# Why IG Bonds Now?

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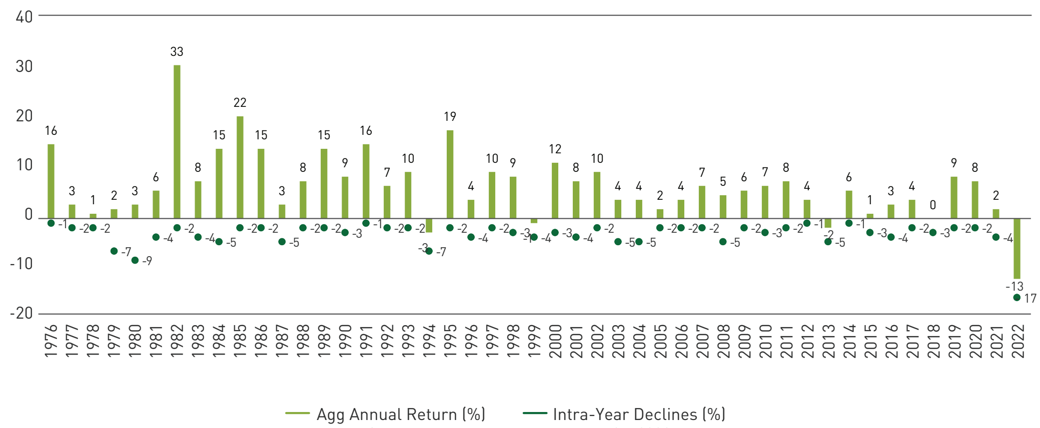
## KEY TAKEAWAYS

- Shifts in monetary policy likely marked the end of the cheap-money era.
- Fundamental strength, combined with current high yields, underpin our cautiously optimistic outlook for corporate and securitized bond markets in 2023, as well as our view that the current market offers an opportune time to increase fixed income allocations.
- For investors, a strategy that emphasizes high quality investment grade bonds may be a prudent approach to adding exposure to fixed income in the current market environment.

Investment grade (IG) fixed income investors saw historically painful returns this past year. Interest rates increased significantly across the Treasury yield curve. For the year-ended December 31, 2022, the Bloomberg (BBG) U.S. Aggregate Index[1] (the Agg) year-to-date (YTD) returned negative 13.01 percent. For perspective, Figure 1 shows annual returns for the Agg dating back to its inception in 1976. Red dots show the largest peak-to-trough declines: 2022 is the worst performance by far.

Even as interest rates across fixed income markets were increasing to multi-year highs, the credit landscape remained relatively benign during 2022. Corporate credit spread widening YTD only modestly contributed to negative returns.

FIGURE 1: BLOOMBERG U.S. AGGREGATE ANNUAL RETURNS AND INTRA-YEAR DECLINES DESPITE AVERAGE INTRA-YEARDOPS OF 3.1 PERCENT, ANNUAL RETRUNSPOSITIVE IN 42 OR 46 YEARS




Source: Barclays, as of December 31, 2022.

The option-adjusted spread (OAS) of the BBG U.S. Corporate Investment Grade (IG) Index[2] (the Index) began 2022 at 93 basis points (bps) and widened 37bps to 130 bps as of December 31. However, at this level, IG spreads are more akin to an earnings recession rather than a full-blown economic recession.

During recessions, spreads tend to peak in the 200 to 250bps range, according to BBG data. For perspective, during a period of acute credit concerns in late-2008 and early-2009, the IG OAS reached nearly 600bps. With a relatively low OAS, positively biased corporate earnings, and corporate balance sheets in favorable conditions broadly, fixed income losses in 2022 appear largely attributable to interest rate increases.

## Looking ahead

As of December 31, 2022, real yields are positive across the entire Treasury curve and spreads for corporate bonds rated A and BBB offer positive real yields. While yields still may not be quite high enough to cover a full 5 percent spend rate, or a 7 to 8 percent discount rate, IG fixed income is in a position to substantively contribute to those investor objectives after the significant 2022 rate rise and in anticipation of a less aggressive Fed monetary policy moving forward.

We consider several factors as we form our cautiously optimistic view of fixed income investing opportunities in 2023. Among them are:

- Despite higher correlations relative to historical levels across assets at times during 2022, IG fixed income should continue to provide diversification benefits and a ballast within an overall portfolio.
- Potential recessionary concerns could keep longer-maturity treasury yields anchored
- Elevated geopolitical risks could have relatively more negative consequences for economies outside the U.S. Factors like these could potentially cause rates to fall back down quickly.

With these considerations in mind, our view is that seeking to lock in higher yields offered currently in the market by incrementally adding to IG fixed income allocations may make sense.

If rates rise and/or fixed income markets continue to sell-off, for investors taking a measured approach to deploying capital over time the current market could offer an opportune time for investors to start legging back into IG fixed income.

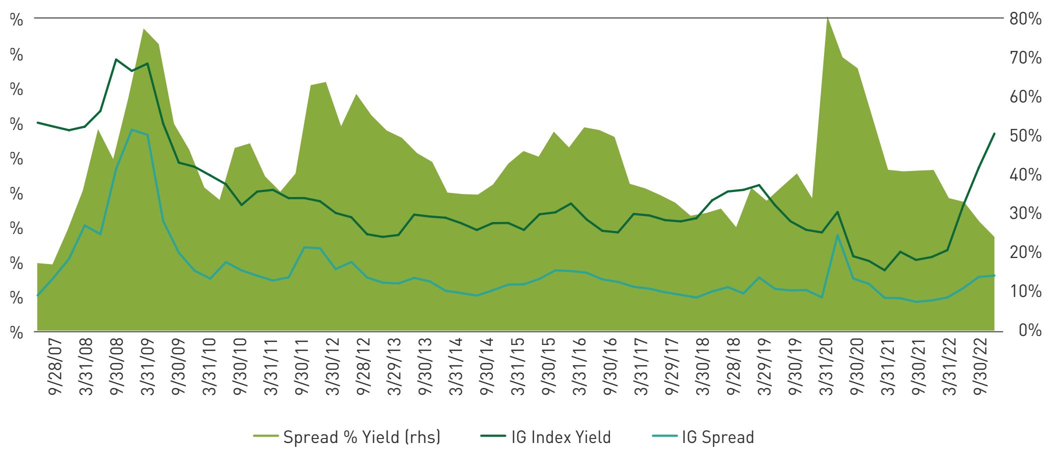
## What about credit impacts that could result in further pain in the IG fixed income market?

The IG corporate market has endured three recessions and eight market shocks over the last 25 years. IG corporate excess returns typically turn positive during recession as the Fed cuts rates. Ex-recession, market shocks and volatility can be equally damaging to IG corporate excess returns.

On December 31, 2022, AA and BBB corporate spreads were slightly wide to their 100-year medians, still well inside recessionary levels. BBB spreads at 159bps on December 31, 2022, were consistent with growth/earnings slowdowns in 2015 and 2019, but not recessions or crisis (2012, 2020). We see potential opportunity in corporate bonds as all-in yields historically have spiked back to 2010 to 2011 levels, excluding the brief period during the height of pandemic fears in March and April 2020. Figure 2 illustrates that the rate component of IG yields through December 2022 dominated the spread component, and consider at 130bps, the IG Index OAS is actually 19bps below its mean since 1993, suggesting stable fundamentals.

Beyond corporate bonds, we believe IG securitized bond sectors also look interesting at current levels.

FIGURE 2: HIGH IG CORPORATE YIELDS NOT DRIVEN BY CREDIT CONCERNS




Source: ICE BofA US Corporate Index, Bloomberg, Wells Fargo, EPFR, Breckinridge Capital Advisors, as of date September 30, 2022.

Interest rate volatility and the Fed's decision to discontinue purchases of mortgage-backed securities (MBS) for the first time since 2011 put MBS on track for its worst year on record. With a 12-month excess return of negative 223bps through December 31, 2022, based on the Bloomberg MBS Index,[3] MBS was the worst performing sector in the Agg Index.

A surge in mortgage rates moved origination to higher coupons and led to slower prepayment speeds. In fact, with so many borrowers significantly away from refinancing thresholds, the MBS index was positively convex for the first time ever during the 2H22.

Despite headwinds including Quantitative Tightening and lack of bank demand, with nominal spreads at 140bps, based on Barclays data, we believe the MBS sector stands out as historically cheap relative to other IG sectors, as marginal, less price-sensitive buyers of MBS (such as the Fed and banks) step away.

Asset-backed securities (ABS) also continue to look attractive given the sector's high quality, short duration characteristics and wider spreads YTD through December 31, 2022, based on BBG ABS Index data.[4] In fact, AAA ABS spreads are close to YTD wides. Consumer credit performance continues to normalize, with default rates and loss severities up, albeit still below pre-pandemic levels.

Beyond the securitized market, taxable municipal bonds historically perform well in risk-off environments. Furthermore, we believe, with a unique credit cycle and a lower correlation than corporate bonds to the S&P 500 Index[5] and other risk assets, taxable municipals can also provide diversification benefits within an overall IG Fixed Income allocation.

## Next Steps

The level of volatility during 2022 in the IG Fixed Income markets was historically high. In addition, credit spreads experienced bouts of meaningful widening and tightening in 2022.

Investors increasing allocations to fixed income may want to consider an approach that emphasizes high quality bonds across corporate and securitized sectors. Over the last 30 years, Breckinridge's approach has focused on opportunistically improving risk-adjusted returns, while remaining grounded in the understanding of why investors allocate to investment grade bonds—capital preservation and income.

We strive to deliver consistent fixed income returns, especially in times of economic distress and market uncertainty, while seeking opportunities to add value. Conducting in-depth, independent fixed income research that integrates fundamental and environmental, social and governance (ESG) research underpins our investment process centered on striking the right balance between mitigating risk and pursuing returns.

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FOOTNOTES:

1. The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities. You cannot invest directly in an index.
2. The Bloomberg U.S. Corporate Bond Index is an unmanaged market-value-weighted index of investment-grade corporate fixed-rate debt issues with maturities of one year or more. You cannot invest directly in an index.
3. The Bloomberg MBS Index tracks agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual pools into aggregates or generics based on program, coupon, and vintage. You cannot invest directly in an index.
4. Bloomberg Asset-Backed Securities (ABS) Index: Is the ABS component of the Bloomberg US Aggregate Index. The Asset-Backed Securities (ABS) Index has three subsectors: credit and charge cards, autos and utility. The index includes pass-through, bullet and controlled amortization structures. The ABS Index includes only the senior class of each ABS issue and the ERISA-eligible B and C tranche.
5. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. Itis a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.