Back in Favor: The New Case for Fixed-Income

SEPTEMBER 2023

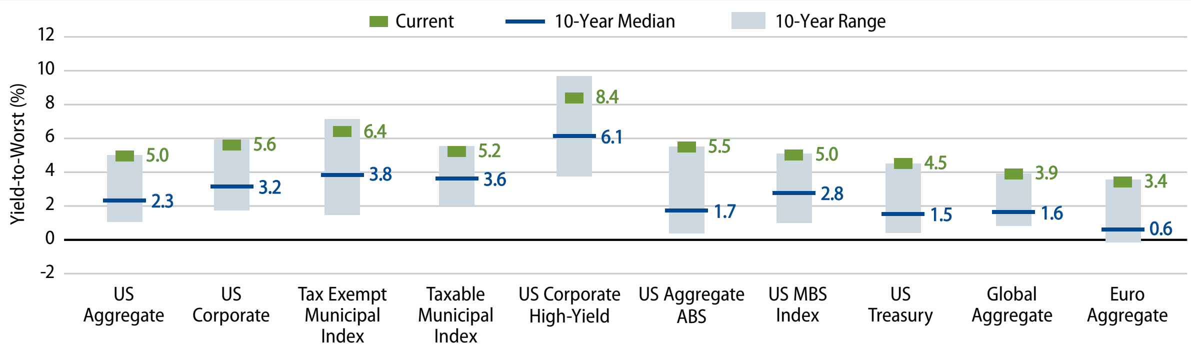
With bonds offering the most attractive yields in nearly 15 years, this could be an ideal time for investors to reconsider their allocations to fixed-income. Given today's investment environment of higher rates, lower inflation and the Fed likely at or near the end of its current rate-hiking cycle, the backdrop appears quite favorable.

What's more, after 2022's poor returns for nearly all risk assets and the breakdown of the traditional 60/40 (equities/bonds) portfolio, historical correlations have largely been restored. Bonds once again can serve as a valuable hedge to equities and other risk assets. This is especially important as they offer compelling income in both nominal and real terms, which is well above recent equity yields (S&P dividend yield of 1.6%). In other words, one of the most important qualities of fixed-income—the diversification benefit—appears to be functioning again. Finally, we believe current yields may be a good indicator of what investors can earn over time.

1 **Attractive Valuations:** Most Favorable for Investors in Last 15 Years

Bond valuations are attractive—with investment-grade credit currently yielding around 6%, investors can beat cash rates and don't need to reach for yield in riskier sectors any longer. Bond yields are also as attractive as they've been since the global financial crisis, according to Bloomberg. But one benefit in the aftermath of 2022's rough patch is that yields and valuations have been restored—offering new opportunities for carry.

Exhibit 1: The Return of Appealing Returns—Fixed-Income Yields by Sector



Source: Bloomberg. As of 31 Aug 23.*

- *Following the recent rough patch, bond yields and valuations have been meaningfully restored.*
- *Attractive valuations amid falling inflation sets the table for a more promising investment environment.*
- *When rates are higher overall, sector-specific investments tend to present better opportunities for enhanced yield.*

2 **Improving Backdrop:** Strong Tailwinds for Fixed-Income

We believe that inflation in the US has peaked and is now headed lower (albeit in a two steps forward, one step back cadence.) Fiscal policy stimulus is abating after carrying the economy through the Covid pandemic. Along with the Fed's rapid tightening of policy, the year-over-year change in the money supply is now negative for the first time since the Great Depression. These headwinds to inflation should command the attention of central bankers, as they often cite the "the long and variable lags" to policy effects. Fed policy from here is likely to be asymmetric in terms of interest rate hikes versus cuts given that real rates are already higher than they've been in years. We believe the Fed is more likely to bring interest rates down if there is ultimately a recession than it is to hike further to bring down inflation.

Exhibit 2: Post-Hike Return Bumps for Bonds Over the Years

			Bloomberg US Aggregate Index Returns			
Period	**Rate Hike**	**Event**	**+6-Mos**	**+1-Yr**	**+3-Yr**	**+5-Yr**
Mar 1988 - Feb 1989	3.25%	Savings and Loan Crisis	9.4%	12.9%	12.3%	11.0%
Feb 1994 - Feb 1995	3.00%	Bond Market Massacre	8.9%	17.1%	10.2%	7.3%
Jun 1999 - May 2000	1.75%	Dot-com Bubble	7.7%	13.7%	11.1%	7.8%
Jun 2004 - Jun 2006	4.25%	Housing Bubble	5.4%	6.5%	6.6%	6.6%
Dec 2015 - Dec 2018	2.25%	Oil Price Collapse	6.0%	8.8%	5.0%	-
Average	**2.90%**		**7.5%**	**11.8%**	**9.0%**	**8.2%**
Mar 2022 - Present◊	5.25%	Inflation Spike Post COVID-19	-	-	-	-

Source: Bloomberg. Federal Funds Rate Index, US Aggregate Index. Returns for periods greater than one year are annualized. ◊As of 04 Sep 23.
Past results are not indicative of future investment results.

- *Historically, following a pause by the Fed after a series of rate increases, bonds have delivered positive returns, and we expect the Fed is either at or nearing the end of its current hiking cycle (which began in March 2022).*
- *Regardless of a hard or a soft landing for the economy, bonds have traditionally provided an attractive stream of income.*
- *The unprecedented magnitude of this latest hiking cycle is another reason why we believe bonds will offer attractive returns for investors.*

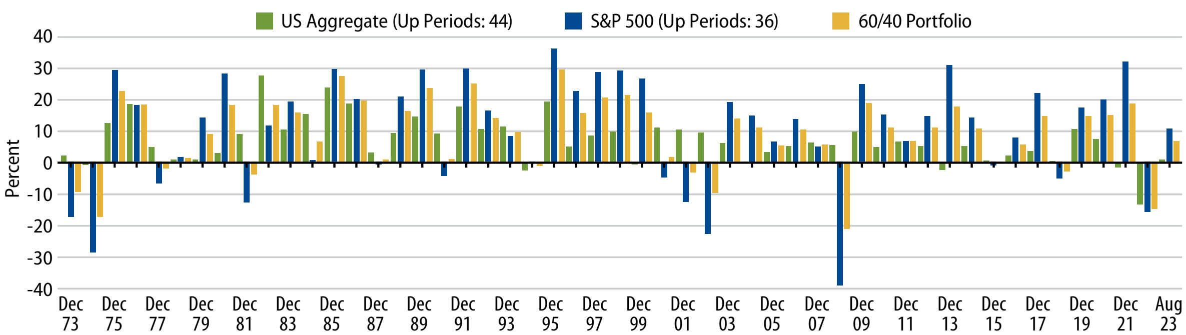
**Bloomberg, US Aggregate Total Return, Global-Aggregate Total Return, US Corporate Total Return, US Corporate High Yield Total Return, US Treasury Total Return, Municipal Index Taxable Total Return, US MBS Index Total Return, US Aggregate ABS Total Return, EuroAgg Total Return. Yield-to-worst is the lowest possible yield that can be received on a bond apart from the company defaulting. All sectors shown are yield-to-worst except for Municipals, which is based on the tax-equivalent yield-to-worst assuming a top-income tax bracket rate of 37% plus a Medicare tax rate of 3.8%.*

3 **Diversification Benefits:** Traditional Correlations Are Back

Lower and more stable inflation—along with the Fed's admission it is likely nearing the end of its tightening cycle—has helped equity/bond correlations return to their historically negative relationship. YTD, equities are up 13% and Long Treasuries are down more than 8%‡; bonds once again offer compelling value as hedges to equities. In short, the classic 60/40 investment strategy is working again. The evidence of this can be seen in the sharp decline of bond yields in March 2023 (notably at the front end of the yield curve) following a "flight to quality" due to heightened concerns over US and European banking system stability. We are painfully aware that markets are not linear and there will be setbacks—case in point: the Treasury market performance in August 2023 that resulted in more positive correlations between stocks and bonds. However, we firmly believe that over the long run, bonds will behave like bonds again, and the negative correlation should ultimately revert to its historical relationship.

Exhibit 3: Annual Returns Comparison

	10-Yr		20-Yr		Since Inception (01 Jan 76)	
	Annualized Return	Standard Deviation	Annualized Return	Standard Deviation	Annualized Return	Standard Deviation
US Aggregate	1.5%	4.3%	3.1%	3.9%	6.6%	5.3%
S&P 500	10.7%	14.8%	7.8%	14.7%	8.6%	15.1%
60/40 Portfolio	7.2%	9.5%	6.2%	9.2%	8.0%	9.8%

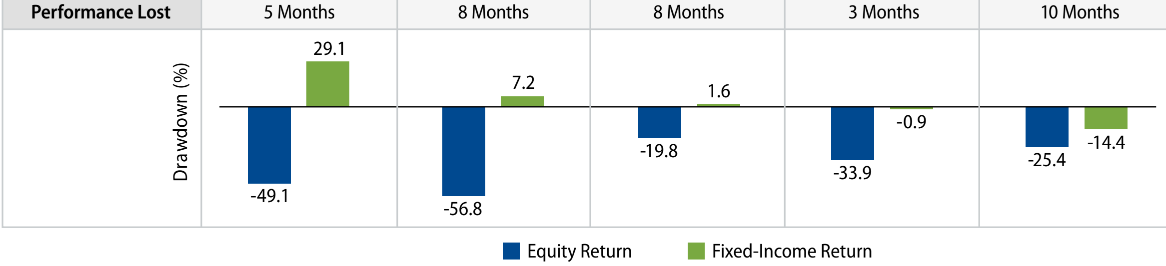


Source: Bloomberg, Western Asset, US Aggregate Index, S&P 500 Index (SPX). As of 31 Aug 23.
Past results are not indicative of future investment results.

- *The Classic 60/40 diversified portfolio can help dampen volatility while preserving returns, especially over longer time horizons.*
- *Over the 50-year period shown here, the benefit of 40% fixed-income in a balanced portfolio is clear.*
- *For the majority of the calendar years shown—and for over a century—stocks and bonds have been negatively correlated.*

Exhibit 4: Fixed-Income Allocation Helps Avoid Portfolio Wipeouts in Volatile Markets

Drawdown Event	Tech Bubble	Global Financial Crisis	Trade War (US & China)	Covid	Post-Covid Inflation Crisis
Years of S&P 500 Performance Lost	5 Years 5 Months	12 Years 8 Months	1 Year 8 Months	3 Years 3 Months	1 Year 10 Months



Source: Bloomberg. S&P 500 Index, US Aggregate Index. As of 31 Aug 23.

- *This chart illustrates the extent to which fixed-income can help portfolios mitigate against major losses, irrespective of historical events.*
- *The five crisis periods shown demonstrate just how significant equity losses can be during major drawdown events.*
- *While the post-Covid inflation crisis has proven to be an outlier, this graphic reinforces just how resilient the diversification benefit of fixed-income has been over the long term.*

‡Bloomberg, S&P 500 Index, Long US Treasury Index. As of 26 Sep 23.

Key Takeaways

- *Given where we are now (i.e., post-Covid, falling inflation, higher rates, restoration of bonds' diversification benefits), we believe that the case for fixed-income is very strong.*
- *Although cash rates are currently attractive, investment-grade credit yields are currently offering outperformance.*
- *Government bond yields are modestly lower than cash rates but look cheap in real terms (30-year Treasuries currently offer 2% real yields), and if yields fall Treasury yields should outperform cash significantly.*
- *Fixed-income has earned its place in investor portfolios due to its long track record—over a century—of providing ballast due to its historically negative correlation to equities.*
- *Today's higher rates and opportunity for enhanced yield across a variety of fixed-income sectors underscores the appeal of the asset class.*

Western Asset's **Active Management Advantage**

Western Asset's deep research, distinct market views and value-investing style distinguish the Firm from other traditional bond managers. By adhering to our time-tested investment philosophy and process, we have historically delivered favorable long-term performance outcomes for our investors. In our portfolios, we've been adding to carry trades at wider spread levels, and we expect income to be the primary driver of overall total returns at this point in the market cycle. In addition, we believe that perpetually blending long-term value opportunities with multiple diversified strategies and active sector rotation is key to meeting our clients' investment objectives within their risk tolerances.

Our Long-Term Fundamental Value Approach

- Our global investment team constantly analyzes macro elements such as real and nominal interest rates, yield curves, currencies, volatility and global central bank policies. We also pay vigilant attention to interest-rate duration, yield-curve positioning, sector allocation, security selection, country and currency considerations, and specific-issue opportunities.
- Our consistent approach helps minimize the distraction of short-term market noise allowing us to instead focus on discovering areas of opportunity.

Diversified Sources of Return

- Our fixed-income team explicitly measures contributions to risk, both in absolute terms and through the lens of expected risk reduction based on correlation metrics. As such, we deploy multiple, diverse strategies so that no single theme dominates performance, which helps to dampen portfolio volatility.
- As a result of our team-based investment management approach and deployment of diversified strategies in client portfolios, there is no reliance on individual investment calls, further serving as a risk mitigator during various periods of market volatility.

Since 1971, regardless of whether markets are risk-on or risk-off, our consistent approach to active management of fixed-income investments allows us to combine the tenets of long-term fundamental value investing with multiple diversified strategies to help us meet our clients' objectives.