Fixed income perspective from the Investment Advisory Group

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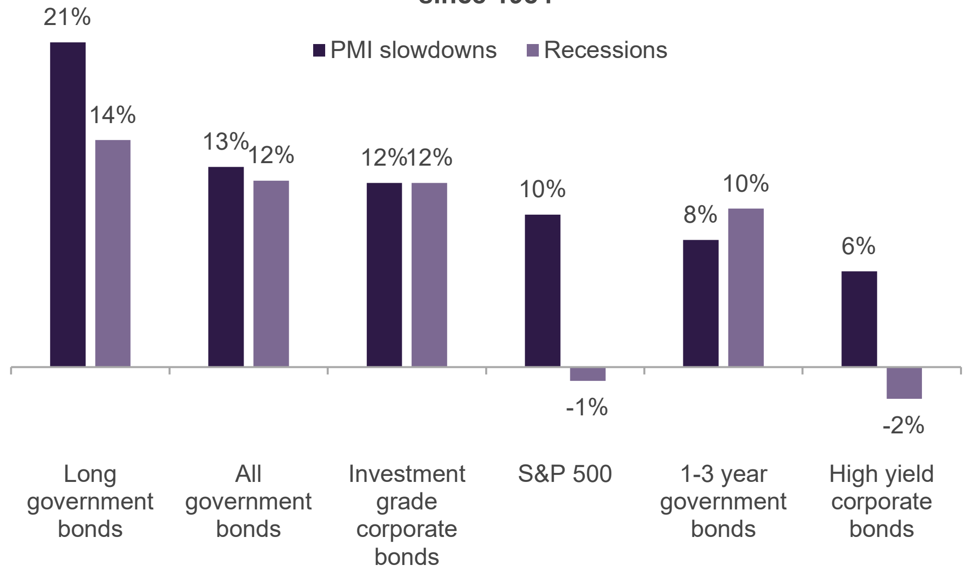
Part II: The active approach to 2023

The increased value of duration for total return investors

- The relentless rise of U.S. Treasury yields in 2022 – which translated into higher yields across virtually all fixed income sectors – dramatically improved core fixed income's ability to deliver on its two key principles: **income and portfolio diversification.**
- As the Fed approaches the completion of its rate hike cycle in the months ahead – and inflation fears shift to growth concerns – **we expect the past year's upward yield momentum to reverse course**, creating an opportunity for improved total returns (via price appreciation/declining yields) in core fixed income.
- This regime shift should also reinstate **a more typical negative stock-bond correlation**, allowing high quality fixed income to provide portfolio ballast when equities are challenged.
- Our work suggests that longer duration and higher quality fixed income each tend to **outperform shorter-dated debt and lower-rated bonds as the economy slows** or enters a recession. For total return investors, our weakening economic outlook supports extending duration beyond neutral and maintaining an up-in-quality bias.
- We recommend **emphasizing high quality fixed income** in the very near term, such as U.S. government debt and investment grade municipal bonds. We expect riskier sectors and those with higher correlations to U.S. equities (high yield corporates, convertibles, leveraged loans) to face challenges in the year ahead.
- Furthermore, the Fed's balance sheet reductions are creating elevated volatility and lower liquidity. As such, we anticipate **outsized day-to-day yield swings to continue**. Longer duration fixed income yields will likely face bursts of strong moves in both directions in reaction to new data and potential shifts in Fed policy.
- To start the year, we are **expecting a wide trading range as a result of elevated volatility and economic uncertainty**. From a tactical perspective, we would view 10-year U.S. Treasury yields at 2.75% as overvalued and near the lower end of our rate expectations. For portfolios with shorter duration profiles seeking to extend, we would view 10-year U.S. Treasury yields near or above 4% as an attractive opportunity to execute. This trading range will likely shift as the impact of the Fed's tightening more fully emerges.

Average total returns during PMI slowdowns and recessions since 1984



Data source: Truist IAG, Bloomberg; Data as of 12/12/2022
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