

Forward Thinking

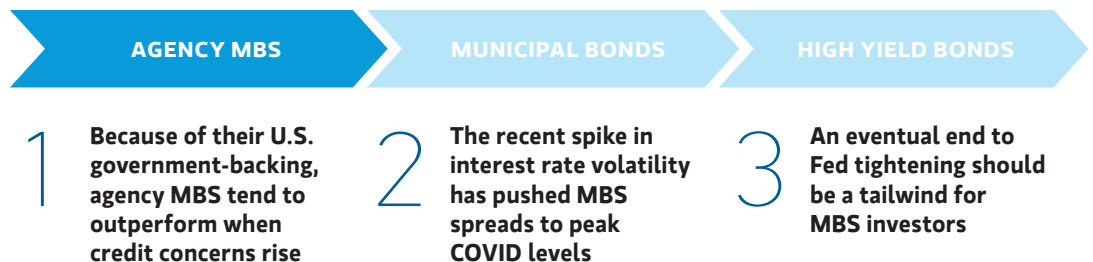
# Navigating the Curve

INVESTMENT INSIGHT | FIXED INCOME TEAM | APRIL 2023

Today's bond market offers investors a rare set of opportunities to suit a wide range of portfolio objectives. Rates have risen across the yield curve in many markets, but the short end has increased more. Our investment managers outline strategies for seeking higher current income or capital appreciation during this unusual yield curve inversion, with more attractive choices than we have seen in over a decade.



**ANDREW SZCZUROWSKI, CFA**  
Head of Agency MBS  
Portfolio Manager

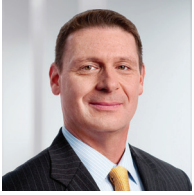


## Agency MBS look set to outshine most other investment grade alternatives

“Recent turmoil in financial markets has led to increased concern about a nearing recession or a potential rise in credit defaults. Flight-to-quality environments, such as 2008 and March 2020, have historically benefited U.S. government securities due to their AAA-rating and the pledge that principal will be returned at par. In a risk-off environment, we would not only expect U.S. government agency MBS to outperform investment grade corporates, as they have done in the past, but for investors actually to be paid for having that extra government backing. Agency MBS spreads are trading near peak-COVID levels, which is more than 20 basis points wider than even Single-A rated corporates.<sup>1</sup> In our view, the asset class’ higher yields and higher credit quality are an attractive combination for the current environment.”

**Note:** The returns referred to in this document are those of representative indexes and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

<sup>1</sup> ICE BofA MBS Index, ICE BofA US Corporate Index. As of March 22, 2023.



**CRAIG BRANDON, CFA**  
Co-Head of Municipals  
Portfolio Manager



- 1 **The macroeconomic picture has become increasingly clouded**
- 2 **High-quality fixed income, including municipals, may benefit from a flight to quality**
- 3 **Exposure to longer-dated fixed income could be beneficial, if duration sees a sudden rally**

### **Municipals are well positioned for a challenging macroeconomic environment**

“The market is pricing in both an economic slowdown and less aggressive central bank action, as recent financial sector woes further complicate the Fed’s battle to rein in inflation. Given the challenging macroeconomic picture, investors may consider adding high-quality, longer duration fixed income segments such as municipal bonds. Technicals appear strong and the asset class could benefit from a flight to quality, given fears of slowing growth. In addition, a less hawkish Fed could be a catalyst for a duration rally. Investors will want a *stick in the fire* to participate in any upturn, as the duration sell off could turn quickly.”



**JEFFREY D. MUELLER**  
Co-Head of High Yield  
Portfolio Manager



- 1 **Yields are hovering near decade-long highs across U.S. and European high-yield**
- 2 **Average bond prices remain significantly below par, offering attractive upside potential**
- 3 **We believe that elevated yields provide significant compensation for increased volatility**

### **Higher yields signal attractive entry point**

“Central bank activity remains a key driver of risk appetite in our markets and will be a determinant in overall yield levels available. As a result, we are closely watching monetary policy and foresee potential for a *higher-for-longer* environment ahead. Historically, starting yields have been a great guide to forward-looking total returns—we believe that this is likely the case once again. Indeed, strengthening investor appetite in early 2023 indicates that today’s higher yields are proving an attractive entry point.”

## **Investor Implications**

### **GOOD ENTRY POINTS**

Last year’s rout in fixed income markets has left starting yields sitting at, or close to, historic highs. From current levels, we see an opportunity to earn respectable income and capital appreciation across the duration spectrum from agency MBS to municipal bonds and longer duration high yield securities.

### **ALWAYS ACTIVE**

While opportunities are emerging, an active approach is warranted for navigating fixed income in the current market conditions. Whether in sovereign debt, corporate bonds or structured securities, we believe that capitalizing on opportunities will require a combination of skilled expertise, careful risk management and the nimbleness and flexibility to adjust positions as market conditions change.

### **SWEET SPOTS**

No two investors will seek to capitalize on the curve in the exact same way. However, broad opportunities exist across several fixed income sectors. This should grant each investor a degree of choice as they seek the sweet spot that best serves their unique aims, objectives and risk tolerance to complement their portfolio.

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**Source of all data:** Morgan Stanley Investment Management, as of March 23, 2023, unless otherwise specified.

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