

Fixed Income Positioning for the Fourth Quarter and Beyond

Phil Gioia, CFA | October 2022

Key Takeaways

- U.S. Treasury yields across tenors are at their highest levels in over a decade.
- While short-end rates could rise further, we believe there is relative value in longer-dated Treasuries.
- The combination of higher rates and wider spreads has led to some of the highest yields across many parts of credit markets in the post-Global Financial Crisis era.
- For investors with an 18-to-24-month horizon, we believe a combination of longer-dated government bonds and higher-yielding credit securities can generate returns in the mid- to high single digits.

Given the repricing higher in U.S. Treasury rates and credit spreads this year, many investors have asked how to position their fixed income portfolios. While each investor's circumstance is unique, the investment team at DoubleLine has recently extended duration across many of our strategies and believes there are opportunities in credit that can generate some of the highest returns we have seen in over a decade.

At the beginning of the year, we suggested investors increase allocations to shorter-duration and/or floating-rate fixed income sectors, as our expectation was the Federal Reserve would need to raise interest rates to combat inflation that likely would not be transitory.

Through the first three quarters of the year, shorter-duration sectors outperformed as the Treasury curve repriced higher due to a hawkish Fed steadfast on combating persistently high inflation. (Figure 1) While shorter-duration sectors have provided some respite, 2022 has been one of the most challenging years for fixed income investors. Year-to-date (YTD) through Sept. 30, the Bloomberg US Aggregate Bond Index ("the Agg") was down 14.6%, on pace for its worst year since its 1976 inception.

Drawdowns in 2022 can be partly attributed to the absolute low yield levels across many parts of fixed income to start the year. At year-end 2021, the yield to worst (YTW) for the Agg was 1.75%, the YTW for U.S. high yield (HY) corporate bonds was 4.21%, and many global government bonds traded with negative yields.¹ When starting off with such low yields, it is difficult to generate positive returns in a rising interest-rate environment.

Fixed Income Performance Overview

As of September 30, 2022

U.S. Treasuries	-13.1%	GOVERNMENT GUARANTEED/ BACKED
Agency MBS	-13.7%	
Agency CMO	-12.6%	
Agency CMBS	-12.3%	
Investment Grade	-18.7%	CORPORATES
Investment Grade - AA	-20.2%	
Investment Grade - A	-18.3%	
Investment Grade - BBB	-19.9%	
High Yield	-15.0%	
High Yield - BB	-14.1%	
High Yield - B	-14.4%	GLOBAL/EMERGING MARKETS
High Yield - CCC	-19.0%	
Global Sovereign Bonds	-21.3%	
EMBI Global Diversified	-23.9%	
EM Corporate Bond	-16.2%	BANK LOANS
Leveraged Loan	-3.3%	
Loans - BB	-0.9%	
Loans - B	-3.7%	
Loans - CCC	-10.7%	SECURITIZED
ABS - AAA	-5.1%	
CMBS - AAA	-11.6%	
AAA CLO	-1.1%	
ABS - AA-BBB	-10.7%	
CMBS - BBB	-12.3%	
BBB CLO 2.0	-7.5%	
Legacy Non-Agency RMBS	-0.4%	
US Aggregate Index	-14.6%	AGGREGATE US INDEX

Figure 1

Source: DoubleLine, Bloomberg

See footnotes at the end of this piece for a full list of indexes referenced.



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Fast-forward three quarters, Treasury yields across tenors have reached their highest levels in over a decade, as the Federal Reserve hiked the target federal funds rate (FFR) 300 basis points (bps). (Figure 2) As of Sept. 30, the two-year Treasury yield was 4.28%, up 355 bps YTD and at its highest level since August 2007. The 10-year Treasury yield was 3.83%, up 232 bps from year-end and at its highest level since April 2010.

U.S. Treasury Yields | As of September 30, 2022

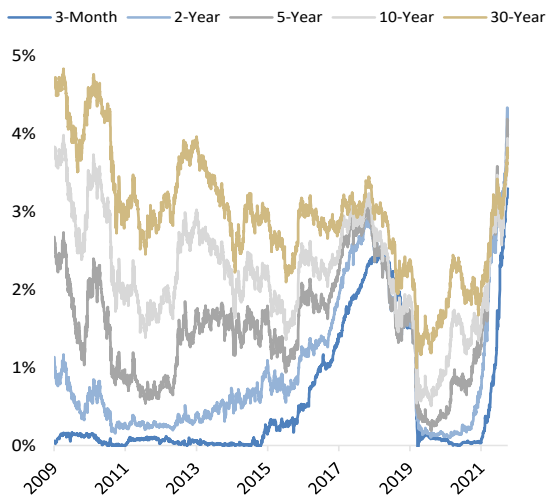


Figure 2
Source: DoubleLine, Bloomberg

Despite the significant moves higher across Treasury rates, short-end rates, which are more sensitive to changes in monetary policy, might still be pressured higher, as the Fed remains focused on bringing down inflation through increases to the FFR. With continued hawkish rhetoric at the Federal Open Market Committee's September meeting, the market's expectation was for the FFR to peak around 4.6% in second quarter 2023, followed by an easing cycle beginning in the latter half of 2023. (Figure 3)

Duration Positioning

While short-end rates could continue higher in the near-term, we believe there is relative value in longer-dated Treasuries that are more sensitive to future economic growth. With investors being compensated for taking interest-rate risk in the form of higher yields, our investment team has recently extended portfolio duration through purchases of longer-dated Treasuries.

However, not all duration exposure will behave in a similar manner. Longer-duration credit sectors, including investment grade (IG) corporate bonds, might benefit from falling long-term rates, but they are susceptible to further spread widening, particularly if the U.S. enters a recession. We believe longer-duration government bonds can help protect portfolios should long-end rates fall, credit spreads widen, and equities remain volatile due to economic weakness.

Fed Funds Implied Policy Rate | As of September 21, 2022

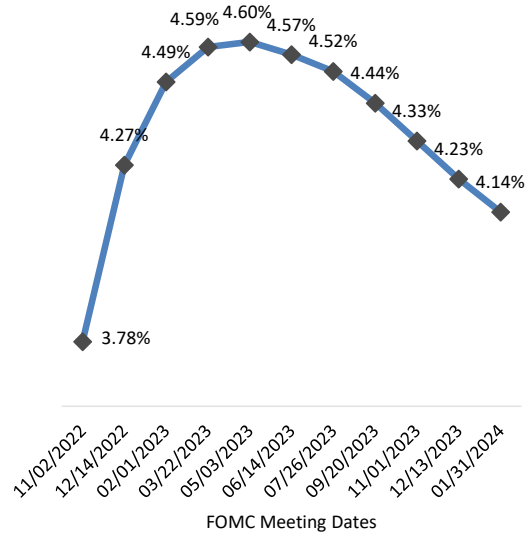


Figure 3
Source: DoubleLine, Bloomberg

Credit markets have been impacted by not only higher Treasury rates but also spread widening alongside broader macroeconomic volatility. YTD through the end of the third quarter, spreads for U.S. IG corporate bonds widened 67 bps and 269 bps for HY corporate bonds.² (Figure 4) The combination of higher rates and wider spreads has led to some of the highest yields across many parts of credit in over a decade.

U.S. Corporate Bond Spreads | As of September 30, 2022

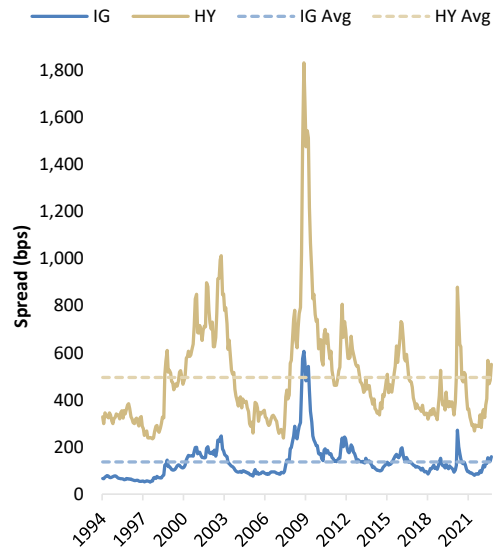


Figure 4
Source: DoubleLine, Bloomberg



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As bond investors, we believe yield is an important driver of forward returns. The current YTW for many bonds rated IG are in the mid- to high single digits. (Figure 5) Further down the capital structure, yields are in the low double digits. We have not seen this type of total return potential within fixed income in over a decade. By way of comparison, the long-run average annualized return for equities has been roughly 7.0%.³

Mezzanine Rated Yields | As of September 30, 2022

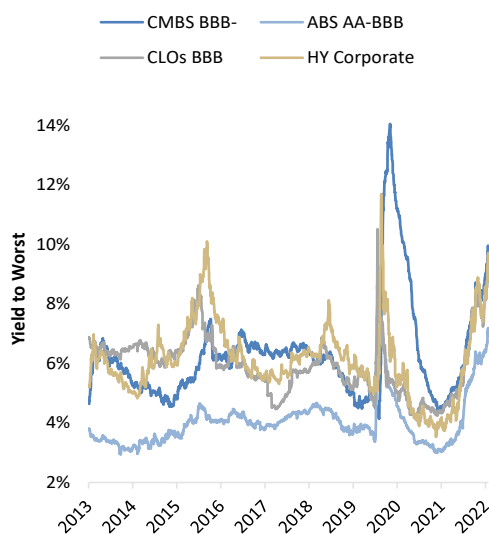


Figure 5
Source: DoubleLine, Bloomberg
Commercial Mortgage-Backed Securities (CMBS); Asset-Backed Securities (ABS); Collateralized Loan Obligations (CLOs)

Credit Positioning

Current spread levels have historically been a good buying opportunity for investors with a horizon of 18 to 24 months. That said, we do expect volatility will remain elevated through year-end and into 2023, as the Fed and other central banks are likely to continue tightening financial conditions, and spreads might widen further should economic data weaken.

However, all-in yields, particularly down the capital structure, present one of the most opportunistic environments in fixed income we have seen post-Global Financial Crisis. (Figure 6) Through active management of sector allocation and security selection, we believe exposure to parts of the credit market can potentially generate low-double-digit returns over a multiyear period. Further, we believe pairing higher-yielding credit with a well-managed duration position in Treasuries can produce better risk-adjusted returns relative to a portfolio of solely credit. ■

Index Yields Year-Over-Year Change | As of September 30, 2022

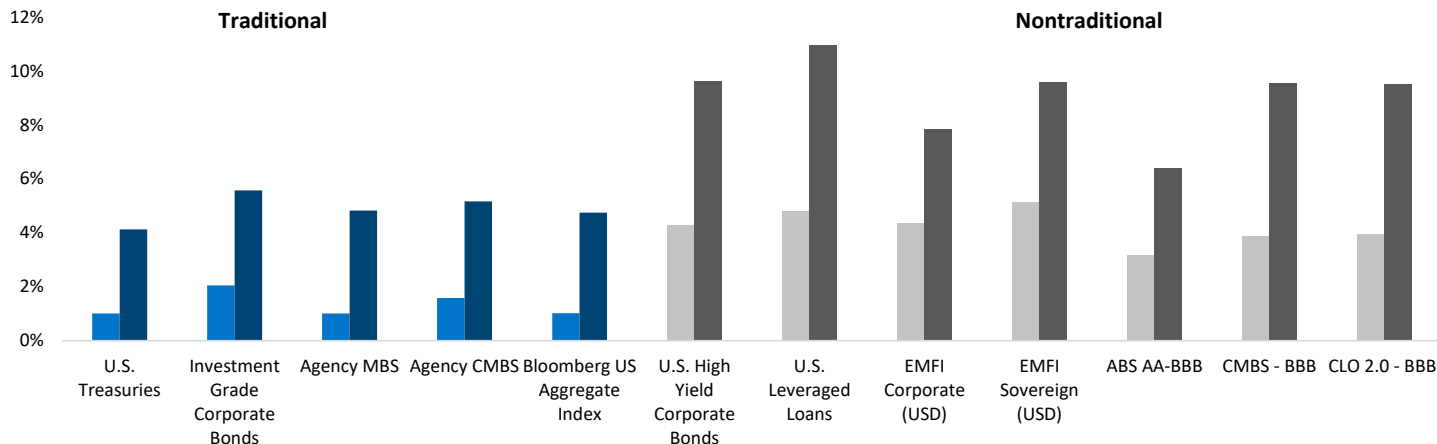


Figure 6
Source: DoubleLine, Bloomberg. Lighter bars represent September 30, 2021. Darker bars represent September 30, 2022.



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Phil Gioia, CFA
Product Specialist

Mr. Gioia joined DoubleLine in 2018. He is a member of the Product Specialist Team. In this capacity, he is responsible for various aspects of DoubleLine product marketing, investment strategy updates, portfolio communications and competitive analysis, with a focus on DoubleLine's Structured Product strategies. Mr. Gioia is also responsible for producing market commentary and dedicated strategy content. As part of the Product Specialist Team he attends the Fixed Income Asset Allocation, Macro Asset Allocation, and Structured Product meetings. Prior to DoubleLine, Mr. Gioia was an Investment Product Manager for Fidelity Investments. He holds a BS in Financial Management and Business Administration with a minor in Accounting from Salve Regina University. Mr. Gioia is a CFA® charterholder and holds the Series 7 and 63 Licenses.

Footnotes

- ¹ Bloomberg US Corporate HY Bond Index
- ² Bloomberg US Corporate Bond Index and Bloomberg US Corporate HY Bond Index
- ³ Annualized return of the MSCI ACWI from Dec. 31, 1987, through Sept. 30, 2022

List of indexes referenced in Figure 1: **U.S. Treasuries:** Bloomberg US Treasury Index; **Agency MBS:** Bloomberg US MBS Index; **Agency CMO:** ICE BofA U.S. Agency CMO Index; **Agency CMBS:** Bloomberg US CMBS Index; **Investment Grade:** Bloomberg US Corporate Bond Index; **High Yield:** Bloomberg US Corporate High Yield Bond Index; **Global Sovereign Bonds:** FTSE World Government Bond Index (WGBI); **EMBI GD:** J.P. Morgan EMBI Global Diversified; **EM Corp Bond:** J.P. Morgan CEMBI Broad Diversified; **Leveraged Loan:** S&P/LSTA Leveraged Loan Index; **ABS AAA:** Bloomberg US ABS Index; **ABS AA-BBB:** ICE BofA AA-BBB U.S. Fixed-Rate Miscellaneous ABS Index; **CMBS returns:** Bloomberg US CMBS Index; **CLO returns:** Palmer Square CLO Total Return Index; **Legacy Non-Agency RMBS:** Markit iBoxx U.S. NA RMBS Index; **US Agg Index:** Bloomberg US Aggregate Bond Index

Definitions

Basis Points (BPS) – Basis points (or basis point (bp)) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument. The relationship between percentage changes and basis points can be summarized as: 1% change = 100 basis points; 0.01% = 1 basis point.

Bloomberg US Aggregate Bond Index – This index (“the Agg”) represents securities that are SEC registered, taxable and dollar denominated. It covers the U.S. investment grade, fixed-rate bond market, with components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indexes that are calculated and reported on a regular basis.

Bloomberg US Asset-Backed Securities (ABS) AAA Index – This index tracks the AAA-rated ABS component of the Bloomberg US Aggregate Bond Index, a flagship measure of the U.S. investment grade, fixed-rate bond market. The ABS index has three subsectors: credit and credit cards, autos and utility.

Bloomberg US Commercial Mortgage-Backed Securities (CMBS) Index – This index measures the market of conduit and fusion CMBS deals with a minimum current deal size of \$300 million.

Bloomberg US Corporate Bond Index – This index measures the investment grade, fixed-rate taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

Bloomberg US Corporate High Yield (HY) Bond Index – This index measures the U.S. dollar-denominated, HY, fixed-rate corporate bond market. Securities are classified as HY if the respective middle ratings of Moody's, Fitch and S&P are Ba1, BB+ or BB+ or below. The Bloomberg US HY Long Bond Index, including bonds with maturities of 10 years or greater, and the Bloomberg US HY Intermediate Bond Index, including bonds with maturities of 1 to 9.999 years, are subindexes of the Bloomberg US Corporate HY Bond Index.

Bloomberg US Mortgage-Backed Securities (MBS) Index – This index measures the performance of investment grade, fixed-rate, mortgage-backed, pass-through securities of the government-sponsored enterprises (GSEs): Federal Home Loan Mortgage Corp. (Freddie Mac), Federal National Mortgage Association (Fannie Mae) and Government National Mortgage Association (Ginnie Mae).

Bloomberg US Municipal Bond Index – This index covers the U.S. dollar-denominated, long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

Bloomberg US Non-Agency Investment Grade Commercial Mortgage-Backed Securities (CMBS) Index – This index measures the market of non-Agency investment grade conduit and fusion CMBS deals with a minimum current deal size of \$300 million.

Bloomberg US Treasury Index – This index measures U.S. dollar-denominated, fixed-rate nominal debt issued by the U.S. Treasury with a remaining maturity of one year or more. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index.

Federal Funds Rate (FFR) – Target interest rate, set by the Federal Reserve at its Federal Open Market Committee (FOMC) meetings, at which commercial banks borrow and lend their excess reserves to each other overnight. The Fed sets a target federal funds rate eight times a year, based on prevailing economic conditions.

Federal Open Market Committee (FOMC) – Branch of the Federal Reserve System that determines the direction of monetary policy specifically by directing open market operations. The FOMC comprises the seven board governors and five (out of 12) Federal Reserve Bank presidents.

FTSE World Government Bond Index (FTSE WGBI) – This broad index measures the performance of fixed-rate, local currency, investment grade sovereign bonds. It is a widely used benchmark comprising sovereign debt from more than 20 countries that is denominated in a variety of currencies.

ICE Bank of America (BoFA) AA-BBB U.S. Fixed-Rate Miscellaneous Asset-Backed Securities (ABS) Index – This index tracks the subset of the ICE BofA U.S. Fixed-Rate ABS Index rated AA to BBB and includes all ABS collateralized by anything other than auto loans, home equity loans, manufactured housing, credit card receivables and utility assets.

J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI BD) – This index is a uniquely weighted version of the CEMBI, which is a market capitalization-weighted index consisting of U.S. dollar-denominated emerging markets corporate bonds. The CEMBI BD limits the weights of index countries with larger debt stocks by only including specified portions of those countries' eligible current face amounts of debt outstanding.

J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI GD) – This index is a uniquely weighted version of the EMBI. The EMBI tracks bonds from emerging markets (EM), and comprises sovereign debt and EM corporate bonds. The EMBI GD limits the weights of index countries with larger debt stocks by only including specified portions of those countries' eligible current face amounts of debt outstanding.



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Definitions (cont'd)

Morgan Stanley Capital International All Country World Index (MSCI ACWI) – This market capitalization-weighted index is designed to provide a broad measure of stock performance throughout the world. It comprises stocks from 23 developed countries and 27 emerging markets.

Palmer Square CLO Total Return Index – This index tracks on a total return basis the Palmer Square CLO (collateralized loan obligation) Senior Debt Index, which comprises CLOs issued after Jan. 1, 2009, and meet certain inclusion criteria.

S&P/LSTA Leveraged Loan Index – This index tracks the market-weighted performance of institutional weighted loans based on market weightings, spreads and interest payments.

Yield to Worst (YTW) – The lowest yield of a bond that can be received short of default.

You cannot invest directly in an index.

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