UBS

The Bond Bulletin

What's happening in fixed income markets

UBS Asset Management I February 2024

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In January US municipal bond prices down 0.51%

- Ending 2023 the market had performed just too well and required a rest bit and recalibration prior to proceeding
- We expect municipal credit ratings will play a bigger factor in performance in 2024
- VRDN yields had a rocky road in the month of January

US corp investment grade total returns down 0.17% in January, US high yield up 0.01%

- The narrative of a soft landing scenario as well as an inflation environment that is trending downward remains on track
- The Fed continues to communicate that Fed cuts are likely the next course of action, but the timing and the amount of cuts should keep market volatility elevated
- Given recent rate movement, we look to be close to neutral duration

Fixed income month in review

The strong gains in fixed income markets from December 2023 failed to carry over into the 2024 with government bond yields rising as central banks pushed back on swift rate cuts for this year. The release of stronger than expected economic growth data in the United States was followed by a more hawkish tone from the Federal Reserve. As a result, fixed income credit returns were mixed this month with investment grade spreads marginally tighter, while high yield spreads widened. US Investment-grade and high yield closed the month at a spread level of +96 bps and +354bps, 3bps tighter and 19bps wider, respectively. For January, the total return for US investment grade credit was down 0.17%, while US high yield was basically flat – up 0.01%.

After two months of rate rally conditions to conclude 2023, the new year opened with a mixed interest rate picture in the US. Shorter tenor US treasuries saw marginal declines, while 10 through 30-year maturity paper saw rates increase slightly in a steepener. The yield on the 2-year US Treasury fell 4bps to 4.21%, while the 10-year and 30-year yields rose 3bps and 14bps to 3.91% and 4.17%, respectively. For the month, the total return for the US Treasury index was down 0.28% with the long-end (20yr+ posting a negative 2.72% return) underperforming the short-end (3-5yr posting a positive 0.23% return). In January, the 2yr vs 10yr US treasury curve remained inverted by -29bps which is well below the peak inversion we saw of -108 bps reached on July 7th. Post January, the inversion is now -36 bps (February 16th, 2024).

In terms of commodities, oil futures rose 6%, snapping a three month string of declines, on heightened geopolitical tensions in the Middle East and some covering of short positioning. Meanwhile, gold futures fell 1.1%, snapping a three month streak of gains, on a higher US dollar. Industrial metals ended the month little changed.

Macro outlook

Growth figures showed the United States economy ended 2023 on a strong note, with the advance estimate for fourth-quarter GDP growth coming in at an annualized pace of 3.3% quarter-on-quarter, besting the 2% estimate. Consumer spending contributed strongly to growth, and ended the quarter on a very robust pace with the retail sales control group up 0.8% month-on-month in December, higher the 0.2% increase that was expected.

Labor market conditions continue to normalize towards pre-pandemic norms. Non-farm payroll growth of 216,000 in December was above the 175,000 estimate. Initial and continuing jobless claims moderated early in the month before rising somewhat thereafter. The Employment Cost Index decelerated in the fourth quarter by more than anticipated, with private wages and salaries growing at an annualized pace of 3.7%. This is roughly in line with levels previously highlighted by the Federal Reserve as consistent with 2% inflation. Job openings rebounded modestly in December to 9 million, defying expectations for a decline to 8.75 million. However, the private sector quits rate continued to recede to 2.4%, which is well below its pre-pandemic peak.

Encouragingly, soft survey data picked up notably. The preliminary reading of the University of Michigan Consumer Sentiment Index rose to 78.8 in January, above 69.7 in the prior reading and the projected 70.1. The S&P Global US Manufacturing Index rose to 50.3 in its preliminary January reading, its first reading above 50 (which separates expansion from contraction) since April. The December CPI report was largely in line with expectations. Once again, a lower-than-anticipated reading of the producer price index, where the core number was flat month-on-month, put modest downside pressure on estimates for core PCE inflation – the Federal Reserve's preferred gauge of inflationary pressures. Core PCE ultimately rose 2.9% year-on-year in December, slightly below expectations. Six-month annualized core PCE inflation continues to run at 1.9%.

The Federal Reserve held rates unchanged at 5.375% at its January meeting, as expected. The statement removed the central bank's tightening bias, but also included language suggesting there would be no quick pivot to easing. Fed Chair Jerome Powell further added that he viewed it unlikely that monetary policymakers would have sufficient confidence that inflation was heading durably back to target by March, dimming hopes for a cut at the upcoming meeting. The statement contained a modest tightening bias, but the central bank's "dot plot" implied that policy rates would be 75 basis points lower at the end of 2024 if economic conditions evolved in line with their outlook. Fed Chair Jerome Powell indicated that rate cuts were discussed at the meeting, and did not push back against any of the easing of financial conditions (higher stock and bond prices) that had occurred since the November meeting.

[1]See last page for further information

Municipal fixed income

Performance Backdrop

In our opinion, the strength of the 2023 year-end municipal bond rally took most of the wind out of the sails of January 2024's performance. Ending 2023 the market had performed just too well and required a rest bit and recalibration prior to proceeding. Typically, the municipal market enjoys a period of positive performance in January as technical factors (low supply & high demand) feed what is commonly referred to seasonally as the "January Effect". Municipal yields were higher across the curve having experienced a slight month of bear flattening. TM3 data reports 2-year yields higher by 12 basis points, 5-year yields higher by 8 basis points and both ten and thirty year yields higher by 10 basis points. The Bloomberg US Municipal Bond Index[1] bucked tradition this January and posted a -0.51% return. January's return represented the worst January monthly performance since 2011 and the fourth worst recorded January.

On the back of the market's negative performance measures of relative value cheapened in all maturities except for the thirty-year maturity. Relative value measures, along with still attractive yields, have been somewhat of a conundrum for investors. Do I wait till municipal bonds get cheaper? Or, am I going to miss out on locking in attractive yields? We believe, legging into this market dynamic makes sense versus the all or nothing (timing) approach. Market volatility has not completely abated and taking advantage of market disruptions whether it be cheaper valuations or higher yields, at regular intervals presents the best strategy for a diversified portfolio. According to Bloomberg data: 2-year municipal/treasury ratios finished the month at 62.67% after starting the month at 59.29%; 5-year municipal treasury ratios finished at 61.37% versus 59.22%. 10-year municipal/treasury ratios finished at 60.6% from 58.7%; and, thirty-year ratios actually richened slightly to 84.3% from 84.8%. A surprising market factor for January included robust supply. Bloomberg reports the largest issuance for the month since 2017 with $31.8 billion in municipal debt coming to market. This exceeded Decembers' issuance of $23.5 billion and was up 35% over January 2023. Had the market not experienced inflows from maturities and coupons, performance may have been even more challenged. The strong demand, in the face of elevated supply, played a factor in keeping municipal market under-performance in-check for January. Lipper reporting funds experienced a little over $2.0 billion in in-flows for the month.

Not to be unexpected in the backup in performance, shorter duration assets performed better than longer duration assets. The best performing sub-indices in January were as follows: 1-year sub-index (1-2) generated a return of -0.03% followed by the 3-year sub-index (2-4) return of -0.22%. As stated, longer duration assets performed worse as demonstrated by the 20-year (17-22) sub-index with a return of -0.56%; naturally followed by the long bond sub-index (22+) with a return of -0.89%. We made no significant adjustments to our duration bias heading into January and currently stand in the same position for February.

Credit factors, while historically playing an important role in municipal performance, have been subdued for much of 2023 and start 2024 with the same level of influence. Bloomberg reports: single-A rated paper performed the best with a return of -0.41% ahead of double-A and triple-B rated paper each of which returned -0.51%. The worst performing rating category for the month was triple-A rated paper returning -0.65%. We expect municipal credit standings (ratings) will play a bigger factor in performance in 2024 as economic conditions unfold and cash balances (Federal Funds) and rainy day funds are spent down. Revenue bonds slightly out-performed general obligation debt to start the year as revenue bonds returned -0.52% and general obligation debt posted a -0.55% for the month. The best performing sector to start the year were pre-refunded bonds (shorter durations assets naturally) had the lone positive index contribution of 0.06%.

VRDN yields had a rocky road in the month of January. The first few weeks we experienced yields as low as 1.90% before peaking at a 4.55% on January 24th. The average yield for the month of 3.17% was slightly behind the 3.33% average for 2023.

[1]See last page for further information

Taxable fixed income

Taxable fixed income performance

US corporate investment grade total return (as measured by the Bloomberg US Corporate Bond Index[1]) posted a negative 0.17% return for the month of January. There was performance dispersion across ratings and maturities for investment grade issuers. BBB-rated credit returned -0.04% for the month relative to AA-rated credit at -0.62%. From a maturity standpoint, three-to-five–year maturities were up 0.30%, while 10+ year maturities were down 0.87%. Investment-grade spreads tightened 3bps in January from 99bps to 96bps. During the month of January, the average investment-grade spread was 98 bp with a wide of 105 bps (1/3/2024) and a tight of 92 bps (1/26/2024). For context, the average investment grade spread in 2023 was 125 bps with a wide of 163 bps (3/15/2023) and a tight of 98 bps (12/28/2023). At the sector level, the best performers were retailers, banking, oil field services, other industrials and healthcare, while cable satellite, wirelines, wireless, pharmaceuticals and electric underperformed.

US short duration high yield (as measured by the ICE BofA 1-3 year BB-B Cash Pay High Yield Constrained Index)[1] returned 0.19% for January. During the month, the OAS for the index widened 16 bps to close at a level of 258 bps. Both double B credits and single B issuers widened 18 bps and 15 bps, respectively, in January. Translating spread widening to performance across the major ratings buckets for the short-dated high yield index, BB's were up 0.22%, while B's were up 0.16%. On a total return basis and for the broader high yield index, BB's were up 0.08%, B's were up 0.07%, and CCC's were down 0.64%. In January sector performance was mixed, the best performing sectors were retailers (1.12%), banking (0.92%), oil field services (0.90%), other industrial (0.86%), and healthcare (0.85%). Laggards on a relative basis were cable satellite (-2.84%), wirelines (-2.30%), wireless (-1.78%), pharmaceuticals (-0.96%), and electric (-0.51%).

Emerging market sovereign bonds (as measured by the J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI Global Diversified)[1] and EM corporate bonds (as measured by the J.P. Morgan Corporate Emerging Markets Bond Index Diversified (CEMBI Diversified)[1] returned 1.02% and 0.58%, respectively, during January. Over the month, the OAS for the sovereign index widened by 18 bps to 402 bps and the corporate OAS tightened 2 bps for the month to 305 bps. During the month and with respect to sovereign issuers, total returns across the credit spectrum were negative with investment grade down 1.36% and high-yield down 0.68%. By country, top performers for the month include Ecuador, Bolivia, and Pakistan while Lebanon, Senegal and Jamaica were the weakest.

On the corporate side and during the month of January total returns across the credit spectrum were positive with investment-grade up 0.10% and high-yield outperforming at 1.27%. By industry sector, top performers for the month include Real Estate, Metals & Mining and Transportation while Oil & Gas and Pulp & Paper were the only ones that posted negative returns.

Taxable fixed income market update

Attractive yields and a resilient economy continue to support the investment grade corporate market. This has driven large cash inflows into the asset class with over $42 billion to start the year. Even though we have seen a large amount of new issuance to start the year, this has easily been absorbed by the strong demand. The narrative of a soft landing scenario as well as an inflation environment that is trending downward remains on track. Recent inflation data which has proved to be somewhat sticky has not changed the belief that inflation will continue to trend downward. Even though recent economic data has the market pushing out the first rate cut until the summer it doesn't change the belief that the Fed will eventually cut interest rates. In addition, upbeat earnings data is coming in above expectations for Q4 2023 which continues to support the fundamental side for investment grade credit. Overall corporate yield remains attractive at roughly 5.25%, but we remain somewhat cautious as we believe current corporate valuations highlight how much good news is priced into the market.

In terms of the high yield market, we saw a strong push into risk assets during the last two months of 2023. During this time, high yield spreads tighten a cumulative 107 bps from the October wides – 60 bps and 47 bps worth of tightening in November and December, respectively. For context, in 2023 we saw a wide, a tight and an average high yield spread of 518 bps, 327 bps and 413 bps, respectively. We closed out the year at a spread level of 332 bps but backed-up 19bps during January after the more hawkish Fed comments and stronger than expected economic prints.

Despite the move wider, high yield technicals (supply vs demand) remained strong during January. We saw $32.6bn in new issue volume (vs $20.5bn Jan 2023) making it the most active month since 2021. New issues were heavily skewed to refinancing existing debt (81%), while 42% were issued as secured notes and 12% as CCC instruments. For 2024, street estimates are tracking flat to +25% with expectations of 2025 maturities pulled forward for early refinancing as borrowers look to tackle maturity stacks. High yield maturities for 2024 are manageable with <2% of the universe due to mature (of which 62% are BB rated). In 2025 maturities accelerate to 6.6% of the universe with the composition of those maturing deteriorating (at 45% BB maturities). Although the 1yr maturity profile present no concerns, the rolling 2yr debt financing need of at 9% of the overall universe is on the higher end of historical refinancing volume. Private equity markets are expected to play a role in this higher refinancing period but we need to be conscious that the loan market as well sits with similar maturity pressures which could weigh on risk assets. In 2023, bond for loan deals accounted for 18% of HY bond total issuance up from 13% in 2022. Overall, we expect high yield technicals to moderate from 2023's very strong levels as the new issue supply will be heavily influenced by developments in rates and as well as any acceleration of

[1]See last page for further information

loan to bond activity into the space.

From an earnings perspective, less than 15% of high yield Q4 earnings have been reported but early signals reflect a greater number of corporate earnings beats over misses as well as a higher number of company positive outlooks than negative warnings. Overall, Q4 ‘23 fundamentals are expected remain relatively healthy, but we anticipate continued deterioration going forward as we normalize from an exceptional period of strong balance sheet and credit metrics in a higher rate slower growth environment. While default levels gravitate closer to historical averages, we are comforted by the quality and manageable size of near-term debt as well as the growth of alternative debtor financing away from traditional banks. We are watching the pace of loan to bond refinancing to see if the markets appetite remains in balance.

Taxable fixed income strategy

The Fed continues to communicate that Fed cuts are likely the next course of action, but the timing and the amount of cuts should keep market volatility elevated. This will provide many opportunities for investors when looking for attractive entry points. The Fed policy rate remains unchanged at 5.25% to 5.50%. This Fed rate hike cycle, which began in March 2022, has seen 10 straight hikes with a current Fed funds rate in the 5.25% to 5.50% range. The Fed paused at the June 2023 meeting, and has now pivoted to 75 bps of cuts in 2024.

The Bloomberg US Corporate Bond Index[1] is currently 92 bps. Corporate spreads have been range-bound over the last few weeks as the market absorbed heavy new issue supply. The technical landscape for investment grade credit remains very positive with consistent cash inflows. The all in yields for intermediate investment grade debt are around 5.15%-5.25%.

In terms of sectors and for our active investment-grade strategies, we are overweight the utility sector, as we believe the sector offers attractive relative value. We remain underweight issuers that have poor ESG scores. We are neutral the financial sector. We continue to believe the banking sector will maintain solid fundamentals and we are maintaining an overweight to select US money center banks. We remain underweight the industrial sector, but we have begun adding exposure to select industrial names. We remain overweight the energy sector as fundamentals within the sector remain strong, and we are overweight the technology sector as we believe valuations have become attractive. We are underweight the non-cyclical sector, but within the non-cyclical sector we are moving to an overweight within the healthcare & pharmaceuticals sectors. Increased M&A activity in these sectors is being partially funded by debt which is providing attractive new issue opportunities. We remain overweight the telecom, media and cable sectors.

From a credit curve perspective, we are neutral the short-end of the credit curve (2-4 yrs.), and are overweight the intermediate part of the credit curve (5-10 yrs). We continue to take advantage of the new issuance calendar but we are focusing on up-in-quality when looking to add exposure into the portfolios.

In terms of the high yield market, levels for the broad index of 7.81% remain historically attractive but we have reason to be cautious as we progress into the new year given the impressive year-end rally. Further bond price appreciation is becoming more limited given high yields callability nature and price convexity factors. At current levels, we would expect the income carry to make up a larger portion of returns. Dislocation between the markets timing of the first rate cut and with the Feds data dependency narrative give us concern as spreads currently linger near 18-month lows. With each economic data point becoming more polarized, we expect periods of heightened credit spread volatility to present opportunities to leg into the high yield space at more attractive levels.

Given recent rate movement, we look to be close to neutral duration and remain up in credit quality while looking for idiosyncratic opportunities to develop. For lower quality credits, we are targeting shorter maturity bonds with strong access to capital and continue to remain focused on credit selection as tighter financial policy works its way through the economy and to borrowers.

From an industry perspective, we continue to add and to rotate names within the energy space. The backdrop for this sector remains sound as corporate discipline over recent years has led to stronger balance sheets for most issuers. Away from energy, we remain underweight telecom and cable due to higher financing needs and/or tight spreads. We have allowed our healthcare exposure to drift lower leaving us with an underweight as we see the sector trading riches which historically have been more defensive in nature supporting our higher quality liquid bias. From a ratings perspective, we have a quality bias with a focus on fundamentally-driven security selection. We are currently overweight BB-rated credit relative to B in our short duration high yield SMAs. We have been holding onto our rising stars as we still see them offering attractive risk adjusted returns. In terms of maturity focus, we have been primarily invested in 2–3 year maturities. With more proactive 2025 debt retirement actions to take place, as we will look to reinvest into slightly longer portfolio duration in efforts to take advantage of anticipated declining rate environment.

In our emerging market ladder portfolios, we have no direct exposure (sovereign, corporate and quasi-sovereign) to Russia or Ukraine. From a regional perspective, we are seeing attractive relative value opportunities in Latin America especially in markets such as Brazil, Mexico, Panama, Peru, Turkey and Uruguay. We continue to prefer sovereigns to quasi-sovereigns and corporates. Within corporates, we have allocations to the energy, basic materials and industrial sectors.

[1]See last page for further information

Outlook

Transitioning from 2023 into 2024, we believe the market is over-exuberant in pricing over 6 cuts in 2024 and too optimistic that the first cut would come as early as March. What's more, we are cautious as to the extent of larger corporate and treasury supply, and the propensity for rates to head higher as a result. Still, we're apt to play duration from the longer side looking forward and maintain our inclination that a positive carry environment will likely characterize early 2024. We continue to anticipate there being advantages to tactical maneuvering throughout the year as the economic mosaic continues to play out and while rate volatility remains elevated.

Month-end choppiness in credit lent to a more mixed picture for January to pair with what was observed in rates, even as excess returns across the FI landscape were predominantly positive. Developed market credit in both investment grade and high yield experienced spread tightening. We remain cautious in developed market credit gauged by the credit metrics we study, given now tighter valuations and the potential for still challenging early-year supply. The worst laid fears of a dour economy's potential to weaken credit fundamentals in future quarters appears less imminent and justifies selectively maintaining exposures in those higher compensation names and market segments where relative value persists.

Municipal Fixed Income	Taxable Fixed Income	US Multi sector	SMA Fixed Income Advisory
Charles Grande Managing Director, Portfolio Manager, Head of Municipal Fixed Income	**Craig Ellinger** Managing Director Head of Fixed Income, North America **Matt Iannucci** Managing Director, Senior Portfolio Manager US High Yield **David Vignolo** Executive Director, Senior Portfolio Manager US Investment Grade **Robert Martin** Executive Director, Fixed Income Specialist **Shamaila Khan** Managing Director, Head of Fixed Income Emerging Markets	**Patrick Matijevich, CFA** Director, Portfolio Manager	**Anthony Liotti** Managing Director, Head of SMA Fixed Income **Steve Canter, CFA** Executive Director, Fixed Income SMA Advisory Specialist **Neil Talbot** Executive Director, Fixed Income SMA Specialist

[1]See last page for further information

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The Bloomberg US Municipal Bond Index includes investment grade, tax-exempt and fixed-rate bonds with long-term maturities (greater than two years) selected from issues larger than $50 million. The index is unmanaged and does not reflect the deduction of any fees or expenses. The index returns reflect all items of income, gain, loss and the reinvestment of dividends and other income.

The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The ICE BofA 1-3 year BB-B Cash Pay High Yield Constrained Index tracks the performance of non-investment-grade corporate bonds with a remaining term to final maturity less than three years and rated BB-B and limit individual issuer concentrations to 2%.

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