Truist Advisory Services, Inc.

Fixed income perspective from the Investment Advisory Group

Yield signals – U.S. fixed income signaling caution, not panic

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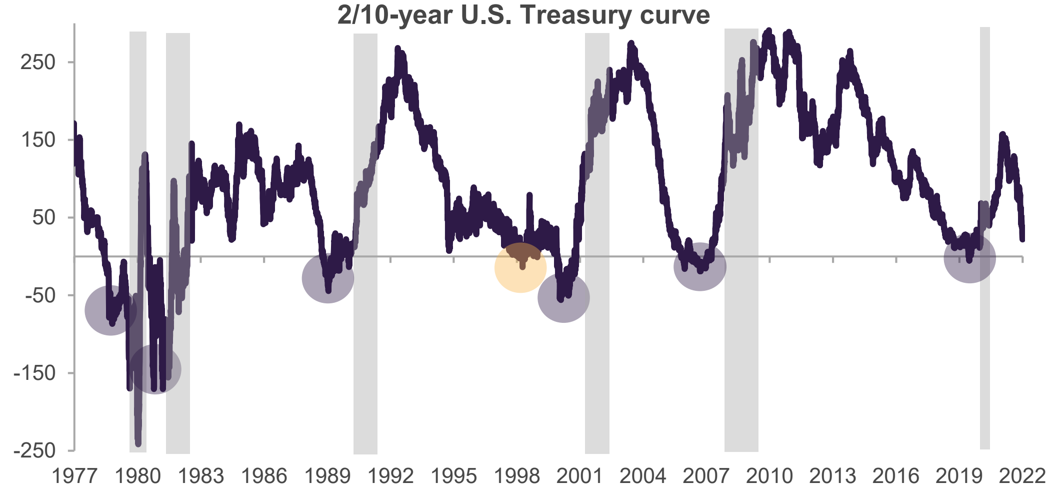
Chip Hughey, CFA
Managing Director
Fixed Income

Evan Moog, CFA
IAG Associate

Executive summary

Over the past half-century, U.S. fixed income markets have served as a reliable barometer for the U.S. economy and financial conditions. In the wake of Russia's aggression in Ukraine and the resultant turmoil in commodity markets, bond markets have recalibrated quickly to heightened global risks and uncertainty. As a result, several bond market indicators—the **U.S. yield curve**, **credit spreads**, **volatility**, and **liquidity**—appear less confident about the future state of the economy. However, at this point, each of these measures is **signaling caution, not panic in our view.**

With the exception of a false alarm in 1998, a 2-year/10-year yield curve inversion has presaged each U.S. recession (shaded grey) since the 1970's.



Data source: Truist IAG, Bloomberg

What happened

As we anticipated, U.S. yields rose to multi-year highs to start 2022 in response to strong inflation readings, receding COVID-19 cases, and less accommodative Federal Reserve (Fed) policy. The upward move was particularly pronounced in the first five years of the U.S. Treasury curve, which tends to be most sensitive to Fed rate moves. However, the Russian

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invasion of Ukraine and the decisive sanctions from the West changed the market backdrop virtually overnight.

The subsequent shift in sentiment to risk-off halted U.S. yields' ascent and injected additional interest rate volatility. The 2-year/10-year yield curve flattened to its narrowest spread since the COVID pandemic. Credit spreads and rate volatility spiked to 2020 levels. Liquidity in fixed income markets deteriorated to the lowest levels since the pandemic.

Our take

While concerning and worthy of close surveillance, the aforementioned indicators have yet to sound alarm bells.

U.S. yield curve – Yield curve inversions—when longer-dated yields fall below shorter yields—have presaged every recession for the last half-century. Typically, a yield curve inversion has forerun a recession by roughly 6 to 18 months, with a notable false alarm in 1998 which wasn't accompanied by a recession. The two primary segments of the U.S. Treasury curve used for recessionary signals are: the spread between 2-year and 10-year yields and the spread between 3-month and 10-year yields. These spreads highlight the relationship between Fed policy accommodation (reflected in short yields) and growth and inflation expectations (tied to longer-dated yields).

The 3-month/10-year curve is more reflective of this policy and economic balance in real time. Given its short investment horizon, 3-month yields tend to reflect Fed policy rates over the very near-term. This spread currently sits at 1.55%, but we expect this spread to narrow (or flatten) as the Fed raises rates starting next week. However, by this measure, the Fed has ample room to tighten its policy stance without threatening a curve inversion.

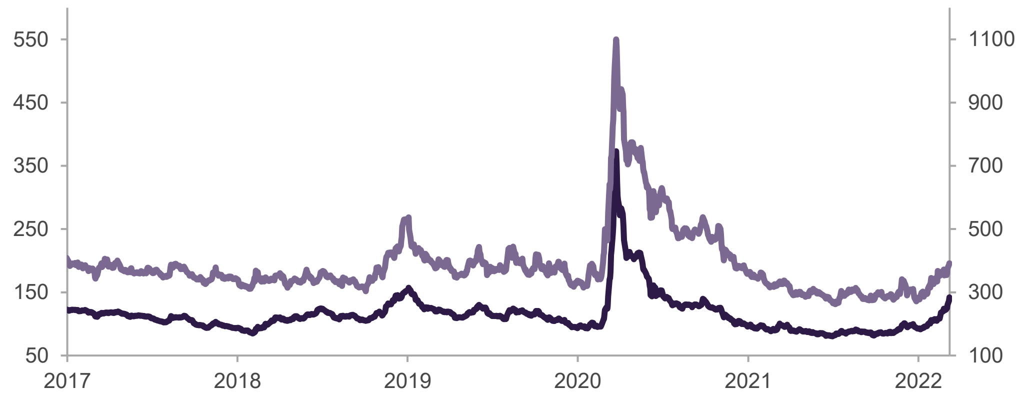
The 2-year/10-year yield curve offers the Fed far less breathing room. This segment of the curve is more forward-looking by nature with 2-year yields accounting for policy rates further into the future. The 2-year/10-year spread is currently hovering near 0.25%, having flattened by 125 basis points (1.25%) since last March. This move is bringing the threat of a yield curve inversion – and its recessionary signal – to the forefront of investor's minds. While a concern, the 2-year/10-year curve has yet to invert in this cycle. The shape of the yield curve suggests the Fed should remain cautious and data-dependent with respect to rate hikes. Additionally, above trend growth, high inflation, and Fed balance sheet reductions should each contribute to higher intermediate and long U.S. yields, which should encourage a healthier curve.

Credit spreads – Credit spreads, which reflect the additional yield offered by investment grade (IG) and high yield (HY) corporate bonds relative to U.S. Treasury securities with the same maturity, have served investors well as an economic barometer. As one would expect, U.S. investment grade and high yield credit spreads have widened in response to the quick escalation in Ukraine, reflecting the risk-off sentiment. IG credit spreads are at their widest levels since the pandemic, but are still hovering close to their long-term average. HY credit spreads have shown greater volatility throughout their ascent, but remain below their 10-year average.

We classify these elevated credit spreads as notable, but not alarming. Thus far, we have not yet seen anything close to the magnitude of credit spread spikes observed before the 2001, 2008, and 2020 U.S. recessions. Additionally, the recent spread widening has not been driven by underlying fundamentals in corporate America, such as profitability, cash flow, or perceived default risk. An abundance of new corporate issuance has also exacerbated the recent move as issuers try to lock-in relatively low borrowing costs. We expect credit spreads to remain within a healthy range and avoid pre-recessionary levels this year.

Credit spreads have widened, reflective of more perceived risk by investors. Still, spreads remain contained from a historical perspective.

U.S. corporate bond spreads



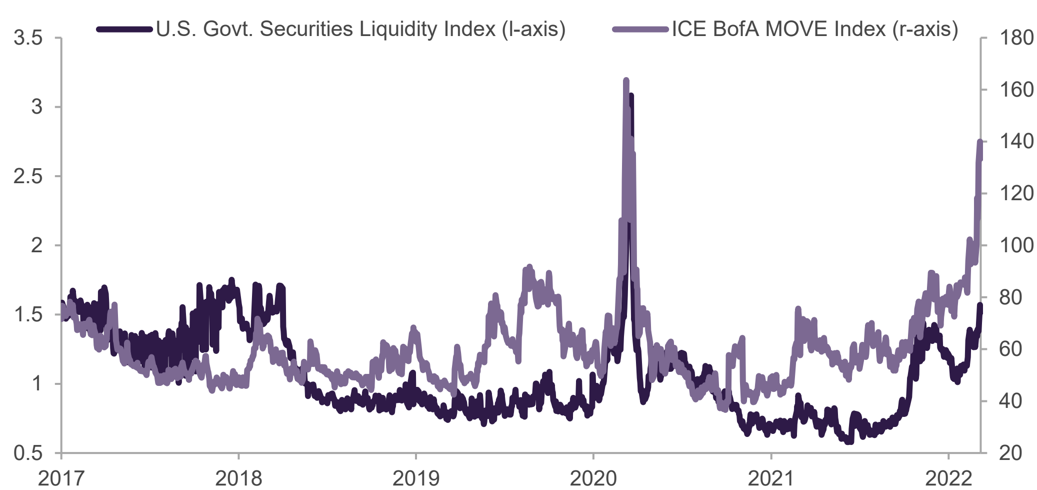
Data Source: Truist IAG, Bloomberg

Volatility – The ICE BofA MOVE Index (MOVE Index), a measure of implied volatility across the U.S. Treasury yield curve, moves higher as investors seek protection from fluctuations in rates. Abrupt spikes in rate volatility are not uncommon and don't solely forerun economic downturns. Two more recent examples: the MOVE Index jumped in 2013 as the Fed discussed tapering its asset purchases earlier than expected and in 2016 following the election of President Trump. However, the largest economic disruptions, such as the Great Financial Crisis and the COVID recession, tend to ignite volatility.

The volatility we've experienced since the Russian invasion is meaningful with current MOVE Index readings at 80% of the highs reached during the pandemic's onset. Rate volatility was already on the rise in anticipation of the Fed's policy shift and persistent global supply chain issues. The blindside effect of the war accelerated the trend dramatically. Progress on the geopolitical front or cooler inflation data in the U.S. would likely help ease volatility readings. However, neither of these appear imminent. We expect volatility to remain elevated relative to historical averages for the foreseeable future.

The Russia-Ukraine war is pushing volatility up and liquidity down to levels not seen for two years.

Volatility and liquidity in U.S. Treasury market



Data Source: Truist IAG, Bloomberg

Liquidity – Some corners of the U.S. bond market are showing early signs of deteriorating liquidity. The level of liquidity within fixed income markets is akin to the oil that keeps our economic engine running smoothly. If an economic or geopolitical crisis leads to a sharp decline in liquidity levels, it can spark a major disruption in financial markets. Right now, the very short end of the U.S. Treasury market and parts of the U.S. Treasury inflation-protected securities market are exhibiting liquidity pressures with bid/ask spreads widening. The U.S. Government Securities Liquidity Index is also showing the lowest levels of liquidity since 2020.

We expected liquidity to decline as a result of the Fed reducing its role in financial markets. The Russia-Ukraine conflict added to this disruption, but despite the lower levels of liquidity, the vast majority of the U.S. Treasury market is functioning smoothly. While elevated, the U.S. Government Securities Liquidity Index remains within range of the readings during the Fed's last tightening cycle. This suggests participants are not sensing a systemic threat to financial stability.

Bottom Line

U.S. fixed income is reflecting the increased risks pervading markets as a result of the Russia-Ukraine conflict. While headwinds exist, indicators such as the U.S. yield curve and credit spreads signaling caution, not panic. Given the uncertainty surrounding the war, a tactical shift to neutral duration within fixed income portfolios may make sense for investors with significant risk exposure until more clarity is achieved. This should help deliver some portfolio ballast in the event of further military escalation or more inflation scares. However, we continue to expect yields in the U.S. to rise moderately above current levels, based on a dovish Fed rate approach relative to market expectations, strong inflationary pressures, and continued economic growth in the U.S.

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