

JANUARY 2023

Fixed Income Market Update

2022 was a challenging year for fixed income investors. The Bloomberg Barclays U.S. Aggregate Bond Total Return Index's return was slightly negative in December and finished the year down about 13%. The index was down nine out of 12 months in 2022.

Throughout the month of December, the world's most prominent central banks doubled down on and/or adopted a more hawkish stance. The Fed remained committed to fighting inflation as the dot plot for the terminal rate moved up 50 basis points (bp) from September. The European Central Bank stressed

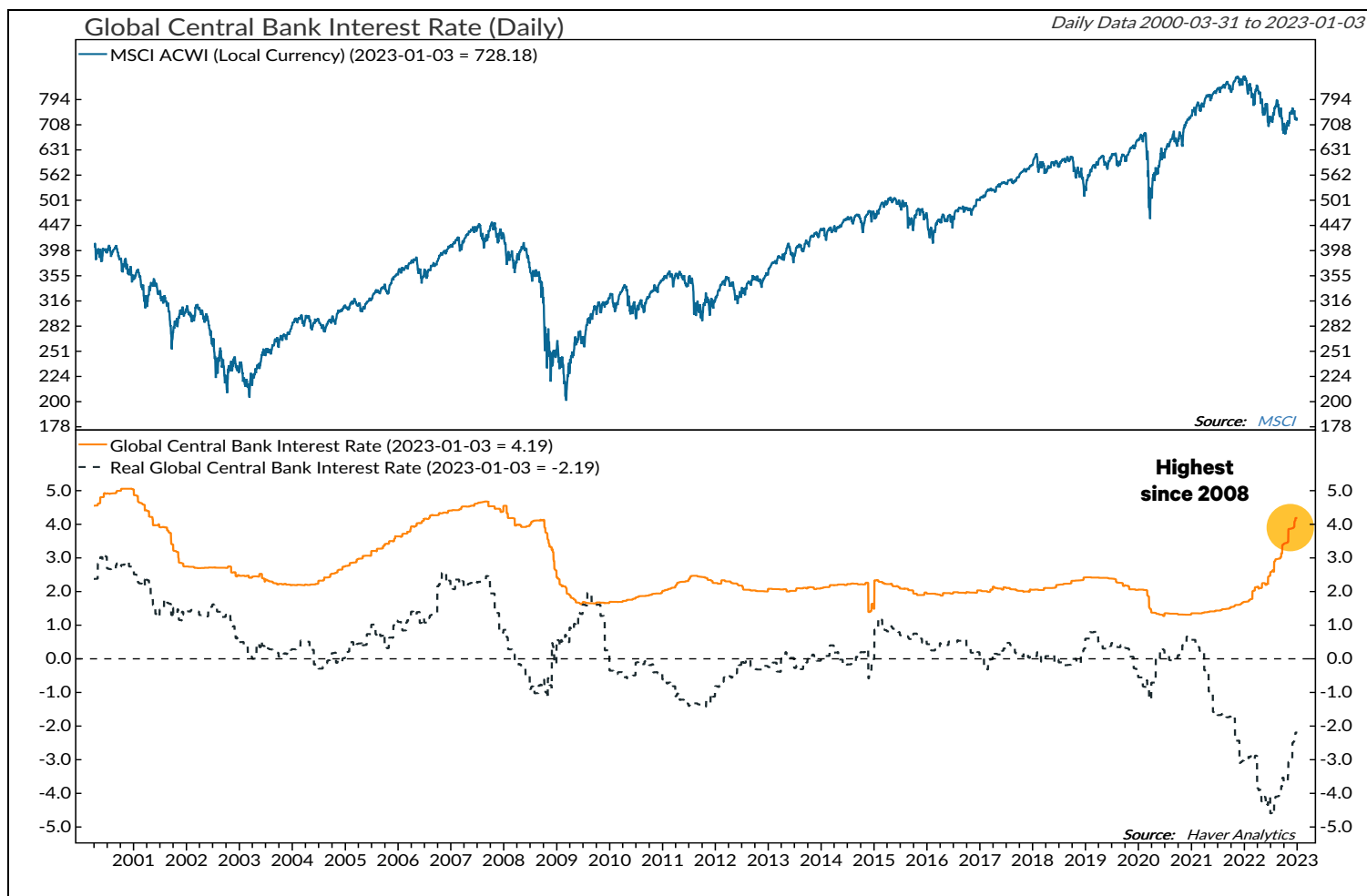
the need for more aggressive rate hikes at its December meeting. Meanwhile, the Bank of Japan surprised investors by increasing the cap on its 10-year yield target.

The global central bank rate increased at record speed in 2022 and is now at its highest level since 2008 (chart below). Based on this metric, one could assume that central banks have sufficiently tightened policy. But on a real basis, interest rates are still resoundingly negative, indicating that global central bank policy still isn't tight enough. Although inflation pressures should ease in 2023, inflation is likely to

stay higher for longer.

Despite the Fed's most aggressive tightening cycle since 1980, the real fed funds rate remains negative. A total of 75 bp of hikes in 2023 could see the real rate finally rise into restrictive territory. Unsure of when the Fed may pause, U.S. Treasuries sold off in December, resulting in a backup of yields, which had implications for fixed income sector leadership.

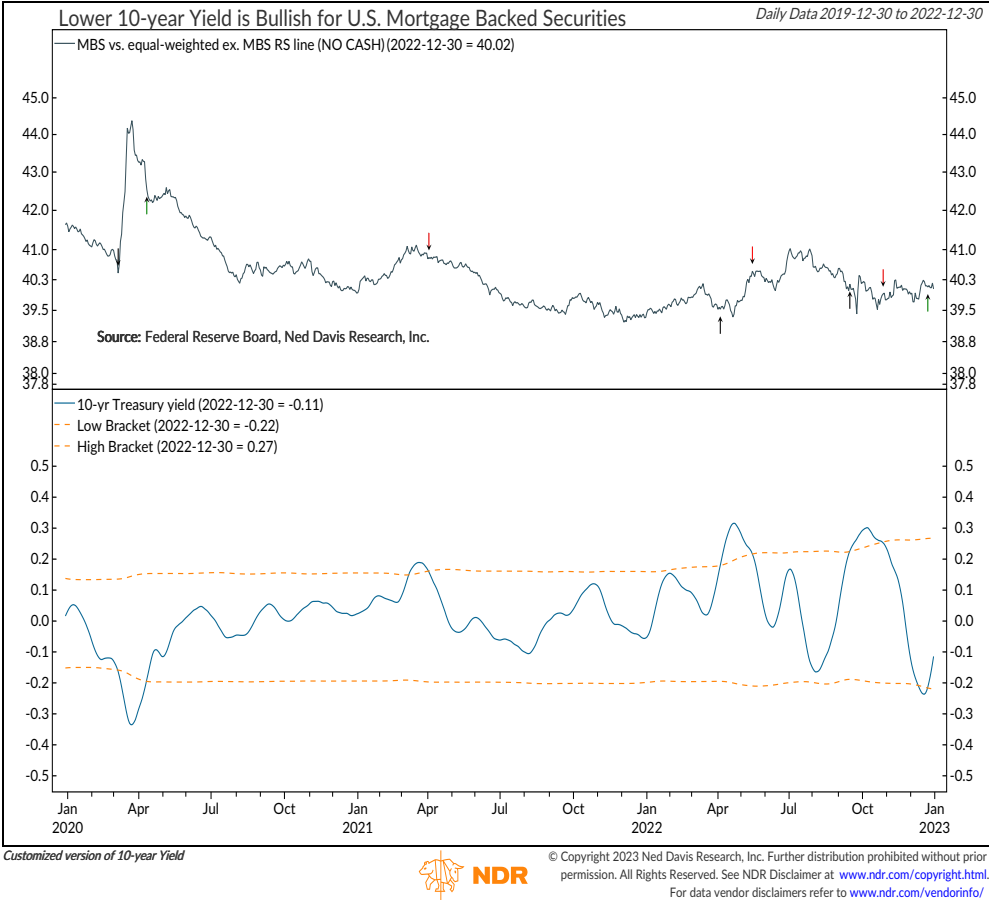
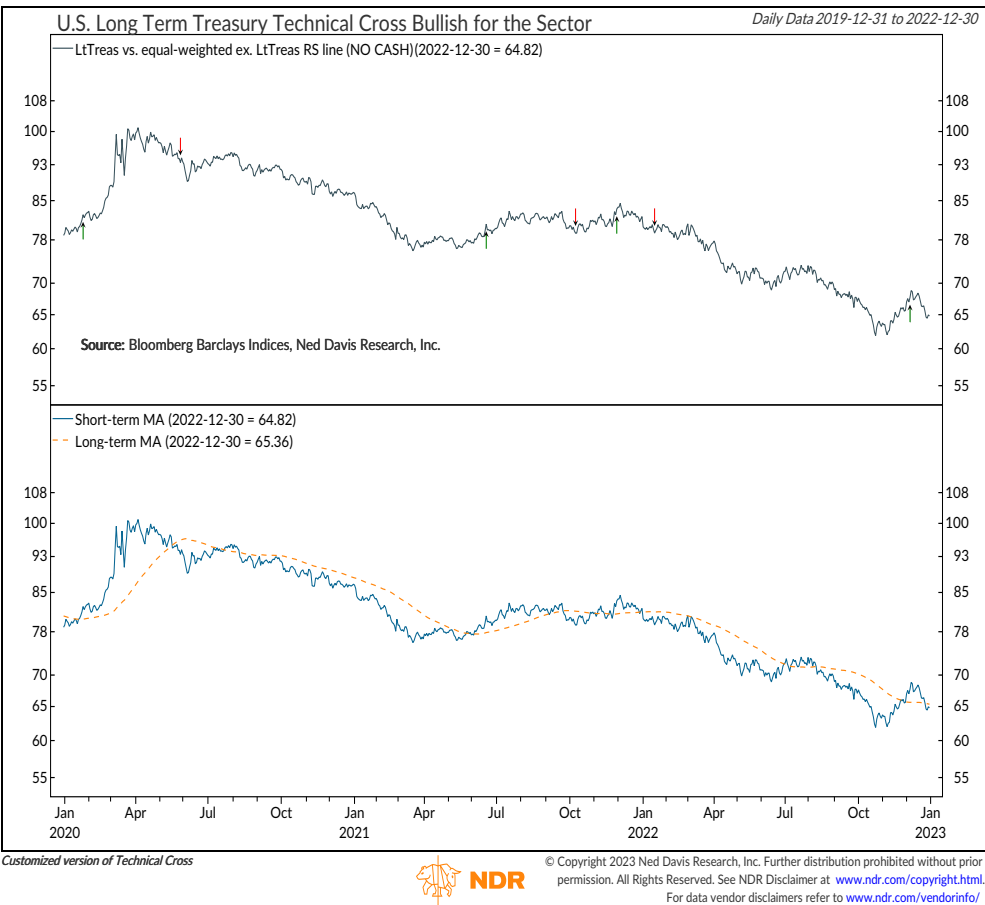
Entering January, the fixed income allocation strategy is overweight U.S. Long-Term Treasuries, U.S. High Yield, Mortgage-Backed



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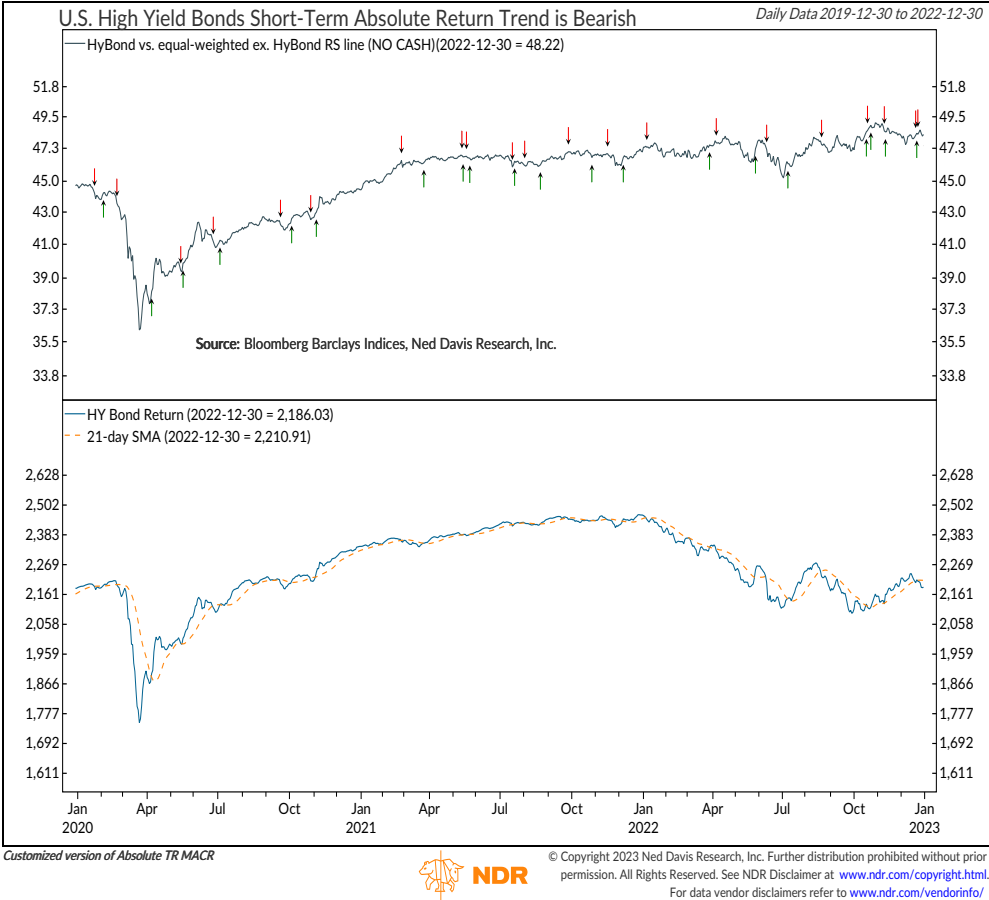
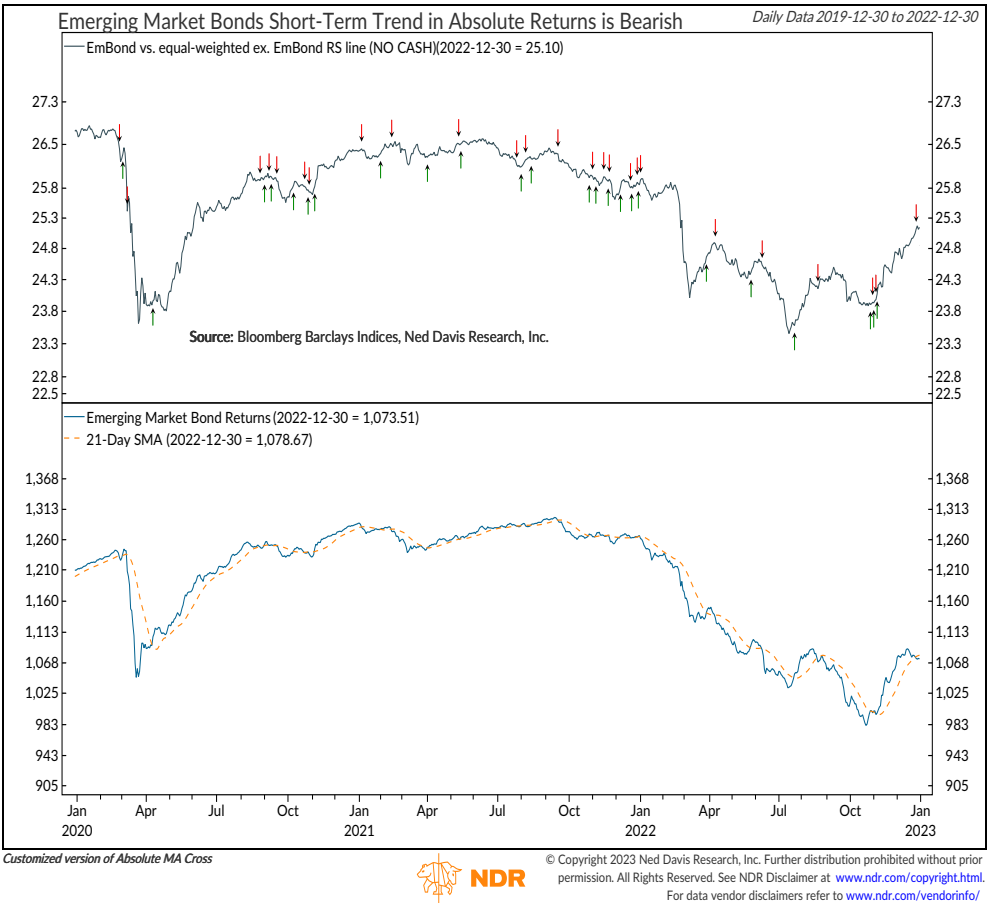
Securities, and Emerging Market Bonds, while being underweight Floating Rate Notes, U.S. Investment Grade Corporate, Treasury Inflation-Protected Securities, and International Investment Grade bonds.

The model's allocation to U.S. Long-Term Treasuries saw a sharp rise in January, which pushed it to a significant overweight. The weak equity market trend and lower inflation expectations remained bullish for the sector. There was enough technical improvement in December to push one trend indicator to bullish (chart right) and another one to neutral.



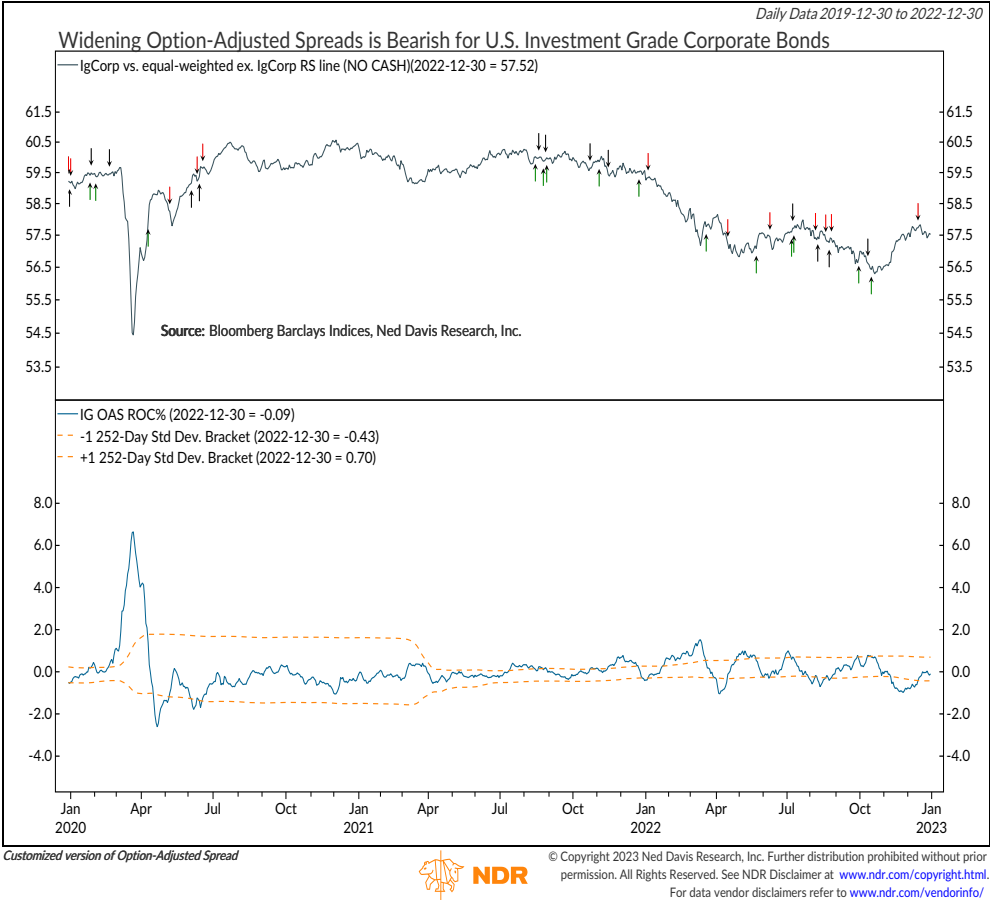
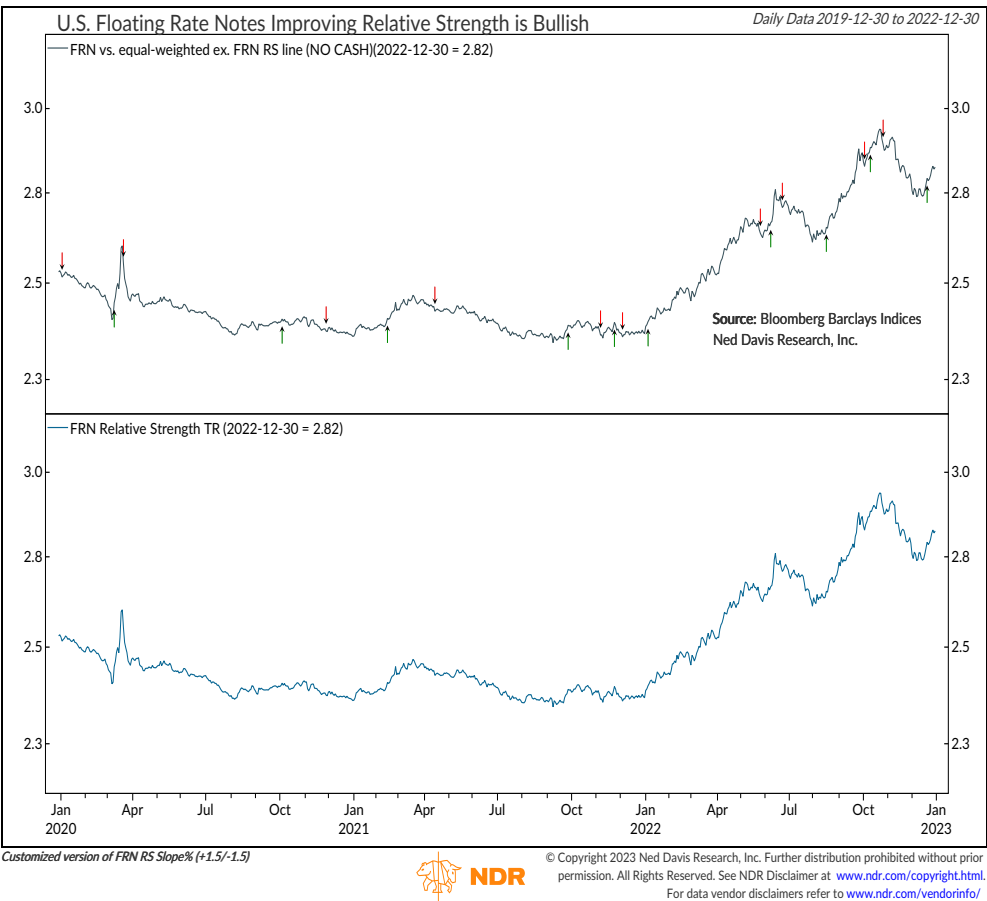
Mortgage-Backed Securities' allocation improved to overweight in January. While technical indicators aren't fully confirming yet, high-yield spreads have narrowed—suggesting greater investor risk appetite—and are bullish for the sector. Additionally, the 10-year yield (which mortgage rates are correlated to) has likely peaked and is now bullish for the sector (chart left).

Emerging Market (EM) bonds dropped in allocation in January but remain overweight. The U.S. dollar continued to roll over from its peak levels. Due to the inverse relationship with Emerging Markets, a weaker dollar is a bullish condition for both emerging market equities and bonds. EM bond technicals are mixed. While relative strength continues to be bullish, the short-term trend in absolute returns turned bearish (chart right).



U.S. High Yield also dropped in allocation this month but remains overweight. Most technical indicators remain positive as relative strength, high yield upside participation breadth, and volatility are bullish. However, the short-term trend in absolute returns moved bearish (chart left), joining the bearish small-cap equity trend.

Floating Rate Notes' allocation jumped sharply in January, but it remains at a slight underweight allocation. Floating rate notes typically outperform during a rising rate environment and yields backed up again in December. Trend, price momentum, and spreads remain bearish for the sector. However, relative strength versus other fixed income sectors improved in December and is now bullish (chart right).



Allocation to the U.S. Investment Grade sector fell sharply, moving the sector from an overweight to an underweight position this month. Only two indicators are bullish—credit default swaps and a technical indicator. Bond volatility, the U.S. dollar, and mean reversion remain bearish for the sector. In December, option-adjusted spreads—another measurement of default risk—widened, which is bearish for the sector (chart left).

Summary

Credit sectors such as high yield and investment grade are now seeing mixed performance. A declining U.S. dollar has led to emerging market bond outperformance and international investment grade underperformance. Lower inflation expectations have made U.S. TIPS less attractive, particularly compared with nominal U.S. Treasuries. U.S. Long-Term Treasuries have seen enough technical improvement to move to an overweight allocation. The likelihood of a recession in 2023 would be an added tailwind to Treasuries.

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