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The Fed's Under Pressure

Global sovereign yields continued to march higher as sticky inflation and resilient consumer spending reinforced the narrative that policy rates will need to be "higher for longer." Against this backdrop, fixed-income sectors produced mixed excess returns.

What's Driving Markets…

1. **Economic data releases surprised to the upside in February**, keeping pressure on the Federal Reserve (Fed) to hike rates further and providing tailwinds to the hawks on the Federal Open Market Committee. Core CPI[1] moderated slightly to 5.6% year-over-year but exceeded expectations, while core personal consumption expenditures (PCE)[1]—the Fed's preferred inflation gauge—accelerated to 4.7% year-over-year. Employment data also proved resilient: A gangbusters payrolls report highlighted a drop in the unemployment rate to 3.4%, the lowest level since 1969. Services PMI[2] remained in expansionary territory, an area of the economy that the Fed has watched closely for signs of cooling.

2. **Soft-landing, hard-landing, or no-landing?** Global economic data across many developed-market economies have proven resilient over the last several months. The predictability of the oft-cited inverted yield curve[3] as a reliable recession indicator looks to be tested, evidenced by exceptionally strong labor markets, stubbornly elevated inflation, and still positive GDP (with a few exceptions). The implication for central banks is likely higher-for-longer policy rates with more country differentiation on economic performance. The bumpy road for the Fed has started to push the dollar higher (**FIGURE 1**, left) and repriced the market's interest-rate expectations on Fed rate hikes and cuts for 2023 (**FIGURE 1**, right).

Insight from sub-adviser Wellington Management

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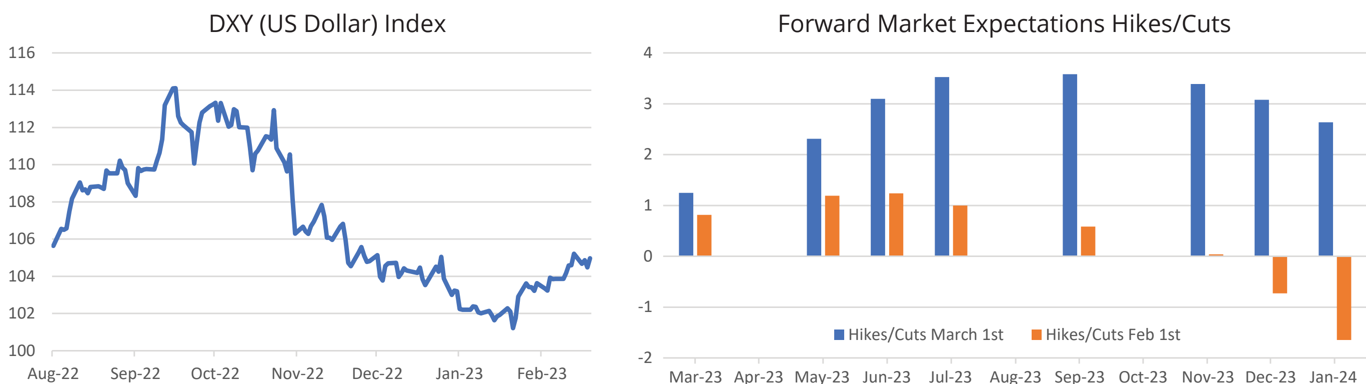
FIGURE 1
The US Dollar Is Strengthening While the Market Prices in More Rate Hikes



As of 3/2/23. Hikes/cuts compares expectations for cuts and hikes on 3/1/23 vs. 2/1/23. Source: Bloomberg.

[1] The **CPI** in the US is defined by the Bureau of Labor Statistics as "a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services." Core CPI excludes volatile food and energy prices. The **Personal Consumption Expenditures Price Index (PCE)** is defined by the US Bureau of Economic Analysis as a measure of the prices that people living in the US, or those buying on their behalf, pay for goods and services. The index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

[2] **PMI** is Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector. A reading above 50 signals economic expansion; below 50 signals contraction.

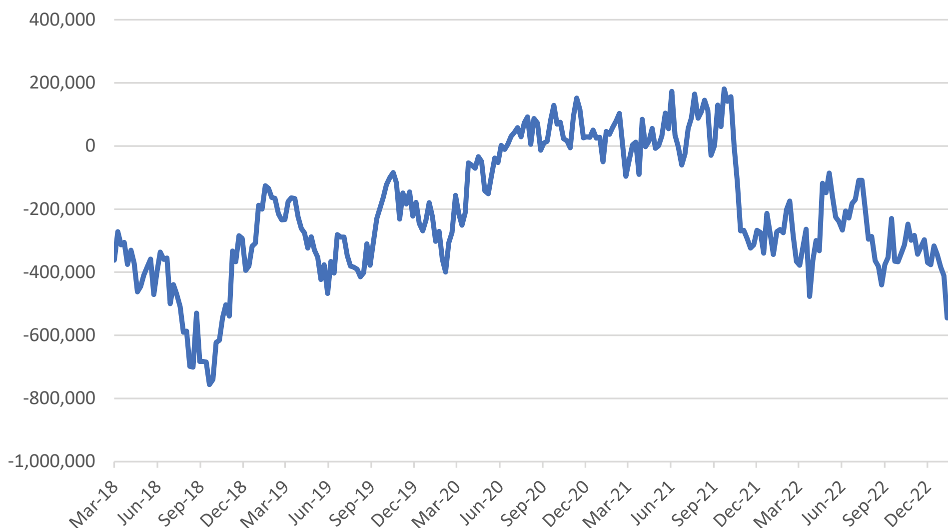
[3] **Yield curve** is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

Positioning has rapidly evolved to be more reflective of the soft landing mentioned above. A substantial short position is in place in US Treasury markets. Spread[4] markets, while somewhat weaker from the start of the year, are still pricing in very benign default scenarios. **FIGURE 2** reflects Commodities Future Trading Commission (CFTC) positioning in 10-year Treasury futures, the negative number reflecting a robust short position that has built up in futures contracts.

Economic data out of China highlights a reopening that's going better than expected.

FIGURE 2

10-Year CFTC Net Non-Commercial Futures Positions



As of 2/2/23. Source: Bloomberg.

3. **The Bank of Japan (BOJ) announced that Kazuo Ueda** will become its new governor after the retirement of Governor Kuroda in April. Ueda is not a typical head for the BOJ; his background is academia, not the halls of policymaking at the Ministry of Finance or the BOJ. He has a background in advocating for unconventional monetary policy. Indeed, the only mention of him in Masaaki Shirakawa's (BOJ Governor from 2008-2013) book "Tumultuous Times: Central Banking in an Era of Crisis" is a singular reference to him regarding the implementation of unconventional monetary policy.

   Markets continue to test the BOJ yield-curve control policy[5] with 10-year Japanese government bonds (JGBs) trading near or at their upper limit, which, along with a sell-off in the mid-range, may force the institution to purchase bonds to stabilize the curve. The BOJ also began to limit the number of 10-year issues it would lend out to the dealer community. This is an attempt to make it harder to short JGBs by creating scarcity in securities available to borrow. In short, it's a way of using bond-market plumbing in order to preserve yield-curve control in the near term and buy policymakers time to determine the future of that policy.

4. **Chinese economic data surprised to the upside**, with PMIs coming in above consensus. This likely highlights a reopening that's going better than expected. The government is also putting heft behind its reopening, with a transfer of approximately US$160bn into the coffers of the People's Bank of China to be used for fiscal stimulus. Overall, the speed, breadth, and manner of the reopening is likely to add to global aggregate demand.

[4] **Spreads** are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

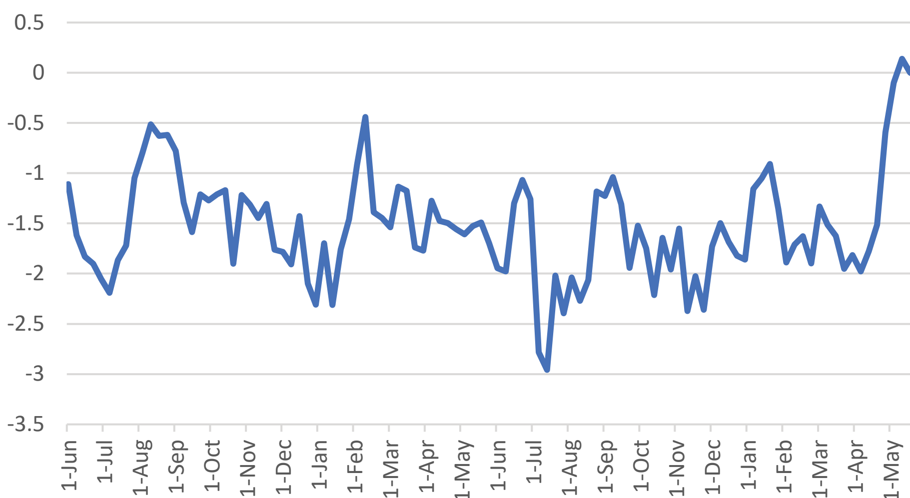
[5] In 2016, the BOJ enacted a strict **yield-curve control** policy that limited yields on Japan's 10-year Treasury bonds to 0.25%. The BOJ recently relaxed the policy.

5. **The Supreme Court** heard oral arguments on the Biden administration's federal student-loan debt-cancellation policy. The student-loan payments moratorium ends on June 30 and, particularly in conjunction with a possible legal defeat for the cancellation measures, should be viewed as another form of fiscal tightening. The restarting of these cash flows may also impact the debt ceiling "X" date given that the restarted cash flows may give the Treasury additional flexibility for debt management.

6. **It's not necessarily a driver,** but it's worth noting that the mortgage-backed securities (MBS) index is the least negatively convex[6] in nearly 30 years. The reason for this change is that the index itself is now heavily skewed toward lower coupon mortgages … which are less likely to prepay given how out of the money they are relative to today's interest rates. Additionally, new mortgage origination at current coupon levels is slow given the slackening pace of the housing market.

The end of the student-loan payments moratorium should be viewed as another form of fiscal tightening.

FIGURE 3
Bloomberg MBS Index Convexity



As of 3/3/23. [6] **Convexity** measures the curvature in the relationship between bond prices and interest rates and reflects the rate at which the duration of a bond would change in response to changing interest rates. **Duration** is a measure of the sensitivity of an investment's price to nominal interest-rate movement. Source: Bloomberg

What's Keeping Us Up at Night…

1. **Elevated geopolitical tensions remained evident** amid the gathering of heads of state at the 59th annual Munich Security Conference. As the one-year anniversary of the War in Ukraine passed with no signs of a resolution, the US accused Russia of crimes against humanity. Meanwhile, the first official meeting between China and the US took place since the balloon incident. China continued to warn the international community not to involve themselves in its relations with Taiwan.

2. **Defaults on loans backing commercial properties** confirm market participants' concerns on the secular trends in the office property sector. Commercial mortgage-backed securities (CMBS) appeared to take the news in stride with little impact on spreads. However, more negative headlines from the office sector could put further downward pressure on office asset values and restrict their access to capital. As such, CMBS office bonds may experience spread widening, as loan modifications and downgrades from rating agencies materialize. We believe higher-quality, new/renovated office buildings are poised to outperform lower-quality, dated buildings as borrowers take advantage of the weakness to upgrade their space.

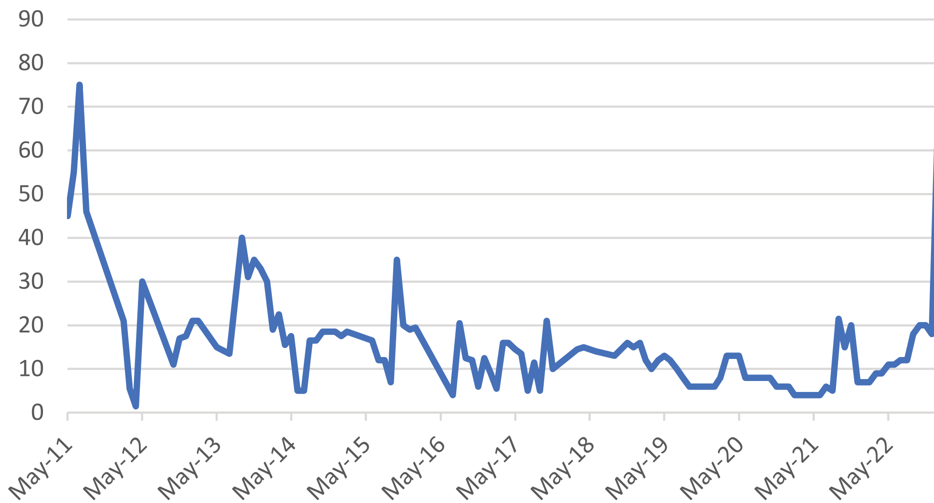
3. **Japan** — It's natural for US allocators to ask themselves why they should care about events in Japan and at the Bank of Japan. But there's an important reason: Japanese

yield-curve control, if ended, has the potential to be a destabilizing event for global rates markets, and, subsequently, most capital markets. Beyond the added volatility and uncertainty it would inject into global relative value relationships in rates and currencies, it would also likely be followed by a substantial repatriation of Japanese capital. Hence, we are watching events in Tokyo rather closely.

4. **The US Government continues it extraordinary measures** to remain below the debt limit. We're closely watching April tax receipts. Higher-than-expected receipts will likely push out the "X" date for Treasury, while lower-than-expected receipts would pull the event forward on the timeline. We believe the latter to be the more volatility-inspiring event as it reduces the window for which to negotiate a deal or for Congress to agree to a discharge petition (a laborious and complicated procedure). The cost to insure against a US sovereign default has risen to the highest level since the 2011 episode during which the US was downgraded below AAA by S&P. It's important to note the caveat that US sovereign credit-default swaps is an illiquid, not-often-utilized instrument (for a variety of reasons). Nevertheless, it serves an early indicator of market reactions that we should start seeing after the April tax season.

If ended, Japan's yield-curve control has the potential to be a destabilizing event for global rates markets.

FIGURE 4
US Credit-Default Swaps (Basis Points)



As of 3/3/23. A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security. Source: Bloomberg

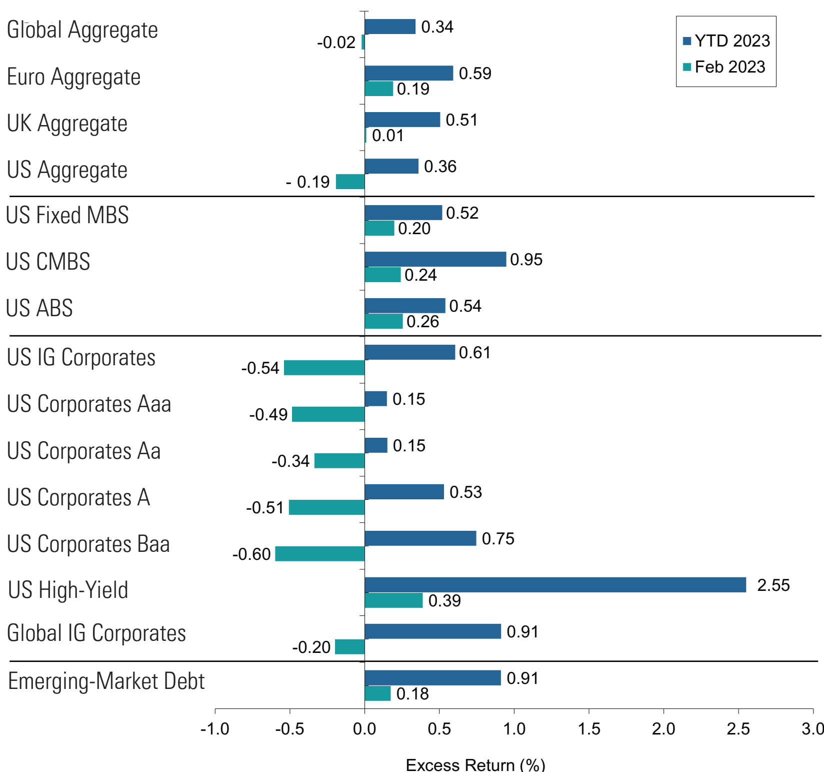
Investment Implications

- We continue to think that we're in the right environment for global sovereign and currency strategies to shine: from a total-return perspective, a risk-diversifier approach, and a soundness perspective. This is another, more diversified approach to monetize the ongoing and expected volatility of global capital markets. This can be implemented either via some liquid global rates strategies with relative-value capabilities or through macro-oriented alternatives. The growing drumbeat of macroeconomic instability and volatility makes this type of allocation even more critical.
- Given the overall slowdown in some sectors of the economy, it may also start to make sense to consider CORE/CORE+ positions[7] as we move later in the tightening cycle. The sell-off in dollar rates, a slowing pace of inflation, rising geopolitical risk, and a slowing economy makes higher-quality fixed income attractive from a recessionary perspective, as well as for a positive relationship between bond prices and bond yields.
- Shorter-duration credit has paid well given the ongoing volatility and uncertainty in markets. For low-risk appetite thresholds, the opportunity cost of this approach has diminished substantially over the last several months.
- Securitized credit may be able to mitigate some rate volatility because it currently has good risk-adjusted spreads. Senior parts of the capital structure, in particular, seem attractive in case the cycle turns faster than expected.

[7] Core funds typically invest in a baseline of investment-grade bonds such as government, corporate, and securitized debt. Core plus funds can take that baseline and add additional sectors such as corporate high-yield, emerging-market debt, or non-US currency exposures to enhance returns.

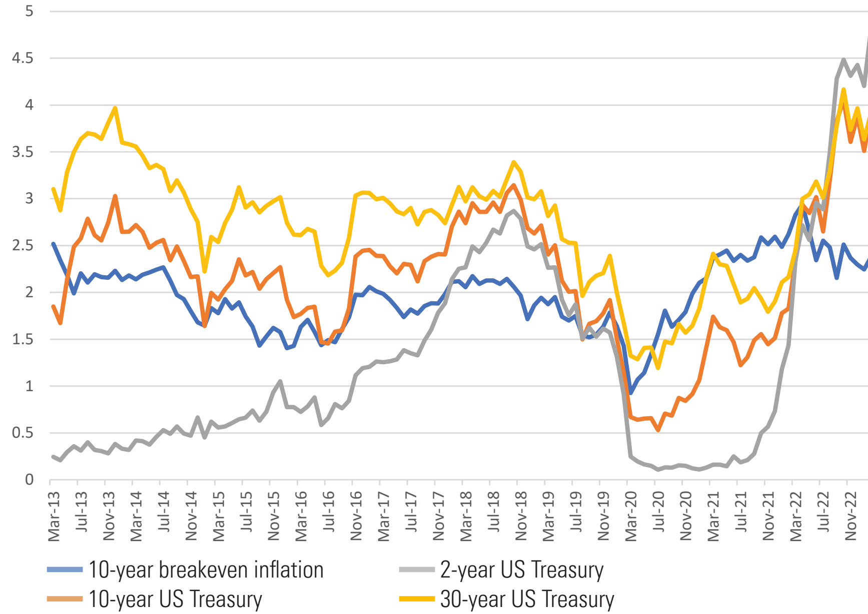
FIGURE 5

Fixed-Income Sector Excess Returns:



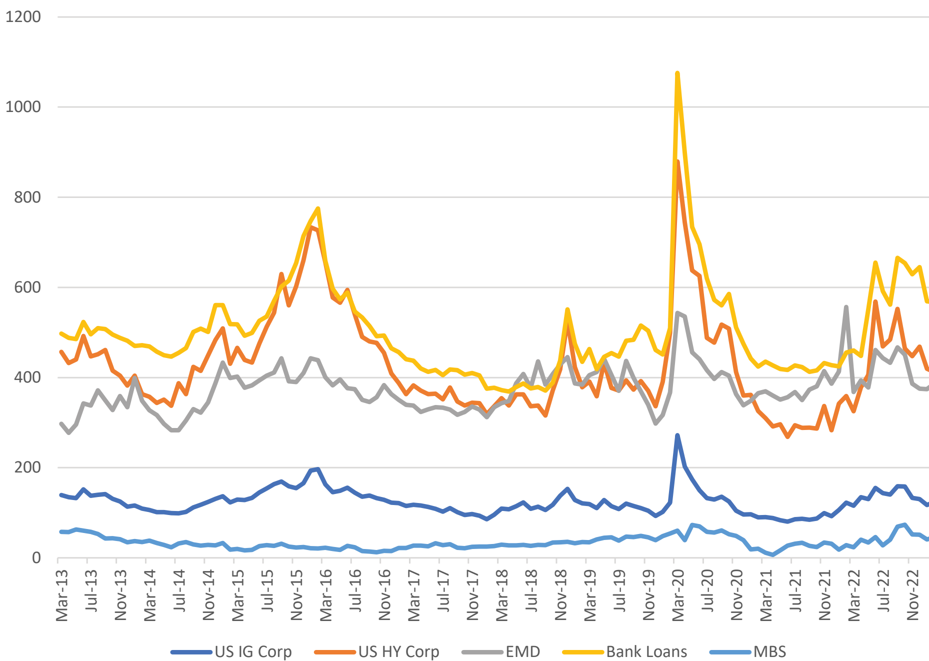
As of 2/28/23. **Past performance does not guarantee future results.** See last page for representative index definitions. Sources: Bloomberg, JP Morgan, Wellington Management

FIGURE 6
US Yields (%)



As of 2/28/23. Source: Bloomberg

FIGURE 7
Fixed-Income Spreads (Basis Points)



As of 2/28/23. Bank Loans are represented by the LSTA Leveraged Loan Index, which is a market-value-weighted index that is designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads, and interest payments. Sources: Bloomberg, JP Morgan, Morningstar LSTA.

To learn more about opportunities in fixed income, please talk to your financial representative.

Global Aggregate is represented by the Bloomberg Global Aggregate Index, a broad-based measure of the global investment-grade fixed-rate debt markets. **Euro Aggregate** is represented by the Bloomberg Global Aggregate Index - European Euro, which includes fixed-rate, investment-grade Euro denominated bonds. **UK Aggregate:** Bloomberg Global Aggregate Index - United Kingdom which includes fixed-rate, investment-grade sterling-denominated bonds. **US Aggregate:** Bloomberg US Aggregate Bond Index is composed of securities from the Bloomberg Government/Credit Bond Index, Mortgage-Backed Securities Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index. **US Fixed MBS:** Bloomberg Agency Fixed-Rate MBS Index tracks fixed-rate agency mortgage backed passthrough securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). **US CMBS:** Bloomberg CMBS ERISA Eligible Index, which measures the performance of investment-grade commercial mortgage-backed securities, which are classes of securities that represent interests in pools of commercial mortgages. The index includes only CMBS that are Employee Retirement Income Security Act of 1974. **US ABS:** Bloomberg Asset-Backed Securities Index, the ABS component of the Bloomberg US Aggregate Index, which has three subsectors: credit and charge cards, autos, and utility. **US IG Corporates:** Bloomberg US Corporate Bond Index covers all publicly issued, fixed rate, nonconvertible, investment-grade debt. **US Corporates Aaa:** Bloomberg Aaa Corporate Index designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aaa; **US Corporates Aa:** Bloomberg Aa Corporate Index; **US Corporates A:** Bloomberg A Corporate Index, designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aa; **US Corporates Baa:** Bloomberg Baa Corporate Index; designed to measure the performance of investment-grade corporate bonds that have a credit rating of Baa; **US High-Yield Corporates:** Bloomberg US Corporate High Yield Index is an unmanaged broad-based market-value-weighted index that tracks the total return performance of non-investment grade, fixed-rate, publicly placed, dollar denominated and nonconvertible debt registered with the Securities and Exchange Commission. **Global IG Corporates:** Bloomberg Global Credit - Corporate Index is an unmanaged index considered representative of fixed rate, non-investment grade debt of companies in the US, developed markets, and emerging markets. **Emerging-Markets Debt:** Bloomberg Emerging Markets Hard Currency Index includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers.

Important Risks: Investing involves risk, including the possible loss of principal. •Fixed income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. •Investments in high-yield ("junk") bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. • Mortgage-related and asset-backed securities' risks include credit, interest-rate, prepayment, and extension risk. • Loans can be difficult to value and less liquid than other types of debt instruments; they are also subject to nonpayment, collateral, bankruptcy, default, extension, prepayment and insolvency risks. • Foreign investments may be more volatile and less liquid than US investments and are subject to the risk of currency fluctuations and adverse political, economic and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets. • Diversification does not ensure a profit or protect against a loss in a declining market.

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