Fixed income perspective from the Investment Advisory Group

Short yields are productive again

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Executive summary

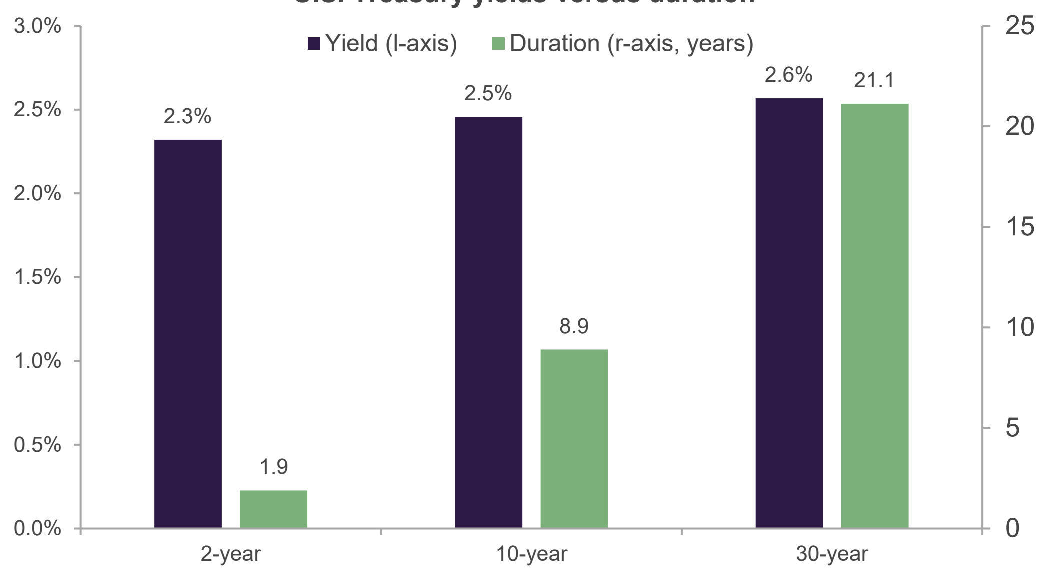
- Most U.S. fixed income **yields between 1- and 5-year maturities have risen aggressively** as a result of broadening inflationary pressures and the Federal Reserve's (Fed) more hawkish stance.

- In this region of the curve, **government, corporate,** and **municipal** bonds currently capture a disproportionate amount of the available yield while offering protection from a rising rate environment.

- For investors seeking to generate income from available cash, several fixed income sectors in the 1- to 5-year maturity range are offering their **most compelling entry point in at least two years.**

U.S. Treasury yields from 1- to 5- years capture the vast majority of the income available in the U.S. with a fraction of interest rate risk.

U.S. Treasury yields versus duration



Data sources: Truist IAG, Bloomberg

What happened

Since the beginning of 2022, a volatile mixture of inflationary pressures, central bank speculation, and long-term growth concerns are distorting the U.S. Treasury yield curve. Yields between 1- and 5-year maturities are trading at their highest levels in roughly three years, fueled higher by speculation the Fed will quickly raise policy rates throughout the rest of the year. Meanwhile, beyond five years, yields have risen far more gradually, expressing concern over the impact of tighter monetary policy, generationally high inflation, and intensified geopolitical tensions. This has created a very flat U.S. Treasury yield curve, where short yields are disproportionately high relative to longer-dated securities. This atypical – and somewhat concerning – shape is similarly affecting a number of traditional fixed income sectors, such as corporates and municipals.

As a result, the first five years of each sector's curve captures the lion's share of the income available in longer-dated maturities, but with significantly less sensitivity to rate volatility. It's also worth noting that yields between 1- and 5-year maturities are currently higher than the S&P 500's dividend yield for the first time since 2019.

Our take

Disproportionately elevated yields are creating compelling entry points across several fixed income sectors in shorter-dated debt, namely in the 1- to 5-year range. This should be notable for investors seeking ways to generate income without a great deal of interest rate risk.

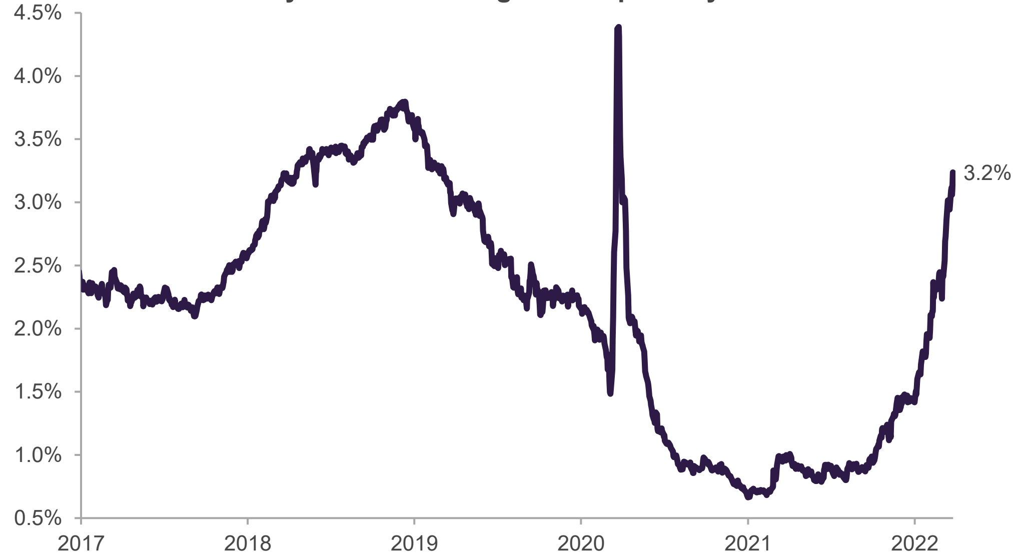
U.S. Treasuries – The front end of the yield curve is extremely sensitive to Fed policy – both implemented and perceived. It also responds to near-term inflation expectations, a related but distinct factor to Fed policy. Each of these factors have undergone a major evolution since the start of the year. For one, the Fed has spent this year acknowledging that inflation is a growing concern that must be tamed by a more aggressive rate hike strategy. The supply chain and energy disruptions caused by the Russia-Ukraine crisis added a new level of complexity to normalizing policy. Over the last three months alone, participants have added an additional 1.50% of rate increases to their forecasts, expecting the Fed funds rate to move to 2.25-2.50% by the end of 2022. That recalibration has applied a powerful upward force on shorter-dated U.S. Treasury yields. Secondly, the spike in commodity prices, ongoing supply chain issues, and robust demand have pushed near-term inflation expectations to their highest levels on record.

Beyond five years, U.S. Treasury yields have been slower to rise, resulting in a very flat yield curve. In our view, the shape of the yield curve is equivalent to the market expressing concerns over the Fed's policy shift and the Russia-Ukraine war's long-term impact on growth. But the outsized move to higher yields in the 1- to 5-year range has created a compelling entry point relative to longer-dated government debt. For instance, 2-year U.S. Treasuries are currently trading at 2.35%. That level captures 96% and 92% of the yield available in 10-year (2.45%) and 30-year (2.55%) U.S. Treasuries, respectively. Additionally, the 2-year carries just 22% and 9% of the interest rate exposure (i.e., duration) of the 10- and 30-year, respectively. This atypical imbalance creates a compelling investment case within this area of the curve. We also believe that longer-dated yields remain too low relative to today's inflationary pressures and nominal U.S. GDP and should rise. If we are correct, shorter-dated debt should offer investors some shelter from declining bond prices.

Investment grade (IG) & high yield (HY) corporates – Of course, most U.S. fixed income sectors are strongly affected by fluctuations in U.S. Treasury yields. IG and HY corporate bonds are no exception, especially IG corporate bonds given their credit risk and duration profile tends to more closely mirror U.S. Treasuries than the HY corporate sector. Year to date, HY corporates' performance has benefited from their lower duration, muted new issuance, higher yields, and heavier energy weighting. However, IG and HY corporates have become more attractive through the combination of higher absolute yields (driven by U.S. Treasuries) and modest spread widening in response to greater economic uncertainty. As it stands today, 1- to 5-year IG and HY corporate bond yields are at their highest levels since March 2020, without a meaningful uptick in credit risk.

Short-dated investment grade corporate bond yields have risen more than 2.50% since 2020, largely in sympathy with rising U.S. Treasury yields.

1-5 year investment grade corporate yields



Data sources: Truist IAG, Bloomberg

Although the widening in credit spreads (the additional yield paid by a corporate bond relative to a like-maturity U.S. Treasury note) is indicative of rising investor concerns, spreads are not sounding alarm bells from a historical perspective. The magnitude of widening within IG and HY credit spreads is minimal relative to what is typically seen ahead of major economic slowdowns. IG corporates spreads are only slightly above their five-year average, partly fueled by a new issuance deluge earlier this year. HY credit spreads briefly eclipsed 4%, but are now well below their five-year average again. They're still attractive from a spread perspective relative to the levels we've seen since the onset of the pandemic. Additionally, HY balance sheets remain very healthy, suggesting low default rates should persist. Lastly, U.S. credit – IG and HY – should benefit from their incremental yield advantage (which helps portfolios combat rising interest rates), and they tend to perform well on a relative basis in positive growth and inflationary environments.

Investment grade (IG) & high yield (HY) munis – Similar to corporate bonds, U.S. Treasuries have dragged shorter-dated municipal bond yields to significantly more attractive ranges. Nominal 1- to 5-year AAA muni yields are at their highest levels since a bout of forced selling in March 2020 created a liquidity crunch that sent muni yields soaring. Absent the pandemic-fueled sell off, we haven't witnessed 1-5 year IG and HY muni yields at these levels since the end of 2018.

In comparison to U.S. Treasury yields, munis entered 2022 at extremely rich valuations after 2021 issuers failed to keep pace with fervent demand. Although AAA muni-to-U.S. Treasury ratios are still somewhat tight relative to the past few decades, muni valuations have improved dramatically this year. The 5-year AAA muni-to-U.S. Treasury ratio currently sits at a more historically normal 76% versus an extremely expensive 45% at the end of 2021. Once again, this adjustment is a result of the recent volatility in U.S. Treasuries, not any deterioration specific to the IG or HY muni sector. Generally speaking, muni issuers remain on very solid financial footing overall, having benefited from windfalls in tax receipts from booming real estate assessments, stronger-than-expected sales taxes, and the supplemental $350 billion fiscal stimulus package aimed at state, city, and essential service muni issuers.

More broadly speaking, IG and HY munis appear well-supported this year by an ongoing supply/demand imbalance and a constructive U.S. economic backdrop. Additionally, demand for municipal bonds tends to accelerate around the April 15 tax deadline, which may fuel some tightening in muni-to-U.S. Treasury ratios in the very near term. As always, high yield munis require more careful credit selection and ongoing surveillance; however, investments in the shorter duration range discussed here can help mitigate some of the credit risk associated with longer holding periods.

5-year AAA-rated muni yields have been dragged to their highest levels since the onset of the pandemic.

AAA muni 5-year yield

Data sources: Truist IAG, Bloomberg

Bottom Line

Yields across many fixed income sectors – from high quality to high yield – are offering some of their most attractive entry points in years, specifically within the first five years of the curve. This cross-section of the yield curve appears oversold from a price perspective, largely on the basis of traders recalibrating for a much more hawkish Fed reaction function. That is creating an attractive income opportunity for investors in the first five years of the curve, which avoids exposure to excessive interest rate risk. Moreover, the sharp upward move in short-dated U.S. Treasury yields has similarly impacted other sectors, such as IG and HY corporates and munis.

Real (or inflation-adjusted) yields remain low-to-negative across the vast majority of the fixed income landscape. However, the yield-inflation disparity is meaningfully larger for those holding cash or cash-equivalents. These rates, whether those of deposit or savings accounts rates, money market funds, or even the first several months of the U.S. Treasury curve, have not yet adjusted to reflect the evolving Fed outlook or the near-term inflationary pressures.

Investors that have been waiting to deploy cash into productive assets now have one of the most attractive windows within fixed income of the past two to four years.

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