2023 Outlook: Fixed Income

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The good news for 2023 is that fixed income has its last name back, meaning yields are higher, there is really income to be earned.

There are several areas that I think can do well in 2023, in particular with higher Treasury yields and also higher risk premiums, I think there are three areas in particular that can perform quite well. The first is the agency mortgage backed securities market. This is a government guaranteed market, but given the elevated level of interest rates, now provide yields near 6%, that can provide very attractive outcomes in a high quality asset class. We also think investment grade corporate bonds can do quite well. These are companies with low leverage and high credit quality that don't have a lot of economic volatility. So if the economy goes into a weak patch, they can be well prepared to handle that. But again, their yields are also much higher than they have been historically. We also like municipal bonds in 2023. Municipals are an area that, as inflation has risen, that has actually improved the tax revenue base of a lot of municipalities. And municipal bonds are trading at yields on a tax exempt basis that we haven't seen in two decades. So really an attractive entry point for investors who need that tax exempt income.

I think fixed income investors need to be thinking about tail risk in this environment of slowing economic growth and higher interest rates. The most vulnerable borrowers will be potentially exposed, and so those could be the consumers that have a little bit too much leverage and are no longer receiving those government stimulus payments that they benefited from during the pandemic. That could also be those companies that maybe could survive at 3 or 4% interest rates, but are going to struggle at 8 or 9% interest rates. And if we can very carefully mitigate those risks, we can find value in the market. But those companies and those issuers, in particular, could really, really struggle, and bond investors are going to be very careful going forward.

I think recession fears are real. There's reason to be concerned that after a central bank has raised interest rates to the degree that it has, that we could see a recession. That's also an environment often where inflation pressures come down and high quality fixed income -- and I would stress high quality -- tends to do actually quite well. So I would expect that after such a poor year for Treasury bonds and high quality bonds, that they can do significantly better in a recession environment. The caveat is credit risk would do a lot more poorly. And so if you look at high yields, securities and potentially the riskier ends of emerging markets, those are areas that could struggle if we see that economic change.

While I might have a sense of caution on the economic outlook, I have a tremendous sense of optimism for future returns in the bond market. Investors need to remember that higher yields provide a sense of cushion against future volatility. At the beginning of 2022, yields were exceptionally low. There was no cushion. Yields are significantly higher now. And even if we see a Federal Reserve that is continuing to raise interest rates to fight inflation, the starting cushion is significant and can buffer a lot of potential volatility and smooth that ride for investors such that future returns can be much more attractive.

There are risks associated with fixed-income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

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