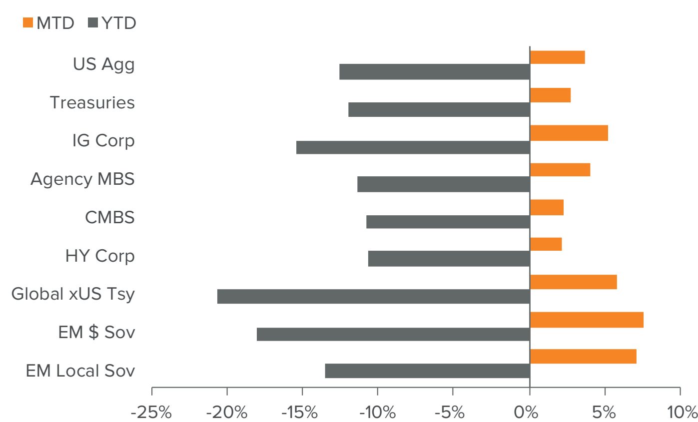
We remain slightly overweight securitized as consumer balance sheets and lower loan to value ratios should continue to support fundamentals in the near term.

Emerging markets

Despite solid EM corporate fundamentals and an improving China, the risk of a global developed economy recession is elevated, putting EM at risk.

Rates, spreads and yields

Fixed income sector total returns as of 11/30/22



		30-Nov	30-Sep	1Y Low	1Y High
Yields (%)	US 2 Yr	4.33	4.23	0.55	4.73
	US 10 Yr	3.61	3.83	1.35	4.24
	GER 10 Yr	1.93	2.11	-0.39	2.42
	JPN 10 Yr	0.25	0.24	0.04	0.26
	EM Local Sov	6.86	7.31	5.63	7.63
Spreads (bp)	IG Corp	133	159	91	165
	Agency MBS	52	69	18	88
	CMBS	202	166	102	207
	HY Corp	448	552	271	583
	HY x-Egy Corp	464	572	263	594
	EM $ Sov	468	559	359	593

As of 11/30/22. Sources: Bloomberg, JP Morgan and Voya Investment Management. **Past performance is no guarantee of future results.**

Sector outlooks

Global rates and currencies

- Global growth continues to slow, though buoyant relative to strong headwinds.
- The US dollar dropped again in November, hinting at a dovish Fed shift.
- Signs of cooling inflation are broadening; global supply chain issues have been largely resolved, crude oil prices dropped dramatically last month and the Fed has hinted at a softening of its hawkishness.
- In the US, easing shelter costs and a cooling labor market will dampen inflation.
- Inflation in Europe is slowing as well; most economists now expect a recession

Investment grade corporates

- Valuations look less compelling at current levels after latest spread rally.
- We expect interest rate volatility to recede, allowing markets to shift focus to fundamental risks as global growth continues to slow.
- We have increased dry powder ahead of a heavy new issue calendar to start the year.
- With a possible recession looming, we remain cautious, preferring high quality to high beta.
- Favorite sectors are utilities and financials due to their defensive nature.

High yield corporates

- Spreads tightened this month, though somewhat less than IG.
- HY continues to price in only a mild recession; the economy remains vulnerable to something worse.
- HY pros: Street inventory is light; pipeline is bare; buyer cash is ample; valuations are reasonable.
- HY cons: Fed is hawkish despite slowdown; Ukraine war extends; inflation is sticky.
- We're overweight building products on relative value and energy, particularly natural gas on positive supply/demand dynamics.

Senior loans

- We've been trading out of weak B-rated issues and into stronger credits.
- Cracks are emerging in sectors exposed to discretionary consumer spending.

- High inflation, input costs, tight labor and supply chain issues remain key headwinds.
- The 3-month downgrade-to-upgrade ratio declined slightly in November to 2.24x from 2.47x in October.
- Key downgrade themes: earnings, margin pressure, elevated leverage levels, increased borrowing costs.

Securitized credit

- We remain positive on a short-term tactical basis, favoring higher-rated collateralized loan obligations (CLOs) and select seasoned commercial mortgage-backed securities (CMBS), while de-emphasizing non-agency residential mortgage-backed securities (RMBS).
- Secondary selling pressure has diminished; banks have emerged as net buyers.
- Attributes are attractive: US-centric; diverse sub-sectors; multiple forms of consumer credit.
- We expect a strong labor market to offset headwinds facing the consumer.
- We're looking for new issue volume to drop, providing an investment tailwind.

Agency RMBS

- Agency RMBS posted record outperformance in November on the heels of declining rates and interest rate volatility; the latter will continue to drive near-term performance
- A paucity of new issue supply should tighten technical factors within the sector going forward.
- YTD private label supply is $98 billion, falling behind last year's pace by about $55 billion.

Emerging market debt

- While recent developments on US inflation and China growth fronts have offered some reason for optimism, the outlook for next year is far from clear.
- Focus is likely to shift more towards the growth outlook in 2023. US central bank policy has increased the risk of a recession, which could significantly impact emerging economies.
- Dollar strength and increased rate and equity volatility have weighed on EM spreads for much of this year, but we look for those pressures to abate.
- The Chinese economy remains challenged by housing weakness and softening external demand, but the recent easing of Covid policy provides a more constructive backdrop.
- Inflation has begun to peak and central bank hiking cycles are nearing an end.

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