FIXED INCOME REVIEW AND OUTLOOK

Fourth Quarter 2022

Soft Landing, or Not?

The US economy has shown impressive resiliency in the face of significant headwinds. Inflation at multi-decade highs, weak global activity, a challenging geopolitical environment, a rapid Federal Reserve tightening cycle, negative inflection points within the housing market, and waning fiscal stimulus have all posed challenges, yet growth has bounced firmly back from the negative readings in the first half of 2022. GDP in the third quarter was 3.2% and the fourth quarter is likely to produce another above trend reading. This better than expected outcome can be attributed to many factors, including the still robust labor market, declining level of inflation, albeit from an extreme level, and relatively strong balance sheets across healthier consumer and corporate segments. As measured by AAA, retail gasoline prices declined $0.59 over the last 3 months, giving a much-needed boost to consumer confidence. The unemployment rate held steady at the exceptionally low rate of 3.5% and there remain close to two jobs available for every person seeking employment. This is both good news and bad for the economic outlook. The Federal Reserve and financial markets have cheered strong output growth with declining inflation but the question remains if inflation can move to an acceptable level in an elevated growth environment. A strong labor market has resulted in meaningful wage gains, that if sustained, could make it difficult for inflation to achieve the stated 2.0% target of the Federal Reserve. Services comprise the largest share of the US economy and this sector is highly sensitive to wage costs. This has become the next stage in the evolution of the inflation debate now that Federal Reserve policy has begun to have the intended effects on the housing market. What started as a commodity- and supply chain-led discussion has now moved into the need to weaken the labor market to tame wage pressures and thus inflation. Ultimately, in our view, a requirement for keeping the US economy out of recession and producing the elusive “soft landing” will be a gradual reduction in the demand for labor while still maintaining a low unemployment rate. Given the recent performance of stocks and bonds, along with market expectations that the Federal Reserve will be lowering rates in 2023, we would conclude the “soft landing” thesis remains intact.

INDEX PERFORMANCE AS OF 012/31/2022	QTR (%)	PAST 12 MONTHS (%)
Bloomberg U.S. Aggregate Bond Index	1.9	-13.0
Bloomberg Int. Aggregate Bond Index	1.7	-9.5
Bloomberg U.S. Treasury Index	0.7	-12.5
Bloomberg Long U.S. Treasury Index	-0.6	-29.3
Bloomberg Mortgage-Backed Sec. Index	2.1	-11.8
Bloomberg U.S. Corporate Index	3.6	-15.8
Bloomberg U.S. Corporate High-Yield Index	4.2	-11.2

Source: Bloomberg

Market Review

Although the Federal Reserve increased the overnight interest rate by 1.25% in the fourth quarter, longer maturity US Treasury yields were little changed, although volatility was heightened. The minimal change in absolute yield levels is largely a result of the Federal Reserve meeting market expectations with their well-telegraphed intentions for the path of monetary policy. The lack of a negative central bank surprise, together with stronger than expected economic output and declining inflation, helped riskier asset classes perform better in the quarter. The S&P 500® Index, Bloomberg US Corporate High Yield Index, and Bloomberg US Corporate Index returned 7.6%, 4.2%, and 3.6%, respectively. In contrast, the Bloomberg US Treasury index returned just 0.7%. This period was also a continuation of the unusual positive correlation of fixed income and equity returns.

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Brown ADVISORY
Thoughtful Investing.

Outlook

We still expect significant weakness for the US economy is ahead of us, rather than behind us. The full effects of interest rate increases have yet to be felt and economic leading indicators continue to deteriorate. Historically, survey measures of new orders for both the service and manufacturing sectors of the economy, released by the Institute for Supply Management, have been reliable indicators of future activity. Both are indicating a weaker environment ahead. The housing sector is already in recession due to the rapid increase in mortgage rates and is unlikely to experience a meaningful bounce in the near future. We believe the key, however, to the accuracy of our forecast will be how the labor market evolves over the course of the year. Job openings are elevated and unemployment remains low. The consumer personal savings rate continues to decline and revolving debt is increasing at an alarming rate as people dip into savings and borrow money to meet financial obligations from soaring prices. Yet, they are still employed and thus paying their bills and consuming goods and services. Recently, the Federal Reserve has shifted their focus in the fight of inflation. Their new stated goal is to weaken the labor market in order to exert downward pressure on wage gains. We remain skeptical of their ability to strike the right balance. Therefore, if the unemployment rate moves higher, along with weakness in other sectors, a recession will be the most likely outcome, in our view. We do expect inflation to moderate, potentially more than Federal Reserve forecasts, but don’t anticipate a meaningful loosening of monetary policy over the course of 2023, unless there is a meaningful and unanticipated shock to the economic system. A restrictive level is likely to be maintained for some time. While the depth of the recession may be shallow, the following recovery may be weak as the policy support that historically accompanied economic weakness may be slow to materialize. In this environment, we are particularly concerned about eroding fundamentals in corporate credit. Weaker revenue and higher wage costs will likely pressure operating margins and earnings. Additionally, firms will likely be refinancing at materially higher rates than the recent past. We expect credit spreads to widen and will continue to hold an underweight position with the expectation of adding at more attractive valuations. We do not expect longer-term US Treasury yields to be nearly as volatile as 2022 and are biased for lower rates later in the year. The shape of the yield curve is likely to steepen, in our view, as expected rate cuts become more likely as the year progresses. Higher quality securitized assets should hold up well yet we remain cautious on securitized credit, particularly those backed by collateral we view most at risk. Overall, we expect a less eventful year for fixed income and one that produces meaningful positive return.

DISCLOSURES

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The **Bloomberg U.S. Aggregate Bond Index** is an unmanaged, market-value-weighted index composed of taxable U.S. investment-grade, fixed rate bond market securities, including government, government agency, corporate, asset-backed, and mortgage-backed securities between one and 10 years. The **Bloomberg Intermediate Aggregate Bond Index** is an unmanaged index that consists of 1-10 year governments, 1-10 year corporates, all mortgage and all asset-backed securities within the Aggregate Index. **The Bloomberg U.S. Treasury Index** is an unmanaged index of public obligations of the U.S. Treasury with a remaining maturity of one year or more. The Bloomberg Long U.S. Treasury Index includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have $250 million or more of outstanding face value. The **Bloomberg Mortgage-Backed Securities Index** is a market-value-weighted index that covers the mortgage-backed securities component of the U.S. Aggregate Bond Index. The index is composed of agency mortgage-backed pass through securities of the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac) with a minimum $150 million par amount outstanding and a weighted-average maturity of at least 1 year. The index includes reinvestment of income. The **Bloomberg U.S. Corporate Index** is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers that meet specified maturity, liquidity and quality requirements. The **Bloomberg U.S. Corporate High-Yield Index** measures the market of USD-denominated, non-investment grade, fixed rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt. The U.S. Corporate High-Yield Index was created in 1986, with history backfilled to July 1, 1983, and rolls up into the U.S. Universal and Global High-Yield Indices. The U.S. Corporate Index rolls up to other flagship indices, such as the U.S. Aggregate and the multi-currency Global Aggregate Index. The **Bloomberg Long U.S. Treasury Index** includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have $250 million or more of outstanding face value. The **S&P 500® Index** represents the large-cap segment of the U.S. equity markets and consists of approximately 500 leading companies in leading industries of the U.S. economy. Criteria evaluated include market capitalization, financial viability, liquidity, public float, sector representation and corporate structure. An index constituent must also be considered a U.S. company. Standard & Poor's, S&P, and S&P 500® are trademarks/service marks of MSCI and Standard & Poor's.

An investor cannot invest directly in an index.