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Webcast Summary

Strategy Update: US Core and Core Plus

The last year's environment has been a challenging one for investors due to rising interest rates, but this has been offset by strong performance in other parts of the fixed-income market. Credit quality has remained good and the income from high-quality spread products has been a significant contributor to our strategies' performance. We've concentrated on the importance of diversification in our portfolio construction and the value of income to generate steady returns over time. Looking ahead, we expect slower growth in Europe and China to be a headwind for the US, and we're keeping an eye on potential impacts from conflicts in the Middle East.

Here are some key takeaways.

Market Review

- Market narratives have shifted from concerns about recession earlier this year to an improved outlook for growth more recently, with 3Q GDP coming in better than expected.
- The backup in yields over the past few months is due to this growth narrative and it's been challenging for fixed-income investors.
- With the rise in yields, current levels are even more attractive for long-term investors, strengthening the case for allocating to fixed-income.
- With yields at these higher levels, bonds are likely to start behaving as diversifiers again in investment portfolios going forward.
- Improvements in supply chains, a more balanced labor market, lower energy prices and moderating wage growth are all positive underlying signs about the economy.
- The environment of stronger-than-expected growth, lower inflation prints and a Fed nearing its pause point has benefited spread product sectors in particular by supporting credit fundamentals.

Federal Reserve (Fed) Policy

- Fed developments have been favorable over the past year.
- The Fed is nearly done with rate hikes, having paused at the last two meetings after aggressive hikes earlier in 2022.
- We see the possibility for perhaps one more hike later this year or next year.
- The Fed pausing rate hikes due to declining inflation should be constructive for bonds in a normal environment.

Inflation

- The high inflation last year was driven by pandemic-related supply-chain issues and labor market imbalances, many of which have now resolved.
- Inflation has improved over the past year, with core Personal Consumption Expenditures (PCE) down from 5.5% to around 2.5%. We think the Fed's target of 2% inflation is within reach.
- Declining inflation has increased the chances of a Fed pause; we think rates have already reached a restrictive level.
- The moderation in inflation and a Fed pause are consistent with stable to lower yields, not with the rise in yields seen recently.

Portfolio Positioning and Performance

- We see outright value in yields at these levels.
- Duration also provides diversification if spreads deteriorate and growth slows, leading to lower yields.
- We expect to generate income from high-quality sectors such as agency mortgage-backed securities (MBS) and investment-grade credit, which can offer steady income over time.
- Value opportunities are available in select emerging market (EM) positions given differentiated risk factors and attractive pricing.
- Structured products like commercial MBS (CMBS) offer value in specific credits.

Conclusion

- Growth is likely to be softer than the market consensus expects, suggesting lower yields ahead.
- Financial conditions and other factors point to slower growth (e.g., regional banks trading at a discount, tighter lending standards, high real interest rates).
- Having multiple sources of return is part of our investment process, and particularly important in today's market.
- The current environment of better growth, lower inflation, and a Fed pause have benefited spread sectors.
- Income has mattered given volatility in Treasury yields; spread sectors have been a positive offset.

Q & A

- The Fed is close to finished regarding rate hikes, which creates more stability and less downside price risk at the front end of the yield curve. As a result, we've shifted some duration to the front end of the curve over the course of the year.
- Geopolitical risks are elevated (e.g., with respect to China, Ukraine, the Middle East), potentially increasing energy prices and taxing consumers.
- We believe growth is slowing but a US recession is avoidable if financial conditions don't tighten too quickly.
- The labor market is improving but still needs progress on job openings, wages and workforce participation.
- Consumers are coping by saving less but this is unsustainable over the long term; savings rates are likely to rise again.