FIXED INCOME INSIGHTS / 3Q 2023

Where are We Now?

Weitz | INVESTMENT MANAGEMENT

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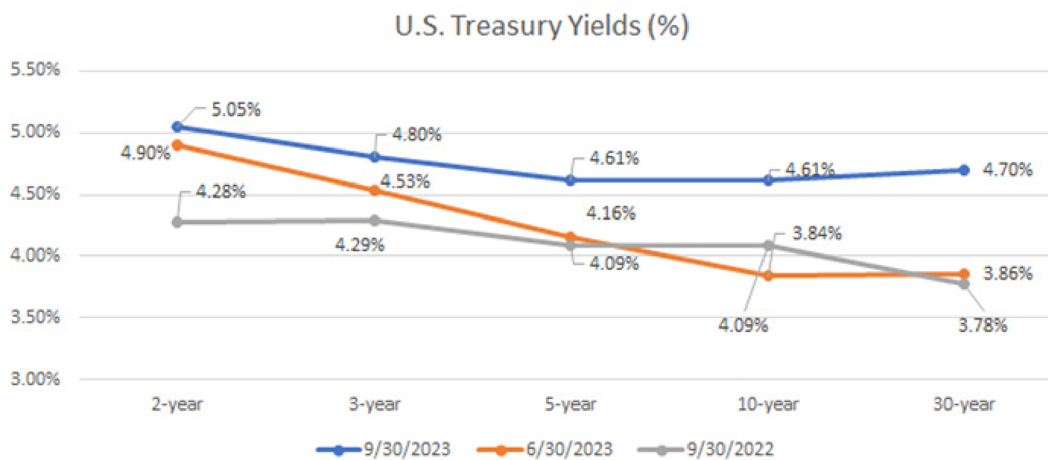
With economic growth accelerating in the third quarter, it appears the consensus has finally abandoned recession island in favor of higher-for-longer island. This shift in narrative played out as expected, with U.S. Treasury yields rising (see chart below), particularly at the long end of the yield curve (10- and 30-year maturities). While cash/T-bills and other shorter-duration investments held up, the result was mostly negative returns for the broad fixed income markets. After dramatic bank collapses and tighter lending conditions failed to sufficiently weaken the economy, fixed income investors may be wondering, "where are we now?" One could think of the current economic landscape as a mighty tug-of-war: with the Fed and its aggressive monetary policy pulling on one side and a spendthrift federal government on the other, pulling hard in support of what is already a resilient U.S. economy. For now, the economy, with its fiscal support, seems to be pulling harder, driving continued labor market strength with rising incomes and strong consumer spending.



Source: Bloomberg

Zooming in on U.S. fixed income markets, the table below provides return data for select Bloomberg U.S. bond indexes for the third quarter. The lower duration profiles in our Short Duration Income and Core Plus Income Funds, our flexible approach, and our overall investment process allowed us to generate strong positive results in our Short Duration fund and index-beating performance in our Core Plus Fund, in what was a very challenging return environment. Our Ultra Short Government Fund also produced strong results as it benefited from the increased short-term rate environment. For details regarding individual fund performance and analysis, see our funds' quarterly commentaries.

Q3 2023 | Fixed Income Returns Bloomberg Indices		
	Q3 Returns (%)	Duration (years)
Bloomberg US T-Bill Index	1.34	0.26
Bloomberg US Aggregate Bond	-3.23	6.15
Bloomberg US Treasury	-3.06	5.86
Bloomberg US MBS (Mortgage-Backed)	-4.05	6.42
Bloomberg US Corporate Invest Grade	-3.09	6.76
Bloomberg US Corporate High Yield	+0.46	3.52
Bloomberg US Securitized	-3.81	6.23

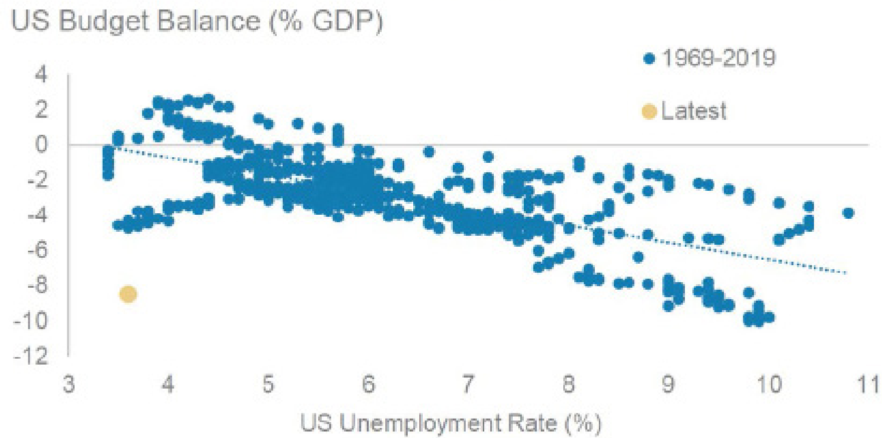
As of 9/30/2023

In July, the Federal Reserve delivered its eleventh increase to the federal funds rate since the cycle began in March 2022, resulting in a 5.25-5.50% target rate at quarter-end. Despite a well-telegraphed pause at the September meeting, the Federal Reserve's message was clear: the inflation fight is not done. The Fed reinforced its higher for longer messaging by removing two interest rate cuts from its latest "dot plot" forecast of Fed rate policy (Fed officials now see a fed funds rate of 5.00-5.25% in 2024, as compared to 4.50-4.75% at the June Meeting), raising its economic growth forecast and lowering its year-end unemployment target to 3.7% from 3.9% in June.

This may suggest the Fed believes the economy is too strong for them to achieve their inflation objectives despite its expectation that core inflation will peak at 3.7% this year – lower than June's projection of 3.9% – before cooling to 2.6% in 2024. Given that the Fed believes monetary policy works primarily through the "wealth effect" channel, the Fed may be trying to tighten financial conditions by engineering higher long-term interest rates and, therefore, higher borrowing costs for consumers and businesses. In a speech on September 28, following the Fed's September policy meeting, Chairman Powell stated "one of our goals is to influence spending and investment decisions today and in the months ahead."

Why has the economy, in aggregate, not responded to the Fed's aggressive hiking cycle? One reason is that large swaths of U.S. debt are unaffected by the Fed's policy rate. The Fed's massive quantitative easing (QE) program during COVID enabled consumers and businesses to lock in ultra-low, long-term, fixed-rate debt. For consumers, this resulted in the lowest debt service costs on mortgages and vehicle loans in a generation, which allows more income to be spent elsewhere in the economy. Corporations benefited much in the same way, locking in long-term, fixed-rate debt at record-low yields. To a large extent, the higher borrowing rates engineered by the Fed only impact new borrowers or those who need to refinance existing debt.

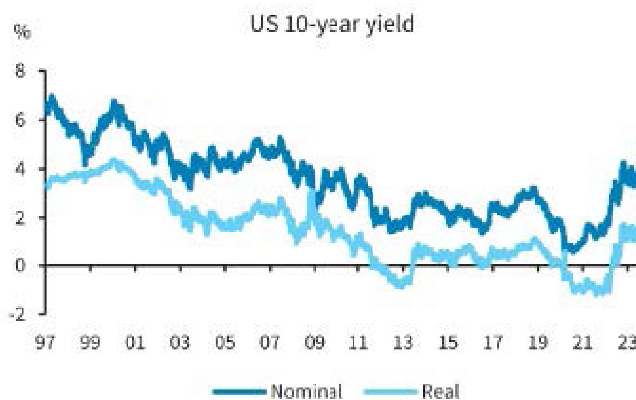
Another reason is the aforementioned tug-of-war between the Federal Reserve and the federal government. The chart below is a stark reminder of how far afield the U.S. deficit as a percentage of gross domestic product (GDP), and in relation to the unemployment rate, is from the historical norm. As legendary investor Stan Druckenmiller bluntly put it during a speech at the University of Southern California in May, "The fiscal recklessness of the last decade has been like watching a horror movie unfold."



Source: Bloomberg, Morgan Stanley Research, "Latest" time period as of September 2023.

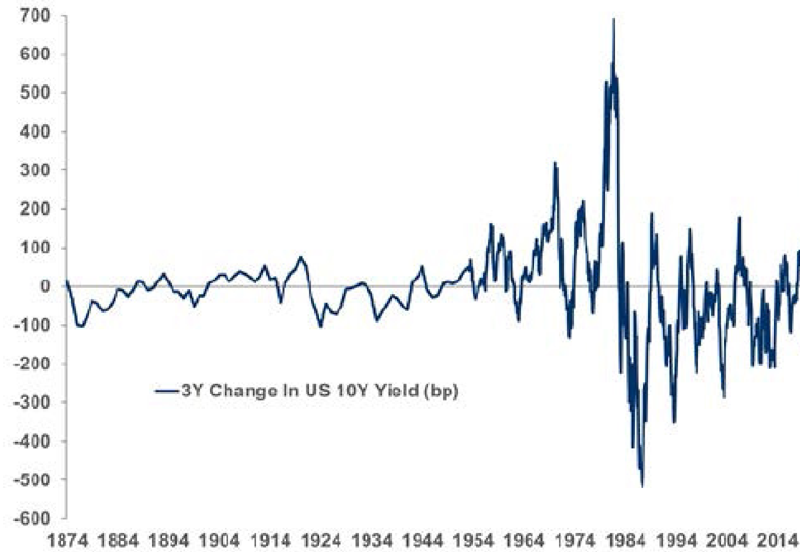
The U.S. deficit has been negatively impacted by rising mandatory payments linked to inflation (i.e., social security and other entitlement spending); higher interest costs due to growing debt balances and rising interest rates; and increased fiscal spending driven by multi-year investments in green energy, manufacturing, and technology industries. A lot of this spending is "pick and shovel" ready, leading to significant employment growth in construction and manufacturing, in particular. In terms of the economic impact, by rule, government deficits must equal a private sector surplus. In other words, one person's spending must equal another person's income.

However, increased government deficits, all else equal, may result in higher U.S. interest rates as an increased supply of U.S. Treasuries is needed to fill the funding gap. The market is in the process of adjusting to this reality with the sell-off in longer-term Treasuries accelerating in the past few months, which has taken 10-year nominal and real yields back to their highest levels (yields) since 2007.



Source: BEA, Eurostat, Haver Analytics, Barclays Research

But it's not only the change in the level of interest rates that matters. The speed with which they have risen is notable as well. The chart below, per Morgan Stanley, shows both the magnitude and speed of the rise in 10-year U.S. Treasuries going back to 1874. The key takeaway is that the only other occasion yields have spiked over 400 basis points in a three-year period was in 1979-1981. In this cycle, the 10-year yield hit a low of 0.51% on August 4, 2020, and hit a cycle peak on Friday, October 6, 2023, of 4.80%. Given the magnitude and speed of this move in longer-term interest rates, we could be nearing the point where they start to slow the economy.

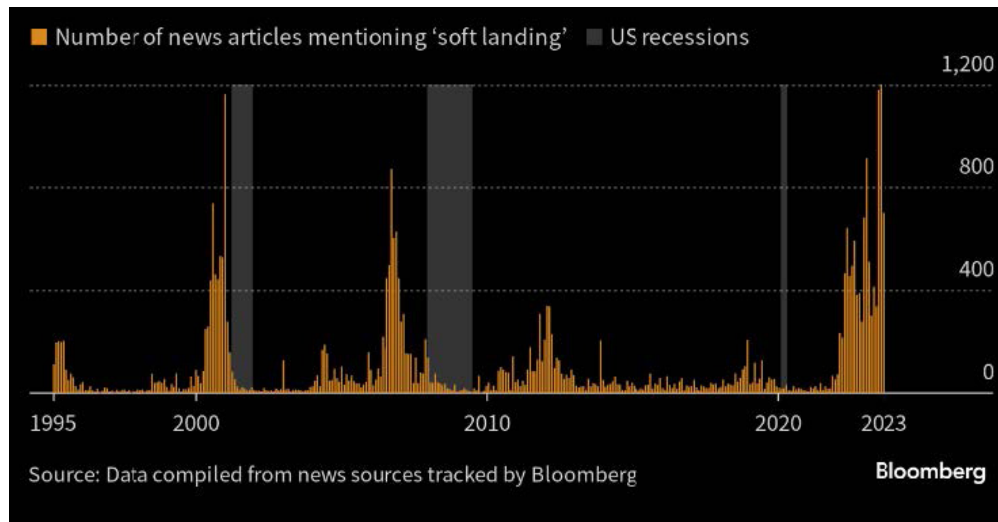


Source: Robert Shiller, Bloomberg, Morgan Stanley Research

Corporate credit spreads narrowed/declined modestly in the quarter, reflecting the continued strength of the U.S. economy. The table below reflects the changes during the quarter in credit spread (incremental return, reflected in basis points – investors require rates above those of comparable U.S. Treasuries as compensation for credit risk) for the broad investment grade corporate (ICE BofA US Corporate) and high yield bond (ICE BofA US High Yield) indexes. The table also shows the changes in effective yield for the indexes. While overall spread levels moved lower in the quarter, the effective yields increased due to the rise in U.S. Treasury rates.

	September 30, 2023	June 30, 2023
ICE BofA US Corporate Index		
Option-Adjusted Spread	125	130
Effective Yield	6.07%	5.55%
ICE BofA US High Yield Index		
Option-Adjusted Spread	403	405
Effective Yield	8.80%	8.35%

With credit spreads narrow by historical measures and the "soft landing" theme spreading in popularity, we are reminded of the echoes of the past and Mark Twain's reminder that "history never repeats itself, but it does often rhyme." As illustrated in the chart below, this is not the first time the chorus cheered for a soft landing. Often with regularity, soft landing calls tend to peak before a downturn hits. From today's vantage point, the type of conditions that would cause the Fed to ease significantly would also lead to earnings significantly disappointing the current growth expectations, which could then lead to much wider risk premiums down the road.



What's the Upshot for Fixed Income Investors?

Rising interest rates across the yield curve pave the way for higher coupon income today and provide the *potential* for greater total returns in the future. For the first time in over 15 years, the return prospects of a diversified portfolio of higher quality U.S. fixed income securities may be highly competitive versus the historical returns on equities, which are likely much less uncertain, and have significantly less downside risk.

We believe our ability to cast a wider net across the fixed income landscape – particularly across securitized products that have meaningful structural enhancements and where higher income relative to bond indexes is available – is a meaningful advantage in today's environment. As we've mentioned before, caution is and will remain our calling card, but we believe the setup for fixed income is as good as it's been in decades.

IMPORTANT DISCLOSURES

The opinions expressed are those of Weitz Investment Management and are not meant as investment advice or to predict or project the future performance of any investment product. The opinions are current through 10/10/2023, are subject to change at any time based on market and other current conditions, and no forecasts can be guaranteed. This commentary is being provided as a general source of information and is not intended as a recommendation to purchase, sell, or hold any specific security or to engage in any investment strategy. Investment decisions should always be made based on an investor's specific objectives, financial needs, risk tolerance and time horizon.

Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.

Definitions: Investment Grade Bonds are those securities rated at least BBB- by one or more credit ratings agencies. **Non-Investment Grade Bonds** are those securities (commonly referred to as “high yield” or “junk” bonds) rated BB+ and below by one or more credit ratings agencies. **Effective yield** is the return on a bond that has its interest payments (or coupons) reinvested at the same rate by the bondholder. Effective yield is the total yield an investor receives, in contrast to the nominal yield—which is the stated interest rate of the bond's coupon. **Option Adjusted Spread:** A “spread” compares the interest rate on a particular bond against a “base line” bond (typically a U.S. Treasury bond). When a bond issuer (or bondholder) has the option to exercise a right (for example, if the issuer can call a bond before its stated maturity date), then the “Option Adjusted Spread” takes into account the possibility that this option might be exercised—so a bond's Option Adjusted Spread may be more (or less) than its regular spread.

Consider these risks before investing: All investments involve risks, including possible loss of principal. Market risk includes political, regulatory, economic, social and health risks (including the risks presented by the spread of infectious diseases). Changing interest rates may have sudden and unpredictable effects in the markets and on the Fund’s investments. The Fund may purchase lower-rated and unrated fixed-income securities, which involve an increased possibility that the issuers of these may not be able to make payments of interest and principal. See the Fund’s prospectus for a further discussion of risks.

Investors should consider carefully the investment objectives, risks, and charges and expenses of the Funds before investing. This and other important information is contained in the prospectus and summary prospectus, which may be obtained at weitzinvestments.com.

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