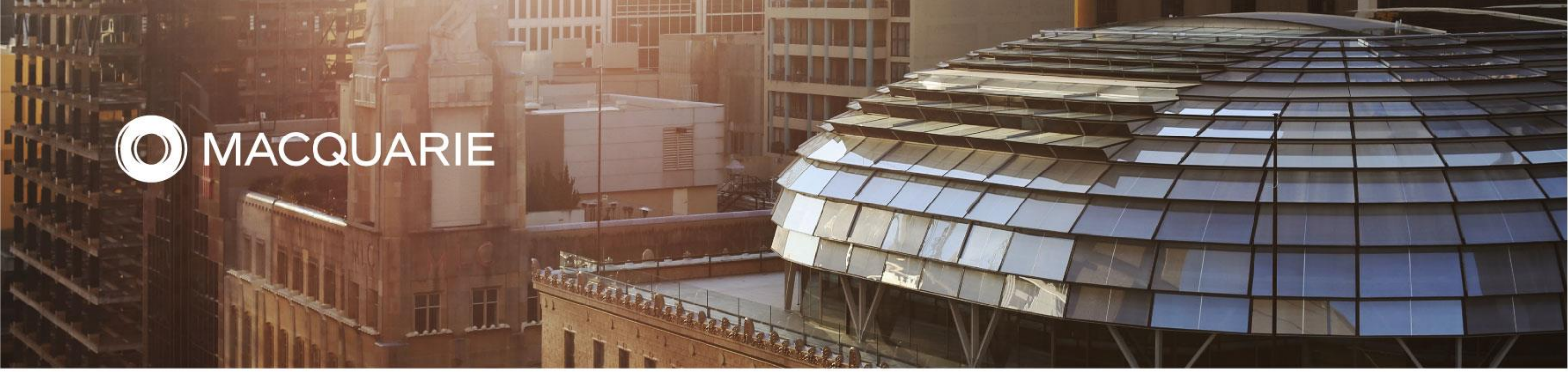


Investment Strategy Update #130

Fixed Income Outlook – Expecting a *"good"* if not a *"great"* year for bonds

- 2022 was the worst year for US sovereign bonds since 1788 and the second consecutive year that sovereign bonds posted a negative return. If 2023 was another negative return year (meaning 2021, 2022 and 2023 were all in the red), it would be the first time in history that the bond market would post three consecutive years of negative returns.

- We don't expect this to happen. We think bonds have a positively skewed return outlook where downside is limited due to an improving inflation and rates outlook while upside could be anywhere between *"good"* and *"great"* depending on whether we see an 'average" or a "worse than expected" economic slowdown.

- We are less optimistic on low quality credit, and this drives a strong relative preference for IG over HY While we see limited risk of a disorderly and/or systemic spike in spreads due to solid corporate fundamentals, we don't think spreads reflect the coming economic slowdown. Spreads typically widen during recession, no matter how deep, and we think spreads should at least reflect "average" recession levels before we would consider taking a more constructive view.

- Notwithstanding some near-term downside risk for credit, yields across all fixed income sectors are compelling particularly versus those on offer over the past decade. For investors with a long-term investment horizon, and who can tolerate near-term volatility, the rate reset through 2022 has provided an extremely appealing entry point for fixed income investors.

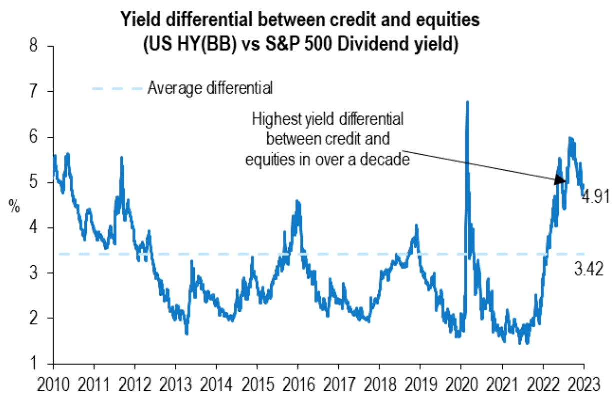
- Investors should look to add sovereign exposure while remaining cautious on credit. For relative credit investors, we think the outlook for investment grade is more appealing than high yield, but this is against a backdrop which sees all credit sectors broadly underperform sovereign bonds.

Absolute and relative value appeal

We are positive on the outlook for fixed income markets. While 2022 was a horrible year for fixed income investors as a decade of low interest rates and ample liquidity came to an abrupt halt, we think 2023 will reverse this trend with the potential for an "average" if not "better than average" year for returns depending on the path for policy rates and the depth of the economic slowdown.

For the first time in over a decade bonds now provide attractive yields on both a relative and absolute basis with the additional benefit of low price volatility and some degree of capital preservation.

Bonds versus equity yields are at decade highs



Source: Factset, MWM Research, February 2023

Sovereign Bond Outlook: Returns skewed to the upside

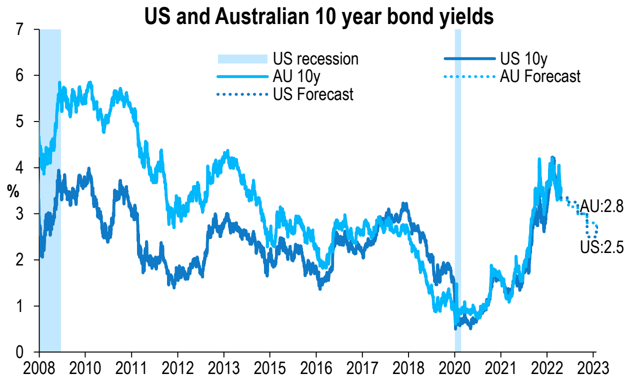
We think we have seen the cycle high in global bond yields and believe the return outlook for sovereign bonds is skewed to the upside for a few reasons:

1. **Headline inflation has peaked** or is close to peaking in laggard nations such as Australia with both near and long-term inflation expectations moderating. Bond yields don't necessarily need to fall in line with inflation, but it does remove a strong upside driver.

2. **Policy rates are close to peak** and with it the potential for hawkish central bank surprises. While uncertainty remains around terminal policy rates, hawkish rhetoric has softened, and the size of rate hikes has normalised across most key central banks. History shows that central banks don't like to sit on their hands, and while some market participants might be premature in expecting rate cuts, the average "pause" period has only been 5 months.

These two forces are likely to put downside pressure on yields as we move through 2023 although we can expect a continuation of two-way volatility as fixed income markets remain sensitive to surprises – both good and bad.

Yields to continue falling as growth slows



Source: Factset, MWM Research, February 2023

Macquarie's economists expect yields on 10-year US and Australian government bonds to be 2.5% (from ~3.5%) and 2.8% (from ~3.6%) by end 2023, respectively. At this stage, it is hard to think that long bond yields fall any further than this unless we see the Fed and/or the RBA begin to cut rates earlier than expected. This is because the spread with policy rates is already approaching all-time highs. However, from an investment perspective, our central case is for sovereign bonds to post total returns which are slightly better than "average" at 11%, with the prospect of a "great year" at 23% should the economic slowdown prove to be deeper than expected.

While there are risks to our total return expectations should the path of inflation and rates not unfold as we expect, we estimate the downside to be limited. Should yields return to previous cycle highs, we estimate total returns in the range of -2% to -3% for Australian and US bonds respectively.

Estimated total returns on US and AU 10-year bonds

	Approx change in yields (bps)		Estimated total return (%)	
Scenario	US 10yr	AU 10 yr	US 10yr	AU 10 yr
Short shallow recession	-100	-75	11	9
Long deep recession	-250	-200	23	19
Return to cycle high	70	65	-3	-2

Source: Factset, MWM Research, February 2023

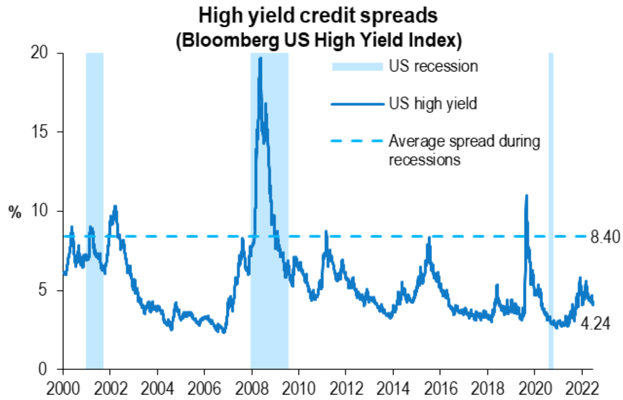
Credit Outlook: Spreads don't reflect growth slowdown

Credit spreads typically widen into a recession as corporate defaults rise, and lending standards tighten. We do not anticipate that this time will prove to be any different.

While credit spreads did widen through 2022, they do not yet appear to be pricing in even a mild recession. We expect credit spreads to widen by approximately 350bps to levels seen in an "average" recession but think solid fundamentals and an imminent reversal in policy rates will prevent a more extreme (systemic) move in spreads like was seen through the Global Financial Crisis in 2008/09, the onset of the pandemic in March 2020 or deep economic recessions such as in the early 1990s.

We prefer investment grade relative to high yield. Investment grade spreads are less volatile, reflecting a greater creditworthiness relative to high yield. Additionally, total returns for investment grade credit are less sensitive to spread widening than in high yield. In the scenario where economic growth weakens and credit spreads widen, we expect interest rates to fall, dampening the impact on investment grade total returns.

Credit spreads are expected to reach "average" recession levels



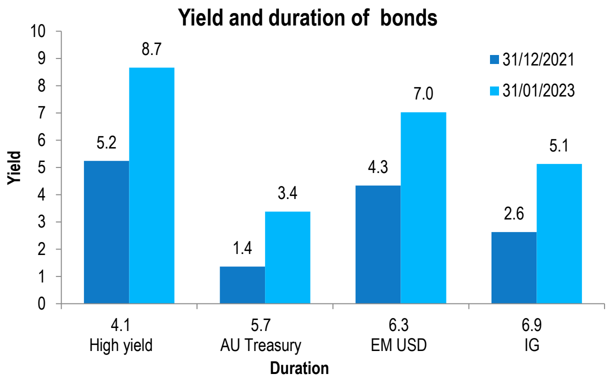
Source: NBER, Factset, MWM Research, January 2023

Attractive entry points for long term investors

While we see further weakness in some areas of credit, we don't think there will be much permanent scarring from the bond market rout in 2022. Consequently, we are positive on fixed income given attractive yields, the prospect of capital protection as growth risks intensify (and growth assets weaken) as well as a normalisation in correlations with risk assets.

Prefer sovereign bonds over credit: We like the yield appeal of sovereign bonds as well as the potential for solid capital appreciation. In addition, we put the likelihood of capital losses (rising bond yields) as very low outside of tail risk outcomes. Credit is a relative call. We think sovereign bonds will outperform credit as growth risks intensify and this means high quality credit (investment grade) should outperform low quality credit (high yield). As confidence in the cycle improves, we would expect the credit outlook to improve vis-à-vis bonds, but at this stage we think it remains too early for this risk on position.

Yields across all fixed income sectors are compelling



Source: Factset, MWM Research, January 2023

For investors with a long-term horizon and who are able to look-through short term downside risk, we view current yields available across all fixed income sectors as an attractive long term entry point.

High yield credit looks particularly compelling to us. The average price of high yield bonds (~$85) is trading well below $100 (or par). Ignoring defaults and assuming average maturity of 3.5 years, this implies an expected return of ~20% pa over the next three years. While investors need to understand that defaults and spreads will rise and this position will be volatile, we would argue that with bond prices at current levels those that can look through to the other side of recession are being well compensated.

Macquarie WM Investment Strategy Team

The report was finalised on 6 February 2023.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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