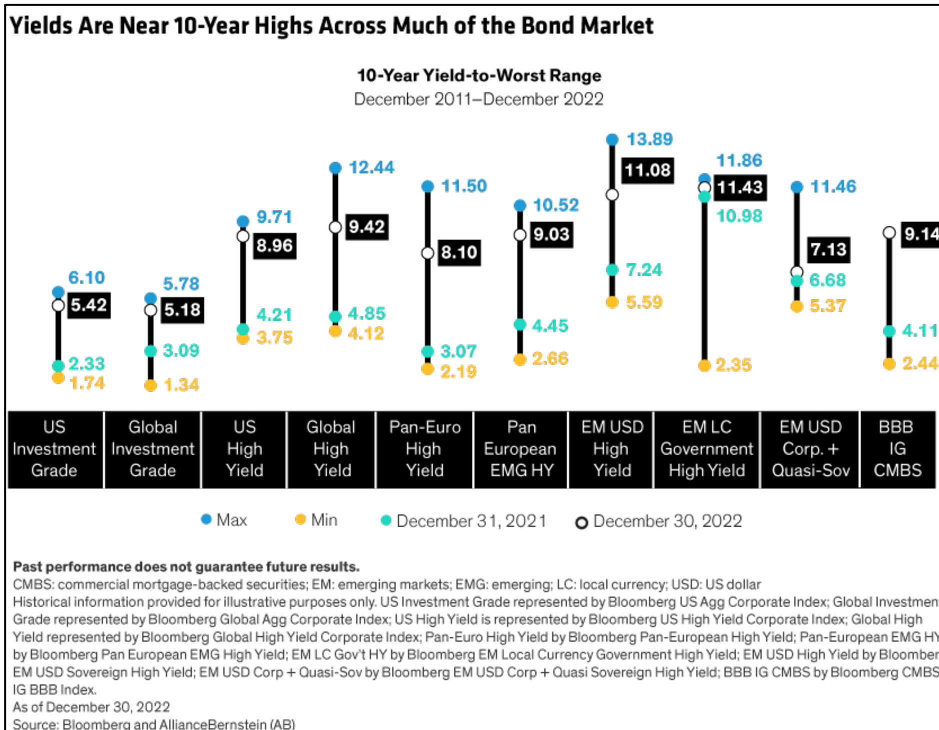
Quarterly Commentary 4Q22

AB FIXED INCOME STRATEGIES

GLOBAL FIXED-INCOME MARKETS

Yields Are Near 10-Year Highs Across Much of the Bond Market



Past performance does not guarantee future results.
CMBS: commercial mortgage-backed securities; EM: emerging markets; EMG: emerging; LC: local currency; USD: US dollar
Historical information provided for illustrative purposes only. US Investment Grade represented by Bloomberg US Agg Corporate Index; Global Investment Grade represented by Bloomberg Global Agg Corporate Index; US High Yield is represented by Bloomberg US High Yield Corporate Index; Global High Yield represented by Bloomberg Global High Yield Corporate Index; Pan-Euro High Yield by Bloomberg Pan-European High Yield; Pan-European EMG HY by Bloomberg Pan European EMG High Yield; EM LC Gov't HY by Bloomberg EM Local Currency Government High Yield; EM USD High Yield by Bloomberg EM USD Sovereign High Yield; EM USD Corp + Quasi-Sov by Bloomberg EM USD Corp + Quasi Sovereign High Yield; BBB IG CMBS by Bloomberg CMBS IG BBB Index.
As of December 30, 2022
Source: Bloomberg and AllianceBernstein (AB)

Finding Equilibrium

2022 was an ugly year for investing. As central banks battled inflation, interest rates soared and recession fears mounted. Equity and fixed-income markets broke with convention and fell in tandem. Nearly every bond-market sector suffered historic losses, leaving almost nowhere for investors to hide.

Now, central banks must slow their pace of tightening and carefully calibrate a soft landing even as they firmly rein in inflation. Below, we address the challenges of a global slowdown, the benefits of higher yields and strategies for the year ahead.

Treading a Fine Line: Growth vs. Inflation

Despite evidence of a global slowdown, central banks remain committed to curbing inflation. However, because of the lag effect of rate hikes on inflation, we expect them to slow their pace so that they can assess the effect of monetary policy on inflation so far.

A more moderate pace should help them avoid a very hard landing that could otherwise result from continued aggressive hiking. Instead, we expect recessions in the euro area and UK to be shallow, and US growth to be roughly flat in 2023. Financial market turbulence may decline as policymakers increasingly adopt a wait-and-see approach.

However, some inflation drivers, such as supply chain bottlenecks and the impact on energy prices of the Russia-Ukraine war, are outside of central banks' control. That means that, while global inflation might have peaked—and recent US inflation numbers are encouraging—the timeline for inflation to subside and stabilize remains elusive. Thus, uncertainty will likely persist in 2023.

Higher Yields Make a Big Difference

The uncertainty that is contributing to market volatility and episodic liquidity challenges is also generating opportunity. Yields are now significantly higher across investment-grade and high-yield markets, with many sectors at multiyear highs.

Such high yields might feel abnormal. But the era of near-zero yields that left investors starving for income was the real anomaly in financial history. Indeed, we believe we have returned to an era of structurally higher interest rates. Investors can now tap into sources of resilient income that have been extremely hard to come by for many years. And while the path to

higher yields was painful, we believe it's now largely behind us.

Credit Metrics Bolster the Case for Corporates

The specter of a recession usually scares investors away from corporate debt. Credit fundamentals tend to have weakened prior to any slowdown, causing issuers to enter a downgrade and default cycle as growth and demand slow further. But today's situation is different.

Today's issuers are in better shape financially than issuers entering past recessions—partly because the corporate market went through a default cycle just two years ago when the pandemic hit. The surviving companies were the strong ones, and they've managed their balance sheets and liquidity conservatively over the past two years, even as profitability recovered.

Interest coverage ratios for investment-grade and high-yield companies are the strongest they've been over the last 15 years. Other measures of fundamental strength—leverage ratios, free-cash-flow-to-debt and EBITDA margins—are also exceptionally strong by historical measures. While we do expect these metrics to weaken, we don't expect to see the kinds of dramatic declines that would lead to a tsunami of downgrades and defaults.

What's more, high-yield issuers have been focused on extending their maturity runways since the start of the pandemic. That means there's no approaching maturity wall, where a large share of bond issues matures and issuers are compelled to procure new debt at prevailing rates. In fact, only 20% of the market will mature by the end of 2025, with the lion's share of maturities coming between 2026 and 2029. This is akin to opening a pressure valve as yields rise, because gradual and extended maturities slow the impact of higher yields on companies.

Strategies for 2023: Be Patient, Stay Flexible, Seek Balance

Here's how active investors can thrive in today's environment:

1. Seek inflation protection. Explicit inflation protection, such as Treasury Inflation-Protected Securities and CPI swaps, can play a useful role in portfolios. If central banks succeed in their mission, we believe inflation will ultimately settle into a 2%–4% range—higher than in recent decades, yet much lower than in 2022. In other words, the 2% inflation that was typically seen as a ceiling by the US Federal Reserve and the European Central Bank would become an inflationary floor in the coming years.

2. Lean into credit. Yields across risk assets are much higher today than they've been in years, giving investors a long-awaited opportunity to fill their tanks. "Spread sectors" such as investment-grade corporates, high-yield corporates and securitized assets, including commercial mortgage-backed securities and credit–risk transfer securities, can also serve as a buffer against inflation by providing a bigger current income stream.

But not all risk assets are equally compelling. For example, while emerging-market debt valuations look attractive, emerging markets remain particularly challenged by slowing global growth and high inflation. Thus, careful security selection remains critical.

3. Don't ditch duration. Leaning into credit doesn't mean ditching duration, or interest-rate risk. As inflation falls and the economy slows, duration tends to benefit portfolios.

4. Choose a balanced approach. Among the most effective active strategies are those that pair government bonds and other interest-rate-sensitive assets with growth-oriented credit assets in a single, dynamically managed portfolio. This approach can help managers get a handle on the interplay between rate and credit risks and make better decisions about which way to lean at a given moment. The ability to rebalance negatively correlated assets helps generate income and potential return while limiting the scope of drawdowns when risk assets sell off.

5. Be nimble. Active managers should prepare to take advantage of quickly shifting valuations and fleeting windows of opportunity as other investors react to headlines. In general, global multi-sector approaches to investing are well suited to a dynamic economic and financial market landscape, as investors can monitor conditions and valuations and shift the portfolio mix as conditions warrant.

The year ahead will bring both challenges and opportunity. By approaching the market with equanimity, bond investors can weather uncertainty with dispassion, embrace the bounty of higher yields and position their portfolios to prosper in the coming year.

The views expressed herein do not constitute research, investment advice or trade recommendations and do not necessarily represent the views of all AllianceBernstein portfolio-management teams.

All returns and financial information are as of December 31, 2022. Source: Source: Bloomberg and AB

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