Payden&Rygel
Investment Management

Fixed Income, Fundamentals and the Fed: A Conversation with Payden & Rygel's Natalie Trevithick

Natalie Trevithick is a Director and Head of Investment-Grade Credit at Payden & Rygel, a global asset management firm with $148 billion in assets under management. We spoke to her to get her perspective on corporate bonds, the fixed income market and what investors can anticipate for the rest of 2023.

Putting your hat on as a fixed income manager, what macro trends are you looking at in the markets?

We're looking at the major macro trends that the market is focused on – that's primarily going to be inflation. Then it's also going to be the employment picture, U.S. gross domestic product. GDP came in strong in March at 2.6%. So, all signals are indicating that we aren't currently in a recession, but with the latest banking fallout, we have to be cognizant that there are other risks in the system. And even if we don't see banking failures, what we're really watching is the extent to which banks are accessing the Federal Reserve's lending programs. We're also looking at banks' lending standards to their clients, including many small businesses. That's probably not going to be felt yet, but that's also something that could slow the economy if these regional banks have to tighten up their lending standards.

Bonds have been in the spotlight this year, but the volatility makes our heads spin. Why is there so much volatility in the fixed income market, particularly the treasury market?

Yes, the volatility has been astounding this year. In January, Federal Reserve Chairman Jerome Powell was trying to be extremely hawkish, telling the market that they were going to continue hiking and there would not be any big cuts. But the market wasn't buying what he was laying down. Rates continued to fall in January and credit spreads were quite strong. Then all of-a-sudden we got that January employment data, 500,000 added to payrolls, and that brought religion to markets - inflation is a concern and employment is definitely not a problem. So that caused rates to skyrocket again with the two-year Treasury going to 5%. However, then came along the banking crisis, which caused rates on the two-year to fall over a hundred basis points. And since that time people thought the problem solved, but I don't think we're out of the woods quite yet.

Is there a way for investors to harness and take advantage of all this volatility?

There are a couple of ways. Despite the bond volatility, bonds are producing positive returns year-to-date, and that's a nice change from last year, since we are close to the end of the Fed hiking cycle. Investors can simply buy six-month Treasury bills. Those are yielding about 4.75%. That's a very attractive yield from where they've been for several years, and that's really a risk-free rate to lock in these returns.

Some investors may want to go a little bit longer though, because then you face less reinvestment risk if rates have fallen in six months' time. So you could think about extending out and buying two-year Treasuries at 4.1% or even 10-year Treasuries at 3.5%. Then if you are willing to go a little further out the risk spectrum you could buy investment-grade corporate bonds, which would add about another 1.5% to your total yield over U.S. Treasuries and enable you to lock in these higher yields for a longer time.

That does sound attractive to lock in these rates, but what are the risks to that?

There are absolutely some risks. The first is going to be the interest rate risk if the Fed has to hike more than expected. If inflation doesn't start to come down, we could see higher interest rates erode returns a little bit. The other concern is spreads could widen. Spreads have widened this year about 20 basis points, but they've retraced about half of the widening from the highs, at the height of the banking crisis. But in a recession, they should be wider than they are today. The other concern is spreads could spike a little bit, but the good news is corporations are well positioned to weather a recession. So we don't think that means there's going to be loss of principle or you aren't going to get your coupon payments. You just might get some volatility from month to month. And that's really what we've been seeing for the past years' time, pretty extreme volatility. But we do think still there should be positive returns in corporate bonds in 2023.

In terms of a recession and recession expectation, what is the feeling at Payden? Is it going to be a mild recession or more severe, or do you even think we will have a recession?

We do think a recession is more likely than not in the next six to 12 months. We were in the camp, before the banking crisis, that the Fed was doing a pretty good job, and maybe they could orchestrate a soft landing or avoid a recession. But given some of this instability in the markets, we don't think we're completely out of the woods yet. As I mentioned, there are going to be stricter lending standards going forward. We think a recession is more likely than not and that we may have a little bit more of a bumpier landing than before. You've got to think that these corporations, and even the small businesses, are looking around at the environment and saying, this is going to be a tougher time. We don't want to engage in more hiring. We want to wait and see what happens. We think this could stall the economy a little quicker than before.

If we have a recession, be it, mild or more bumpy, what will be the impact on the fixed income markets?

It's good and bad. It's going to be good from the perspective that Treasury yields would likely fall further if the Fed were to cut rates, and that would increase bond prices. But it could be a negative from a spread perspective, in that credit spreads would be expected to widen into a recession and really which one wins out depends on the severity of the recession. We think ultimately rates could move lower and that could be positive, but some of this may be offset by spread widening. However, over the long term, we think bond investors are likely to be rewarded with positive returns in the year ahead.

This is an interesting time for fixed income investors. There are so many different possible scenarios. What questions do your clients have? Are you advising clients to go out on the duration timeline?

We work with our clients to understand their preferences and a lot of them are matching assets and liabilities. We offer a broad range of strategies such as absolute return where we make more of the active duration choice. However, a lot of investment-grade corporate investors understand their duration and time horizons and they will make the decision on their maturity and duration profile. We continue to see demand in the front-end from many investors given the inverted yield curve, while we are also seeing demand for 10 and 30-year U.S. corporates from the likes of pensions and insurance companies. We typically manage corporate portfolios relative to an index chosen by the client and then take active duration views around that relative duration positioning to that benchmark. So we're a little bit agnostic here.

And that's because we're in a scenario where we don't know where interest rates are going and if they come down, you want to be locked in.

Exactly. Even though you may get a great return for six months or a year, you don't have the same benefit of locking in these rates for 30 years.

You've been involved with the fixed income markets for a couple of decades now, historically do these rates look high to you?

They definitely look high since the great recession. But they were actually higher before 2008 than they are now. It seems like maybe systemically we've headed into a lower interest-rate environment, but I think people have gotten too comfortable with this zero-range ban we've enjoyed for most of the past 15 years and that that's not really a sustainable environment. We will see if the Fed can get inflation back down to 2%, which would then allow them to eventually lower interest rates again. But it seems unlikely we will need to go back to that zero range unless something dramatically bad happens to the economy.

You believe that there will be positive returns in the bond markets in 2023. Is that a fair statement?

Most likely, but I'm not going to guarantee that. You never know what can happen. I think there's still a lot of uncertainty in the environment, but as I said, it feels like interest rates may have peaked. While there is a chance we may see another spike higher from here, we ultimately think the trend in 10-year Treasuries is likely back down to 3% or lower in the coming years. Given that bond prices move inversely to interest rates, we think U.S. corporates are decently positioned to perform in the year ahead, but there's likely going to be more volatility and some surprises along the way.

Are you looking in the banking sector for corporate bonds that look attractive?

Yes, the global banking sector is huge obviously, and it's a big component of a lot of our indices, typically a quarter to a third percent of their total market value. Banks also tend to come to market quite frequently. They're very liquid, so they have a lot of desirable characteristics. We think that the capital ratios of the major globally systemic, important banks are still quite strong and they may be a beneficiary of some of the regional bank outflows. But we also recognize that the regional banks are systemically important to the operation of small businesses, particularly in the US. In terms of

attractiveness, they've definitely cheapened up and offer value, but we do think there could be more volatility in the coming months and quarters. It's just one area that we're paying very close attention to.

What sectors on the corporate side are you finding the most value?

All U.S. corporates have cheapened up, and we're seeing attractive value coming from a diverse range of sectors. But in particular, we currently like some of the more defensive sectors including utilities, communications and healthcare. Even in sectors that we aren't overly constructive on, we may still see value in specific credits. We do careful bottom-up analysis to identify the companies that we think are likely to outperform given our macroeconomic outlook. Our credit analysts place an emphasis on meeting with management teams and taking a forward-looking approach to their analysis. They focus on what these companies may do in the future, such as what type of merger & acquisitions or spinoffs they may engage in, and the positive or negative impact that may have on bond holders.

I'm going to just throw out a very general question. After all of the trauma in the bond market in 2022, this is a time to really consider fixed income from your perspective? In other words, don't be afraid of 2022. 2023 is a whole new ballgame.

We can't repeat 2022 because we really couldn't imagine interest rates going up another 4% from here. If that were to occur, we would likely be facing much more severe inflation concerns and we just don't think we're heading into that environment. Inflation does seem to be easing, even if it takes time for the impact to actually show up in the data. So we do not foresee a repeat of 2022. 2023 brings with it its own challenges in terms of how we work with this changing banking environment, the approaching recession, and just how aggressive the Fed's going to be and the lag effects.

We're still waiting eagerly to see how this all plays out. This is a good time for investors to not be overly defensive because you don't want to miss out on the returns. Look at the equity market, you still see the NASDAQ doing phenomenally well this year, despite all of these events taking place. So we aren't advising being overly cautious, but be able to stay liquid and be able to take up or take down your risk as the environment warrants. And we think bonds are a very good place to be as part of the stable portion of a well-diversified portfolio. Not to go all-in on bonds per se, but we think they definitely have a place within your broader portfolio.

Are there any bond sectors in the bond market, beyond investment grade, investors should be looking at now?

Sure. The high yield market has come under pressure and spreads have widened, but it's a very diverse sector. There's BBs down to CCCs. We actually think the BBs and even B portion of the market is bound to do well in this environment. They've taken advantage of the cheap financing rates over the past several years, so they don't really have a looming maturity wall. We think CCC securities could be more at risk, especially with these elevated refinancing rates. Their funding costs have gone up quite dramatically. So there may be a little bit more stress in that part of the market.

Within securitized markets, we think there's some opportunity within asset backed securities. Some AAA tranches have gotten pretty cheap. We'd be a little bit more cautious on the collateralized loan market. We also like good old-fashioned U.S. Treasuries. As I said, the Treasury market is more compelling than it has been in a long time. If you just kind of want to wait out this volatility, or think equities are overvalued here and are due for a pullback in a recession, then Treasuries are a nice safe-haven place to

be. And there's also value in emerging markets. That's an area where we spend a lot of time, our analysts go visit these countries, meet with the governments and get their perspectives. While emerging markets do carry their own idiosyncratic risks, they have cheapened up and present some compelling risk-adjusted relative value, particularly within a well-diversified mutual fund.

Is there anything else you feel that investors should be looking at in the market?

You just have to be vigilant. People always ask us to make predictions on where the 10-year Treasury is going to go or what the Fed's going to do. But the reality is we receive new information on a daily-basis and you have to synthesize that into your portfolios, make the minor adjustments, and really be watching and listening to what's happening in the market to capture opportunities for alpha, but also while paying a very close attention to risk management and mitigating the big risks that may occur in the market.

This article is for illustrative purposes only and not intended as professional tax, legal, or financial advice. Please consult your tax, legal, and financial adviser to review your specific circumstances. The statements and opinions herein are current as of the date of this document and are subject to change without notice. Additionally, the opinions expressed in this article may not necessarily be indicative of the house view of Payden & Rygel. This material may not be reproduced or distributed without Payden & Rygel's written permission.