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A Renaissance in U.S. Core Fixed Income: The "Five Percent" Paradox to Start the Year

Despite uncertainties regarding monetary policy and a potential recession, assessing valuations across the bond universe at the start of the year has yielded some interesting fundamentally-driven ideas for 2023, despite the recent bouts of volatility.

Executive summary

— The fixed-income market has shown signs of rebounding from the poor performance of 2022, entering the new year with fundamentals on a strong footing despite swings in volatility.
— Among investment-grade corporate credits, leverage levels have risen slightly, but in a way that has enhanced issuers' financial flexibility. Long-term trends also bode well for the asset class.
— Within Structured Finance, the market is being supported by consumer fundamentals that remain resilient, supported by a still-healthy job market, although we are seeing subprime borrowers come under pressure due to inflation.
— DWS believes a long-duration opportunity is available in Rate Reduction bonds. While in Commercial Real Estate, certain single properties may be an attractive short-duration investment. Esoteric Asset-Backed Securities (ABS) may also be attractive to investors looking for a short-duration alternative.
— The Fed's rate-hiking regime has affected Mortgage-Backed Securities (MBS) dramatically, leading to deep discounts. We favor higher-coupon issues, as they are likely to perform better if volatility continues, but we also recommend buying call protection on these issues.
— Putting it all together, we believe the market is pricing in a significant amount of uncertainty, especially regarding monetary policy. In this environment, we favor a barbell strategy.

The bond market posted deep losses in 2022 as the Federal Reserve continued its efforts to rein in the highest inflation rates in decades. But as investors began to anticipate some kind of end to the Fed's tightening policy, risk assets showed signs of recovery at points. This momentum carried over into early 2023, and investors are finding attractive risk-adjusted opportunities in several segments of the core fixed-income market…something that has not been seen in a number of years.

Corporate credit trend: Welcome back income

The rebound in corporate credit that began late in 2022 has been supported by many factors, including supply and demand dynamics. Demand for corporate credit has been strong, and supply has not kept pace.

It is also worth noting the fundamental stability of this market. Although interest coverage has come down from very robust levels, it has not fallen enough to be concerning. Leverage among U.S. issuers remains stable, and companies are directing more cash into capital expenditures, and from a credit perspective, that is positive. Positive credit rating trends within the asset class and the migration of issuers from the High Yield market (rising stars) continues. We expect the number of rising stars to exceed those of fallen angels in previous years.

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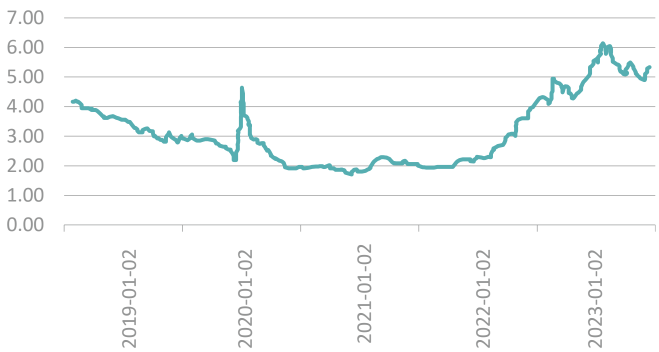
Corporate yields are attractive

Effective yield (%)



Source: St. Louis Federal Reserve, FRED database, ICE BofA U.S. Corporate Index Effective Yield, Percent, Daily, Not Seasonally Adjusted, January 2, 2019 – February 16, 2023.

Also significant is the level of market participation. DWS’s observation is that the increase in international participants in U.S. investment-grade credit continues to be fairly robust. These investors are attracted by the many duration buckets as well as by the diversification and attractive yields.

Longer-term trends also bode well for the asset class, in our analysis. One of these is a greater focus on income by investors, which has helped get U.S. Investment-Grade Corporate fixed income off to a good start this year. The strength of this segment is underscored by the resilience of the asset class during periods of higher volatility thus far, where spreads have widened by a lesser degree to their High Yield and European credit brethren.

Another area of interest are environmental, social and governmental issues (ESG), with “green bonds” continuing to be issued, but also being absorbed by investors. Furthermore, ESG debt interest is emerging in places we did not anticipate, such as Asia. This suggests the trend not only has staying power but could see some acceleration.

Another secular trend worth noting that could play out over the longer term is the move to electric vehicles. This will likely create a need for infrastructure, especially charging stations, which will require financing. Investment in the electric grid must also be addressed, and corporate bonds will likely play a role in that.

Structured Finance: Reversal of fortune from one year to the next

The structured segment of the bond market underwent a dramatic thematic reversal from 2022 to the first-quarter 2023. While weaker and higher-beta sectors such as Commercial Mortgage-Backed Securities (CMBS) and Residential Mortgage-Backed Securities (RMBS) had signficantly underperformed in 2022, this trend reversed with higher-beta sectors leading the way.

Fundamental and technical factors are both contributing to this turn around, with fundamentals stronger than recent headlines would suggest. In autos, for example, although the Intex Subprime Auto Index delinquencies are the highest in 20 years, they are only slightly higher than before the pandemic. Delinquencies on 60+ month subprime loans in January 2023 were approximately 5.25% — not much higher than the 4.91% rate of January 2019 — despite a high rate of inflation that is especially challenging for subprime borrowers.

Among prime borrowers the story is even better. Delinquencies are down slightly from pre-pandemic levels, dropping from 0.45% in January 2019 to 0.41% in January 2023, as measured by the Intex Prime Auto Index. DWS’s analysis points to the prime market remaining relatively strong, given the still-healthy job market.

Technical factors are also favorable. Although new issuance has surged across all of the major subsectors of structured finance to start the year, the market has experienced massive demand up and down the capital stack. DWS’s analysis points to issuance easing, particularly in some CMBS and RMBS, further enhancing the supply/demand mismatch going forward.

One long plus two short equals three investment considerations

In this environment, three trades--one long-duration and two short-duration--are looking attractive based on our analysis. The inverted yield curve and increased recession risks midway through the first quarter of 2023 makes investing in long duration credit assets relatively unattractive. That said, we believe investors should consider certain very high quality, long-duration assets.

One way to potentially implement this trade is with Rate Reduction Bonds. These bonds are backed by surcharges added to utility bills to pay for large, fixed charges facing power companies, such as power plant decommissioning or to fund recovery from natural disasters.

The legal protections around these utility surcharges are strong. Additionally, certain structural features, like true-up mechanisms, should make the charges stable even in a recession. As a result, DWS believes RRBs to be one of the strongest credits in the Asset-Backed Securities (ABS) segment and should be attractive for a long-duration insurance portfolio.

In the short-duration market, the first idea is in commercial real estate, with an interesting opportunity emerging in single-property assets to start the year. Unlike conduit CMBS, which are backed by pools of loans, these are securities on individual properties, such as a large office building or shopping mall.

Single-property assets have underperformed recently because of their idiosyncratic risk, and despite a rebound, the market is still pricing in some material weakness. Some high-quality malls and Class A, LEED-certified[1] office buildings are still trading at a discount into 2023, and DWS thinks it is an appealing trade opportunity—both up and down the capital stack. On properties like these, yields are typically in the mid-to-high single digits.

A similar trade would be to identify weaker properties that are trading at even bigger discount dollar prices. Given the typical two- to three-year liquidation timeline, bonds that are trading at large discounts may actually outperform in a liquidation scenario.

It is crucial to note that in both trades, security and tranche selection is critical, so investors need an analytical team with the technical expertise that can distinguish the good assets from the bad and estimate with accuracy liquidation prices.

Our second short-duration idea is in Esoteric ABS. Esoteric ABS, which includes franchise loans, timeshares, and solar, among other segments, are seasoned and have been through several cycles.

DWS believes the yields on these assets will soon compress, following the pattern with yield compression first occurring in higher-quality credits, and then in weaker credits. We forecast that the "final leg" will occur in these esoteric asset classes into the summer of 2023. Spreads in this sub asset class range from roughly 150 to 200 basis points (bps), amounting to a yield of 6% to 7%, depending on whether the securities are fixed-rate or floating.

Mortgage-Backed Securities: Opportunity enhancements in these acronyms

The rate-hiking regime of last year has affected the housing market perhaps more than any other. Mortgage rates went from 3% to 7% in the span of just 11 months, and this put the brakes on housing prices and sales.

These rate hikes also hit the Mortgage-Backed Securities (MBS) market, causing it to plunge into deep discount territory. In 2022, the Bloomberg Mortgage Index dropped from a dollar price of $102 to a low of $84 before bouncing back a bit. In addition, the average conditional prepayment rate (CPR), which estimates the percentage of loans in a pool that will be paid off early, fell below 5%, a level not seen since 1995. More recently through the first quarter, the CPR fell to around 3.5%, so the market remains heavily discounted.

While prepayment optionality has been sapped from the market, and MBS sensitivity to rates has diminished, rate volatility has risen quite a bit. In concert with the curve flattening, this has raised option costs and widened nominal spreads, particularly for those bonds close to par.

MBS spreads widened in 2022 along with those on other spread products, with the effect most pronounced in the higher coupons. As inflation declined and expectations of some measure of Fed policy stabilization increasing, rate volatility has come down. As a result, spreads tightened midway through February 2023.

[1] Leadership in Energy and Environmental Design (LEED) is a voluntary standard for "green" building design.

We continue to believe that lower rate volatility will be a primary driver of the market. Current coupon spreads, which measure the spreads on the theoretical par-priced bonds, have tightened 70 bps since October 2022 after having peaked at about 130 bps (again through early-to-mid February 2023).

Our outlook for the MBS sector remains fairly positive under the assumption of a continued decline in inflation and a recession that is less severe than expected. This, in turn, should prompt the Fed to adopt a “wait and see” approach sometime this year. Along with potential curve normalization, this should be a boon for the coupons that are currently now around par.

Given this view, we maintain an up-in-coupon bias toward par coupons. At the same time, given the possibility of lower rates, we would recommend buying call protection on these higher coupons via low loan balance or geo pools.

Another trade we would favor is to enhance the income of the lower-coupon bonds by combining them with Collateralized Mortgage Obligation (CMO) Interest-Only (IO) bonds. In essence, this increases the coupon received while retaining exposure to those lower coupon bonds that make up much of the mortgage universe. With the IOs generally having yields ranging from 10% to 14%, this synthetic coupon provides an OAS (Option Adjusted Spread) pickup to the generic coupon that it seeks to emulate. If an investor, for example, goes from 2.5s to 4s, it would yield higher than the 4 that you are looking to emulate. Obviously, there is less liquidity, but DWS thinks that for the longer-term investor, this trade can make sense.

Putting it all together: Security selection and the paradox

While attractive opportunities have emerged across the core and core-plus bond universe, at DWS we are careful to consider both strategic and tactical needs. Regarding the current landscape, a significant but manageable amount of uncertainty remains, particularly as it pertains to monetary policy.

As a result of this uncertainty, we are seeing what we call the “5% paradox.” In nearly all core fixed-income asset classes, investors are earning around 5%, regardless of curve position, quality, duration, or sector. For example, six-month T-bills are now yielding virtually the same as 10-year, BBB-rated industrials and the same as the 5.0% or 5.5% coupon in agency specified pools. This is an overgeneralization, but it sums up the market's perception of risk. When yields are clustered in this fashion, we argue the benefits of sector diversification are even greater.

Given what we have seen for much of the first quarter, DWS would advocate a preference for higher quality assets as well as a barbell positioning. We see significant value at the short end, but also need to be cognizant of re-investment rates two or three years from now. Additionally, investors do not want to “miss out” on locking in yields at the longer end of the curve, so DWS believes the barbell approach makes sense, particularly during periods of extensive bear steepening.

At the short end, we favor esoteric ABS, higher-rated CLOs, and BBB- and BB-rated high-yield bonds. At the long end, we are constructive on A-rated credits, and AAA- and AA-rated CMBS. While this market is can be viewed as “rich” (as of the end of February), DWS suggests adding longer municipal bonds opportunistically when yields cheapen relative to U.S. Treasuries.

In summary

Despite the recent volatility, the market environment in the first quarter represented a return to basics and a renaissance for core fixed income; income is once again part of the conversation. Nevertheless, given the forecast of a modest recession, it is important to remember idiosyncratic risk. Considering all this, investors should know that the focus of our fixed-income managers will be on fundamental analysis and security selection. And in this environment of being data dependent, we have to be very thoughtful of how bond managers invest, and opportunistically invest, when those bouts of volatility persist throughout the year.

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