Invesco

Investment Insights

Portfolio Manager Commentary

Where does fixed income stand?

Taking stock of inflation, banking sector stress and Fed Policy

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Overview

- Banking sector turmoil appears contained following Fed and other central bank actions.
- Fallout from the turmoil is likely to include tighter credit conditions and less bank lending.
- Tighter credit could lead to slower growth and lower inflation – favorable conditions for fixed income.

Fixed income markets have changed a lot from a month ago. Last month the general discussion centered around how high the Fed would hike rates and where the terminal rate would end up. Federal Reserve Chair Jay Powell said that price pressures remained elevated, and that Fed policy needed to remain aggressive. The fixed income market started contemplating a 50 basis point rate hike in March versus the 25 figure it had previously coalesced around. Then Silicon Valley Bank failed, followed by Signature Bank and Credit Suisse. The outlook for interest rates and the economy changed very quickly. Fed rate hike expectations were revised downward and were proven correct. The US 10-year Treasury yield currently sits at 3.42%, down from 4.06% a month ago[1].

This month, we speak to Invesco Portfolio Managers Matt Brill and Todd Schomberg about how they are thinking about fixed income markets in the aftermath of the recent banking sector upheaval. They take stock of where interest rates are headed, their outlook for inflation and the role of Fed policy.

Q: Taking stock after last month's banking sector turmoil, where do things stand today?

When Silicon Valley Bank and Signature Bank collapsed unexpectedly, The Fed swiftly injected generous amounts of liquidity through various facilities, restoring some confidence. It's taken time, but it feels like the market largely believes that the banks, including the regional banks, will weather this storm. Unlike in 2008, the quality of bank assets today is generally high. The current situation involved a mark-to-market issue on high quality securities, versus 2008 when there were problems with the banks' assets themselves and selling them created more panic, cementing further losses on the assets. Given the liquidity-oriented nature of the recent bank stresses, we believe the Fed facilities can help the banks manage through this stress.

Q: What are the likely longer-term impacts of the bank turmoil?

The bottom line is that we think banks will be lending less. Some of the higher quality banks will likely enact tighter lending standards, while the medium quality banks may be more focused on repairing their balance sheets, meaning they will probably reduce their lending outright. This credit contraction could slow the economy, though it is still uncertain whether it would ultimately lead to a soft landing or a hard recession. Our view is that the Fed can achieve a soft landing because it contained the banking crisis fairly quickly. If banking sector stress persists, a soft landing would, of course, be more difficult to achieve. Our baseline view, however, is that the Fed's liquidity support will likely work, based on the notion that this was a problem of high quality assets mismatched with liabilities due to poor management at a few banks, and not a system-wide asset quality problem.

[1] Source: Bloomberg, LP. Data as of 4/11/2023 showing Treasury yields as of 4/10/2023 and 3/2/2023.

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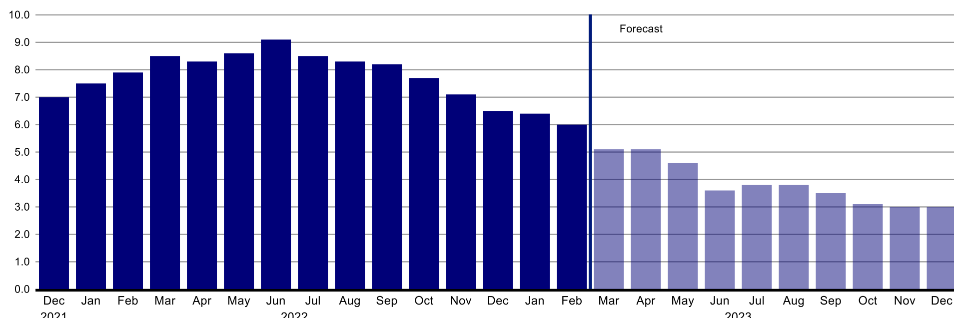
The positive news is that a slowdown of some magnitude could help curtail some of the inflation issues we've had. Tighter lending conditions and slower growth could also aid the Fed by substituting for some of its tightening. As a result, the Fed is probably now at the end of its hiking cycle, and it's probably a coin toss whether it will hike one more time in May - we will need to see how the economic data play out. But either way, the Fed will probably pause after that. If economic activity slows more dramatically than expected, we could even see rate cuts by the end of the year, but that is not our base case. In our base case, growth is likely to roll over a bit and inflation is likely to follow, which tends to be a nice backdrop for high quality fixed income, which is where we are focused in the near term.

Figure 1: Inflation is on the decline in 2023



Source: Macrobond. US CPI YoY NSA with Invesco forecast.

Q: How do you view OPEC's recent plan for oil production cuts?

OPEC's recent decision to cut oil production is worth commenting on. It initially caused the oil price to spike, raising alarm bells over inflation. But we view higher oil prices as a tax on growth that will likely result in slower growth - if the cuts are kept in place. In the past, OPEC has made cuts, then waited for oil prices to rise and then resumed production to profit from higher revenues, so it remains to be seen how long the cuts will last. Right after the announcement, oil and oil-related stocks rose, but stock prices of other large, growth-oriented companies softened. Interest rates also moved lower after the announcement, not higher. So, the market is not telling us that this oil price spike will necessarily be inflationary.

Q: How have fixed income markets reacted to the events of the past month?

Notably, credit spreads have retraced the highs that were reached right before the Credit Suisse unraveling. The spread on the Bloomberg US Corporate Index hit a peak of around 163 basis points right before the Credit Suisse crisis but has fallen back to around 136.[2] I think the market is telling us that the Fed's actions and those of other central banks have helped contain the risk in the global banking sector. We have not yet seen contagion, and risk assets and credit spreads have reacted accordingly by stabilizing. We think this is an important differentiating factor compared to other times when central banks haven't responded as quickly or decisively. Their recent actions have helped stem some of the volatility in markets.

[2] Source: Bloomberg, LP. Data as of 4/11/2023 showing Bloomberg US Corporate Bond Index OAS on 3/15/2023 and 4/3/2023.

Q: What does it mean for your investment strategy?

In this environment, we have favored adding duration with the expectation that the Fed is near the end of its rate hiking cycle. The markets are already pricing in possible rate cuts as early as this fall (Figure 2). Whether or not the Fed cuts rates this year remains to be seen, but we do not fear further aggressive hiking by the Fed. We favor high quality corporate credit that has nothing to do with the banking space, such as utilities, consumer-related companies and non-cyclicals. Credit spreads on these companies widened, even though they were not related to the banking space. That being said, we also favor selected exposure to what we call “super-regional banks”. These are the larger, high quality, regional banks that are well positioned to weather the current environment and whose credit spreads were unfairly punished by the events surrounding Silicon Valley Bank, Signature Bank and Credit Suisse. Not only do the super-regionals enjoy the support of the newly available Fed facilities, but we believe their asset quality and large size will sustain them through the cycle. Our high quality theme also extends to agency mortgage-backed securities, which had dramatically underperformed. With interest rate volatility settling down, we would expect them to perform better going forward. So overall, we see opportunities in adding duration, agency mortgages, investment grade non-financials and certain super regional banks that we think will be able to weather the current environment

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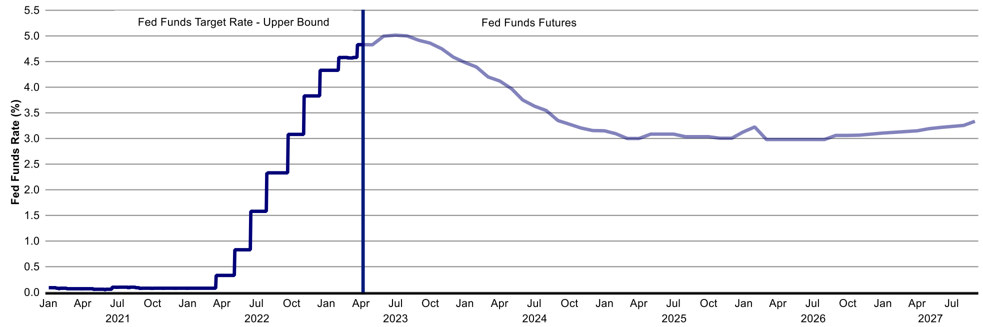
Figure 2: Federal funds futures indicate interest rate cuts later this year



Source: Macrobond. Fed Funds Target Rate – Upper Bound and Fed Funds Futures

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