Webcast Summary

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1Q23 Market & Strategy Update

After an extremely tumultuous 2022, fixed-income markets are improving on the back of ebbing inflation, normalizing supply chains and expectations for a Fed rate hike pause this quarter. Spread sectors now appear very attractive and we see room for additional optimism given China's relaxation of its zero-Covid policies, substantial progress in forward-looking global inflation indicators and our view the US will avoid a recession even as domestic growth slows. Of course, caution is still warranted given overall macro risks and ongoing geopolitical uncertainty. Our highest conviction for potential outperformance this year is emerging markets, but issue selection remains key.

2022 Market Review

- Inflation surprised to the upside in 2022, which drove global central banks to continue hiking policy rates.
- Emerging market (EM) central banks actually led the charge, raising rates before developed market (DM) banks.
- The Federal Reserve (Fed) and the International Monetary Fund (IMF) continually revised down their growth projections for 2022; asset and housing prices were also under pressure but have likely peaked.
- US Treasury (UST) bonds suffered their worst total return year on record.
- Bond volatility was elevated and the traditional inverse correlation to stocks broke down for the second year in a row.
- Investment-grade corporate yields in 4Q22 reached their highest level in 20 years (except for the global financial crisis).
- Agency mortgages were under unbelievable pressure resulting from the combination of higher rates, the flatter yield curve and elevated volatility.
- However, recent valuations have significantly improved, as seen in both UST yields and credit spreads.

Inflation

- Inflation should be easing substantially in 2023, as many of the same reasons that drove it up are now acting as headwinds. These include reversals of monetary policy, fiscal policy and supply bottlenecks easing all over the world as well as a rapid decline in commodity prices.
- The inflation situation in 2022 (and into this year) is not analogous to what was seen under former Fed Chair Paul Volcker, who famously raised rates aggressively to squash double-digit inflation.
- We believe the current battle against inflation is being won. We see peaks were reached in most inflation indicators, including core goods Consumer Price Index (CPI), food and energy CPI and single-family homes.
- Inflation continues to challenge households, and personal savings rates are down significantly.

US Economic Outlook

- The yield curve indicates slower growth and inflation ahead, as evidenced by the 10-year/2-year UST inversion, which is currently the largest inversion since 1981.
- Wage growth is decelerating, but appears fairly resilient, and the unemployment rate continues to be low.

Global Economic Outlook

- Europe's growth has held in well but demand is weakening and support is waning.
- In the UK, economic pessimism continues to rise, as the Bank of England has raised the policy rate meaningfully (most recently to 3.5%) and active gilt sales are under way.
- In Japan, investors continue to show doubts about the yield-curve control (YCC) policy as wage pressure remains low but is expected to increase.
- In China, the relaxation of zero-Covid restrictions along with new regulatory and economic policies support increased growth optimism this year.
- EM is likely set to benefit from the relative weakening of the US dollar and declining commodity prices.

Investment Themes

- **Overall risk assets:** Under immense pressure last year, spreads widened primarily due to macro risks. This year, higher rates and wider spreads are creating very attractive valuations as yields have reached levels not seen in 20 years.
- **Investment-grade:** Spreads today still look reasonably tight relative to the last 10-12 years. Macro fears have driven changes in pricing but have not impacted the fundamental cash flows or debt servicing metrics of these companies. Corporate spreads continue to trade wide to expected default rates.
- **High-yield:** We believe the market is pricing in pessimism that is out of line with current fundamental metrics. In our opinion, the quality of the high-yield market is the highest it's been in decades.
- **Bank loans:** Valuations here are compelling. Five-year implied defaults are well above the previous maximum in realized defaults. Interest coverage ratios remain healthy.
- **Structured product:** The combined forces of tighter policy, a flat yield curve and mortgage-rate volatility resulted in the worst-performing year for agency mortgages versus USTs. However, this has restored valuations, and prepayment risk is currently near zero. A steeper curve and Fed pause would be a tailwind for agency mortgages.
- **Mortgage credit:** The residential market is coming off high levels, but lending standards are still conservative. We remain vigilant regarding issue selection, but believe valuations are attractive in both investment-grade and high-yield mortgages.
- **EM debt:** Given a moderation in the inflation outlook and a moderately weakening US dollar, we think EM will finally have its day in the sun. But central bank tightening and geopolitics continue to pose risks.

Q&A Highlights

- The Fed has been very steadfast, introducing forward guidance that will keep rates elevated for a period with a restrictive policy rate, but its forecasting history has been terrible. A year ago the Fed was behind on inflation, now it will have to overreact with lags still coming through in the data. Our expectation for 2023 is weaker growth, weaker inflation and lower GDP, which should give the Fed the ability to lower rates later in the year after a pause in 1Q23.

- We are concerned that central banks could do too much too fast—overtightening would crush both growth and spread product results.
- The European Central Bank (ECB) is trying to play catch-up to the Fed. The ECB was slow with initial rate hikes, but growth hasn't buckled yet despite widespread fears before the winter. We believe the ECB will follow through on its guidance and EU inflation should recede in 2Q23.
- We are optimistic on the Japanese yen and believe it will strengthen, but this is a slow process.