VICTORY income investors

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2024 OUTLOOK: Locking in Higher Yields

Our 2024 fixed income outlook is driven by three themes

- Attractive yields across fixed income form the foundation of our 2024 outlook. Fixed income looks compelling on an absolute, relative and real basis.
- We expect monetary policy and recession risks to drive volatility in 2024. Inflation is slowly declining. How long the Federal Reserve ("the Fed") keeps rates elevated, and how it balances this with recession risk, is a key theme.
- Asset Backed Securities (ABS) and Agency Mortgage-Backed Securities (MBS) look attractive, in our view, relative to other fixed income asset classes. The corporate investment grade and high yield sectors look expensive, given low levels of credit spreads. Tax-exempt municipals look attractive for tax sensitive investors.

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Executive Summary

Fixed income investors may benefit from higher yields, as historically, fixed income returns have been highly correlated to starting yields. In our view, elevated recession risks and tighter-than-historical average credit spreads supports defensive credit positioning.

Forward Looking Sector Views	Defensive	Neutral	Aggressive
Credit Positioning	☑	☐	☐
Investment Grade	**Underperform**	**Neutral**	**Outperform**
Treasury	☐	☐	☑
Agency Mortgage Backed Securities	☐	☐	☑
Corporate	☑	☐	☐
Loans	☑	☐	☐
Asset Backed Securities	☐	☐	☑
Commercial Mortgage Backed Securities	☐	☑	☐
Taxable Municipal Bonds	☑	☐	☐
Tax Exempt Municipal Bonds	☐	☐	☑
Below Investment Grade	**Underperform**	**Neutral**	**Outperform**
High Yield Bonds	☑	☐	☐
Loans	☑	☐	☐

For illustrative purposes only--not to be construed as investment advice or a recommendation to buy, sell or hold any security.

As of November 30, 2023. The above views reflect the relative value of sectors shown based on the forward-looking return expectations over the next 12 months relative to the Bloomberg U.S. Aggregate Index. A defensive stance in fixed income investing involves making choices that prioritize safety and stability, even if it means sacrificing some potential returns in exchange for reduced risk. It's a strategy often favored by investors seeking to protect their portfolios during periods of uncertainty or economic downturns.

INVESTMENT GRADE CORPORATE BONDS

Investment Grade Corporate bonds are offering lower compensation (or spread), relative to history, for taking credit risk.

HIGH YIELD CORPORATE BONDS

High Yield Corporate bonds have experienced a rise in defaults in 2023 vs 2022, and we expect weaker earnings and wider spreads for the asset class.

TAXABLE MUNICIPAL BONDS

We expect credit quality for taxable municipal bonds to remain strong, however, we view other asset classes within taxable fixed income as offering better relative value.

TAX-EXEMPT MUNICIPAL BONDS

Tax-exempt municipal bonds continue to be an attractive opportunity for tax-sensitive investors, as credit quality remains strong and tax equivalent yields are compelling.

SECURITIZED DEBT

Residential Mortgage-Backed Securities (MBS), Asset Backed Securities (ABS), and Commercial Mortgage-Backed Securities (CMBS) may offer compelling relative value opportunities.

MONEY MARKETS

Cash currently offers compelling yields, but we think reinvestment risk is rising and intermediate duration bonds might offer better return opportunities.

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Historically, Tighter Monetary Policy Increases Recession Risks

The Fed continued to raise rates throughout 2023 in its efforts to drive down inflation to its 2% long-term target. However, the job market has remained robust with unemployment at historically low levels (3.9% as of October 31, 2023)[1], which continues to underpin consumer spending and a resilient economy. The effects of monetary policy can have long and variable lags and isn't fully reflected in the economy in our view. While forecasts for real GDP growth have improved according to Bloomberg's survey of economists, indicating a reduced chance of a recession from 65% to 55%, there are several reliable indicators that suggest the economy may be slowing.

Examples include:

- The inverted yield curve – which has been negative since November 2022 (as measured by the 10 YR Treasury minus the 3M T-Bill).
- The Conference Board Leading Economic Index – which has fallen 4.6% from October 2022 to September 2023. Additionally, federal tax revenues have fallen in 2023.

Chart 1: U.S. Treasury Yield Curve

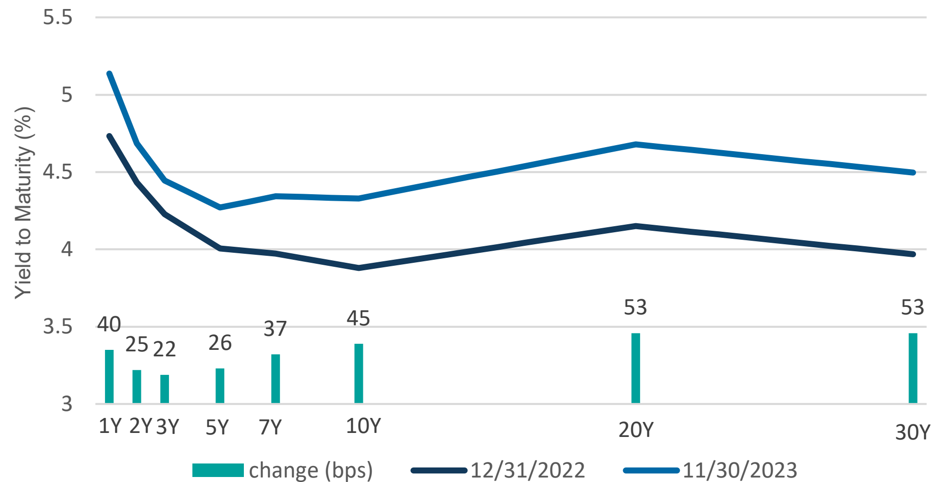
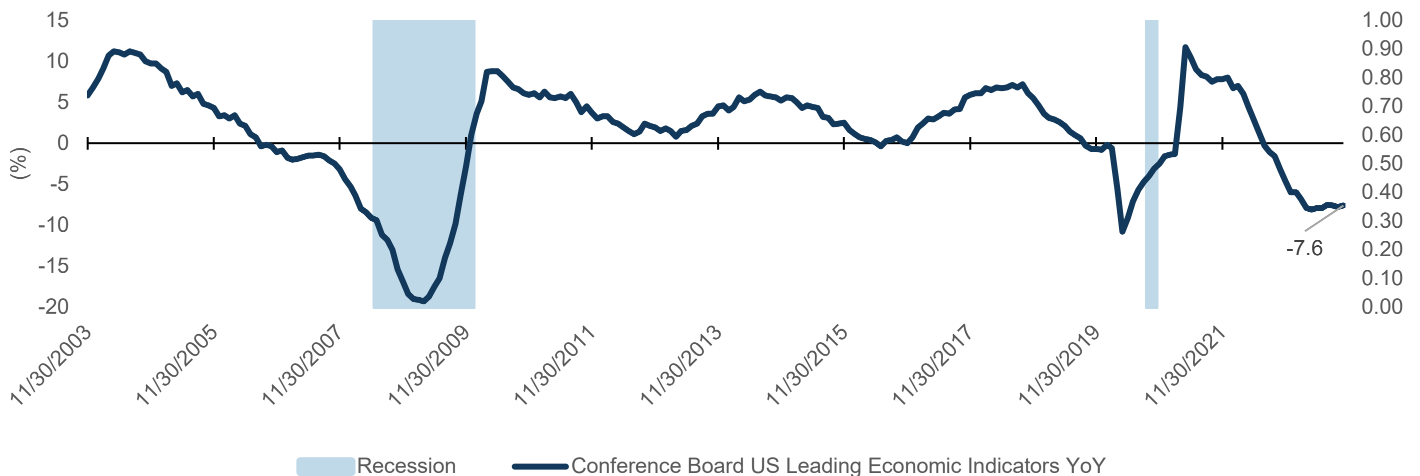


Chart 2: Leading Economic Indicators



Source: Bloomberg, [1]Bureau of Labor Statistics

These indicators signal, in our view, a higher likelihood of a slowing economy over the next 12 to 24 months and elevated risks to corporate earnings.

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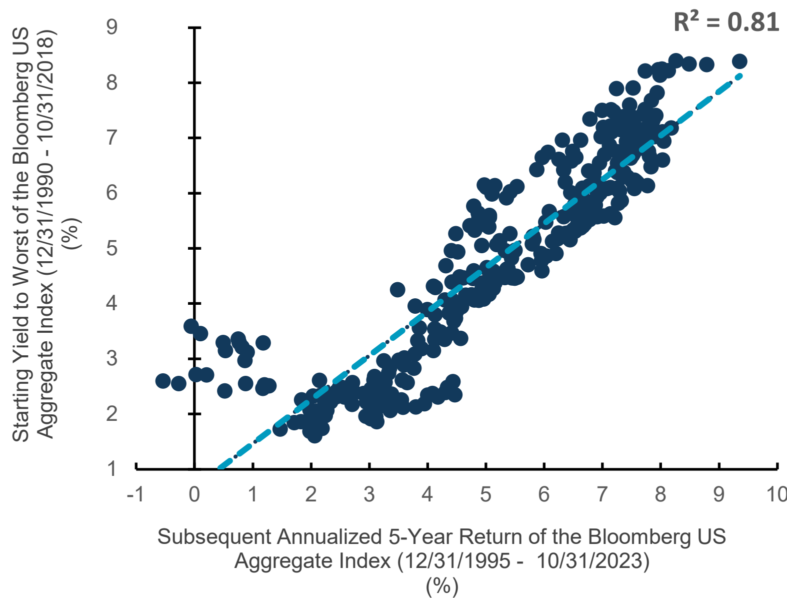
Chart 3: Starting Yields Relationship to Forward Returns



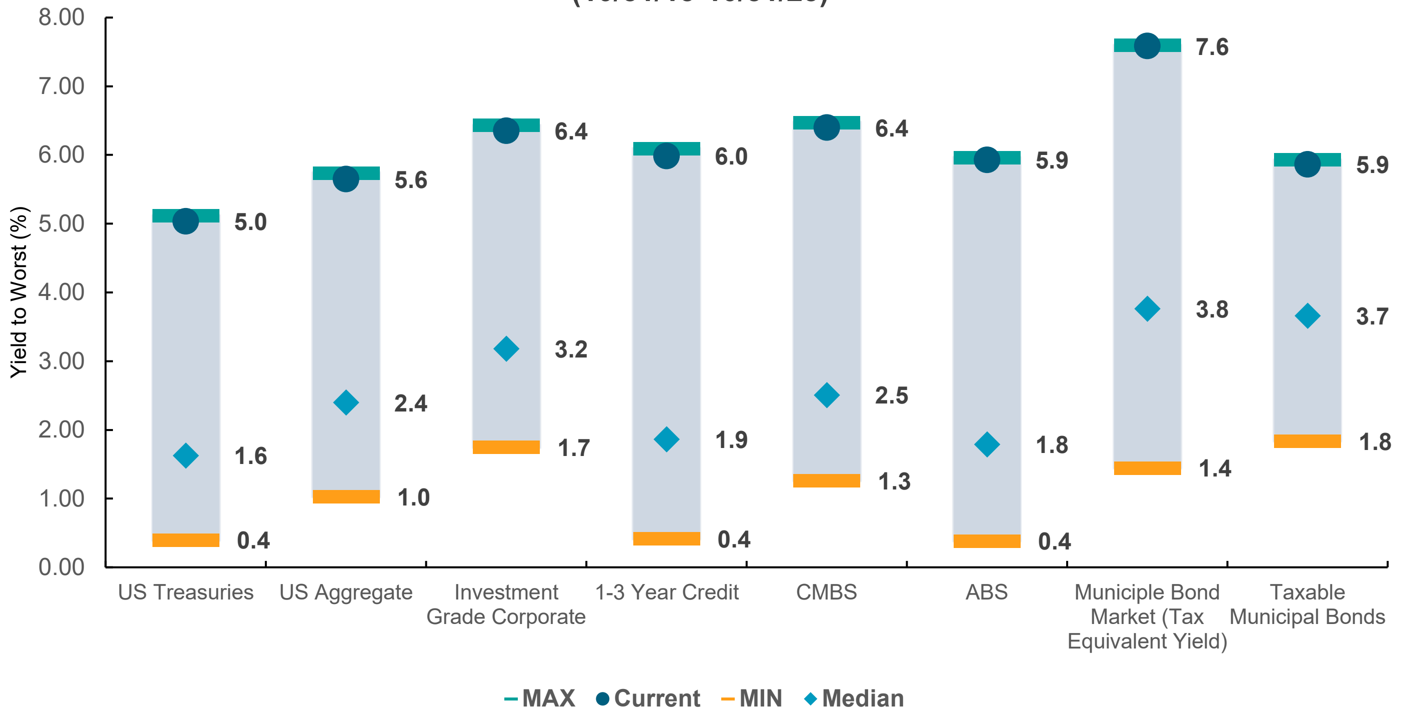
Source: Bloomberg

Past performance is no guarantee of future results. Indexes are unmanaged and do not reflect fees and expenses; One cannot invest directly in an index.

Higher Yields Create a Compelling Opportunity

We are optimistic regarding prospective returns for fixed income investors. Current starting yields, which we believe to be a strong indicator for future returns (Chart 3), remain elevated after reaching the highest levels in a decade in October of this year (Chart 4). Moving into 2024 we think higher yields signal a compelling opportunity for fixed income investors. Also, with the possibility of rate cuts on the horizon, current interest rates leave ample room for possible price appreciation whether the Fed begins cutting rates in the first half or the second half of 2024.

Chart 4: Ten-Year Historical Yield Ranges (10/31/13-10/31/23)



Source: Bloomberg; Indices represented are Bloomberg US Treasury Index, Bloomberg US Aggregate Index, Bloomberg US Corporate Index, Bloomberg 1-3 yr. Credit Index, Bloomberg US CMBS: Erisa Eligible Index, Bloomberg US Aggregate ABS Index, Bloomberg Municipal Bond Index, and Bloomberg Taxable Municipal Bond Index. Yield-to-worst is the lowest possible yield received on a bond, absent default. Tax Equivalent yield for Municipals assumes the highest tax bracket.

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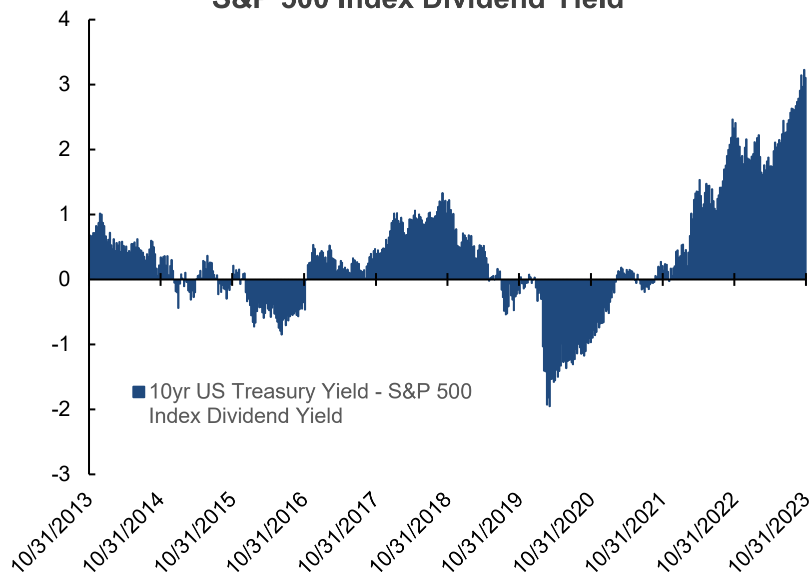
Relative Valuation Looks Attractive

Fixed income looks attractive relative to equities. We looked at two valuation metrics to consider the valuation of Treasury bonds and investment grade bonds versus the S&P 500 index. The yield on the 10-year U.S. Treasury currently exceeds the dividend yield on the S&P 500. In our view, this indicates bonds are cheap (Chart 5). This view is further supported by comparing the yield on investment grade U.S. corporate bonds to the earnings yields on the S&P 500. As is demonstrated in Chart 6, the yield on investment grade corporates has surpassed the *earnings* yield on the S&P 500.



Source: Bloomberg

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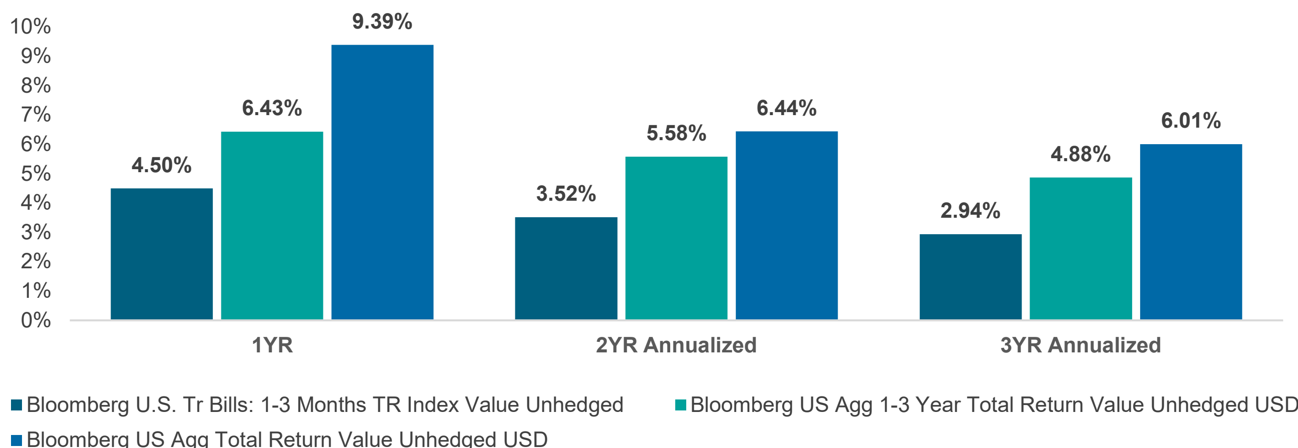
Historically, Fixed Income Has Outperformed Treasury Bills Following Final Rate Hikes

While we remain defensive with regards to credit risk across strategies due to recessionary headwinds, the market is presenting investors an opportunity in fixed income that we have not seen in years. Based on historical Federal Reserve rate hike cycles, once the Fed has finished raising rates intermediate-term (or intermediate-duration) bonds outperformed short-term bonds, which, in turn, outperformed Treasury Bills (Chart 7). A more granular view of asset class returns after the last rate hike (Chart 8) provides further evidence that intermediate-duration asset classes historically performed following the end of past rate hike cycled, while shorter-duration asset classes lagged.

Chart 7: Average Annualized Return Following Final Rate Hikes



Note: Chart 7 and 8 measure annualized returns after the final Federal Reserve rate hike for each rate hike cycle beginning in 1984**.**

Chart 8: Annualized Returns after Pause in Fed Rate Hikes

1st Year	2nd Year	3rd Year	4th Year
Corp 14.9%	EAFE 12.6%	Corp 10.8%	Corp 9.6%
AGG 12.9%	Corp 12.5%	AGG 10.0%	HY 9.4%
Russell 2000 12.2%	AGG 11.7%	S&P 500 9.6%	AGG 8.8%
S&P 500 11.4%	S&P 500 11.0%	HY 8.8%	S&P 500 7.8%
HY 11.0%	Russell 2000 10.2%	Russell 2000 8.3%	Short Credit 7.6%
EAFE 10.9%	HY 9.3%	Short Credit 8.1%	Russell 2000 7.1%
Short Credit 10.0%	Short Credit 8.9%	EAFE 7.6%	EAFE 6.2%
Treasury 3-M 6.4%	Treasury 3-M 5.8%	Treasury 3-M 5.2%	Treasury 3-M 4.8%

KEY: S&P 500: S&P 500® Index; **EAFE:** MSCI EAFE Index; **Corp:** Bloomberg US Corporate Index; **Russell 2000:** Russell 2000® Index; **AGG:** Bloomberg U.S. Aggregate Bond Index; **Short Credit:** Bloomberg Municipal Bond Short 1-5 Year Index; **HY:** Bloomberg U.S. Corporate High Yield Bond Index; **Treasury 3-M:** U.S. 3-Month Treasury.

Past performance is no guarantee of future results. Index performance includes reinvestment of dividends and other income but does not reflect management fees, transaction costs or expenses. One cannot invest directly in an index.

Source: Bloomberg

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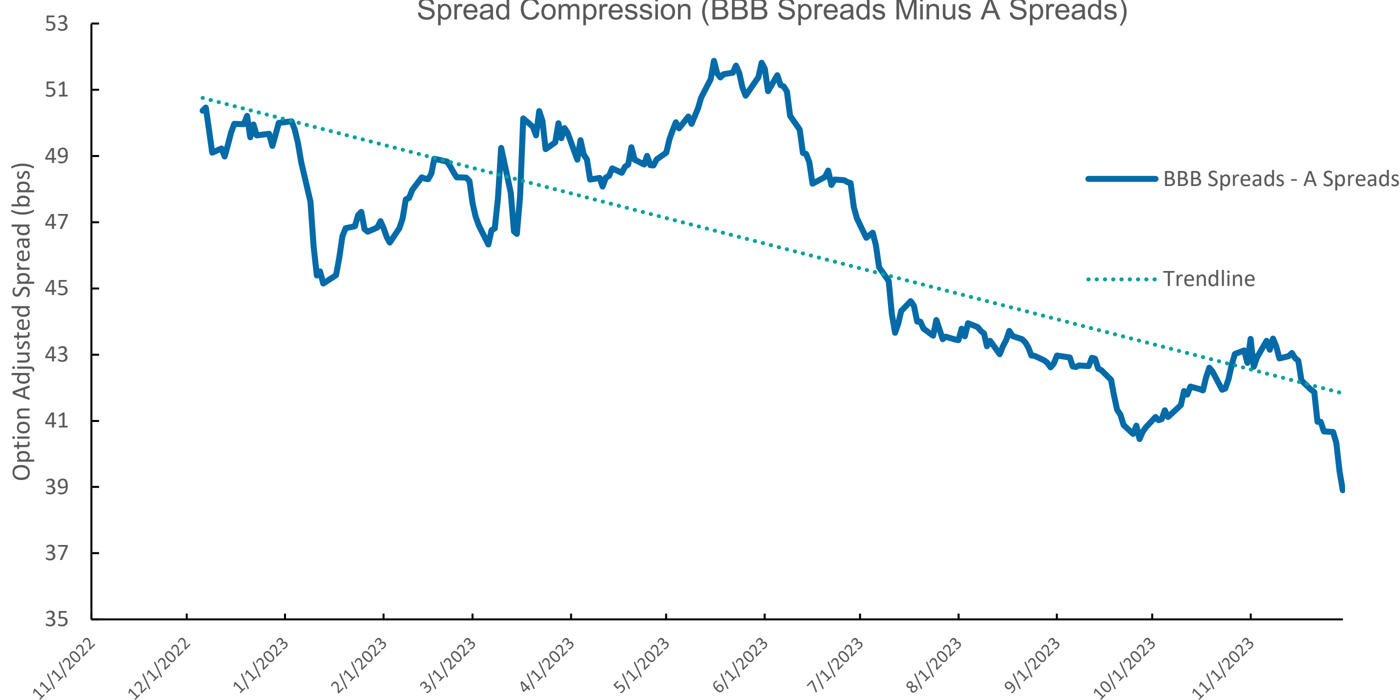
Investment Grade Corporate Bonds

Many corporates are entering this period of economic uncertainty on the tailwinds of strong earnings and relatively healthy balance sheets for their issuers. While significant stress in the banking sector earlier in the year appears to have passed, there remains mounting pressure on other sectors such as commercial real estate. Thus far this year, the difference between interest rates on high-quality corporate bonds and government bonds (namely "credit spreads") reached its highest point in March at 163 basis points and has since come down to about 129 basis points. Narrower credit spreads, which measure the difference in yield between a U.S. Treasury bond and another debt security of the same maturity but different credit quality, indicate that compensation for taking on additional credit risk has decreased.

The current spread level is 9 bps lower than 2022 year-end levels. Currently, only financial sector spreads are trading wider than corporates. There is risk that slowing growth, tightening credit conditions and high rates could have an increasingly negative impact on other sectors into 2024.

Despite only modest increases in credit spreads in most non-financial sectors, overall yields in IG corporates remain elevated on a historical basis, although they do not appear to have fully priced in a recession. As a result, a defensive approach toward credit risk may make sense at this time. We believe active management and asset allocation will be important as the year progresses and could help investors take advantage of compelling yields, while navigating the potential for more volatility in corporate credit spreads.



Credit spread is the difference in yield between a U.S. Treasury bond and another debt security of the same maturity but different credit quality. Credit spreads are the additional compensation that investors require to hold securities that are not as safe and liquid as those issued by the US Treasury. Basis point "bps" is 1/100th of a percentage point.

Source: Bloomberg A Corporate Index (I0822US Index), Bloomberg BBB Corporate Index (LCB1TRUU Index).

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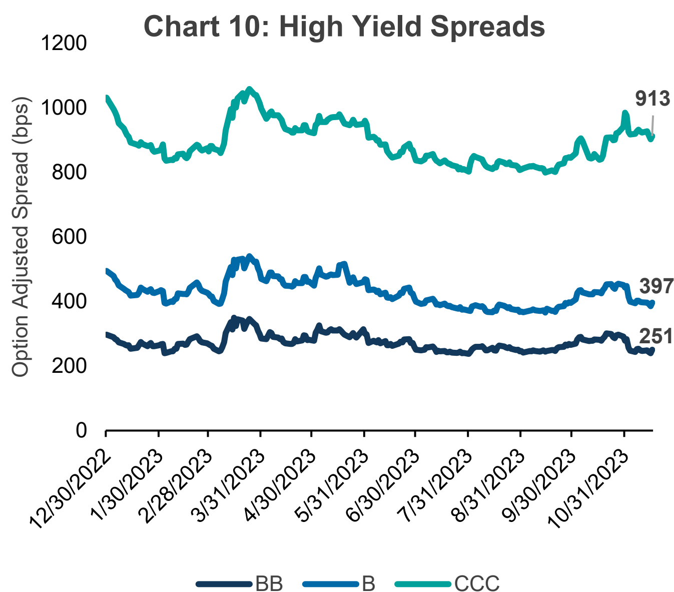
High Yield Corporate Bonds

Year to date, returns for the high yield and leveraged loan markets were positive despite volatility throughout the year due to heightened investor uncertainty regarding potential Fed actions, a banking crisis that resulted in the failure of SVB/ Signature/ First Republic, the mandated takeover by Swiss regulators of Credit Suisse by UBS, and geopolitical tensions continuing in Ukraine and arising in Israel.

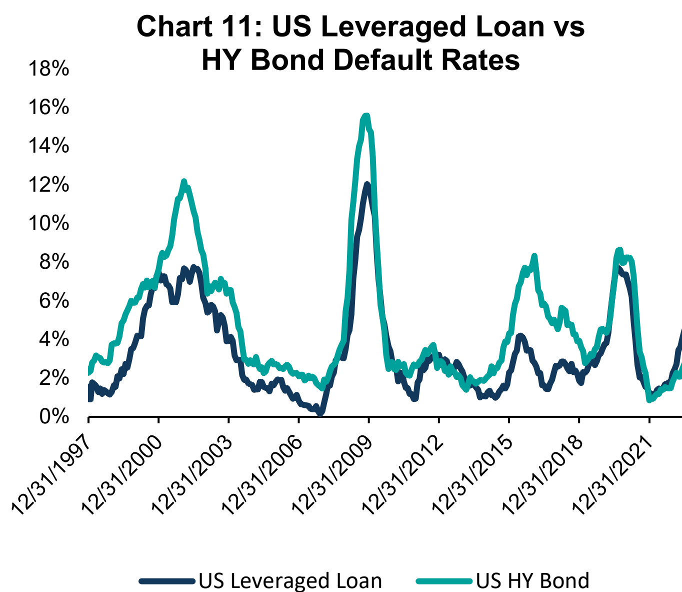
Despite this, Single-B credit spreads were resilient during the year, beginning at 468 bps, widening in March to a peak of 516, but then coming back down to end at 397 as of November 17th (Chart 10).

High yield and leveraged loans have both experienced a rise in defaults. The default rate for leveraged loan issuers, for example, rose to 3.84% in 2023 from 1.83% from 2022 as shown in Chart 11, and there is mounting pressure on a few sectors of the high yield market, such as media and commercial real estate.

Heading into 2024, we believe that earnings will weaken, spreads will widen (in particular in the lower-rated high yield and leveraged loan issuers), and the default rate will continue to gradually rise. While the credit quality of the high yield index has improved, but much the improvement comes from bonds being upgraded to investment grade. In 2024, we anticipate that more bonds will be downgraded to high yield ("fallen angels") than upgraded to investment grade ("rising stars").



Source: Bloomberg. Indices represented are Bloomberg BB US High Yield Index, Bloomberg B US High Yield Index and Bloomberg CCC US High Yield Index.



Source: Moody's

High Yield bonds, aka junk bonds, are bonds that pay higher interest rates because they have lower credit ratings (below BBB) than investment-grade bonds. As such, High Yield credit spreads correlate inversely with credit rating, lower credit ratings generally have higher average credit spreads.

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Municipal Bonds

Municipal credit spreads fluctuated throughout the year but remain tighter over the end of 2022 and may continue to tighten as we move into the next year. Tighter credit spreads are indicative of market sentiment that the credit risk of fixed income assets is on a decline.

Starting yields, which we view as a good predictor of long-term returns, are at much higher levels at this point than last year, providing a very attractive potential entry point for investors. As we anticipate rates may have leveled off, this very attractive level of yields may have reached somewhat of a peak, which we believe is all the more reason to try to lock in the historically high levels at this point.

Heading into 2024, we expect creditworthiness of municipal issuers will remain strong in the near term, due to financial positions that have in many cases been bolstered by generous amounts of federal stimulus funds received over the past few years. At this point credit quality remains strong and default rates remain low.

Chart 12: Municipal vs US Aggregate vs Tax Equivalent Index

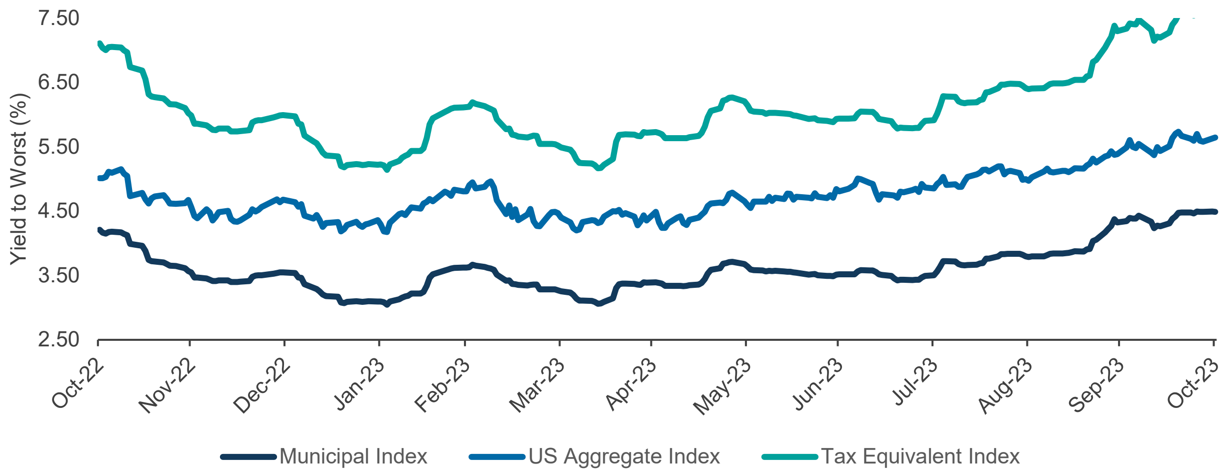
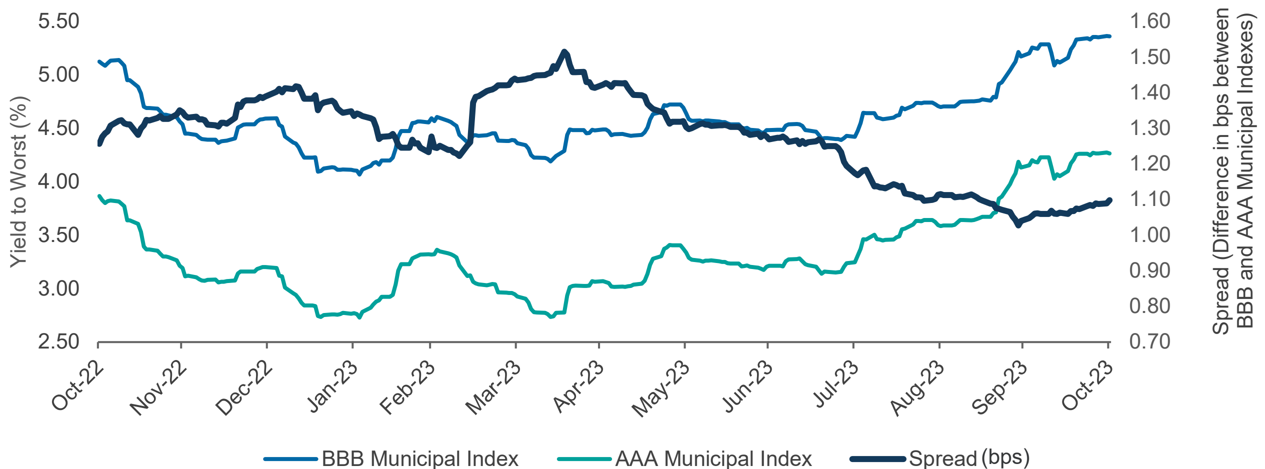


Chart 13: BBB vs AAA Municipal Index Yield to Worst



Source: Bloomberg. Indices represented are the Bloomberg Municipal Index, the Bloomberg US Aggregate Index, Bloomberg Municipal BBB Index, and Bloomberg Municipal AAA Index.

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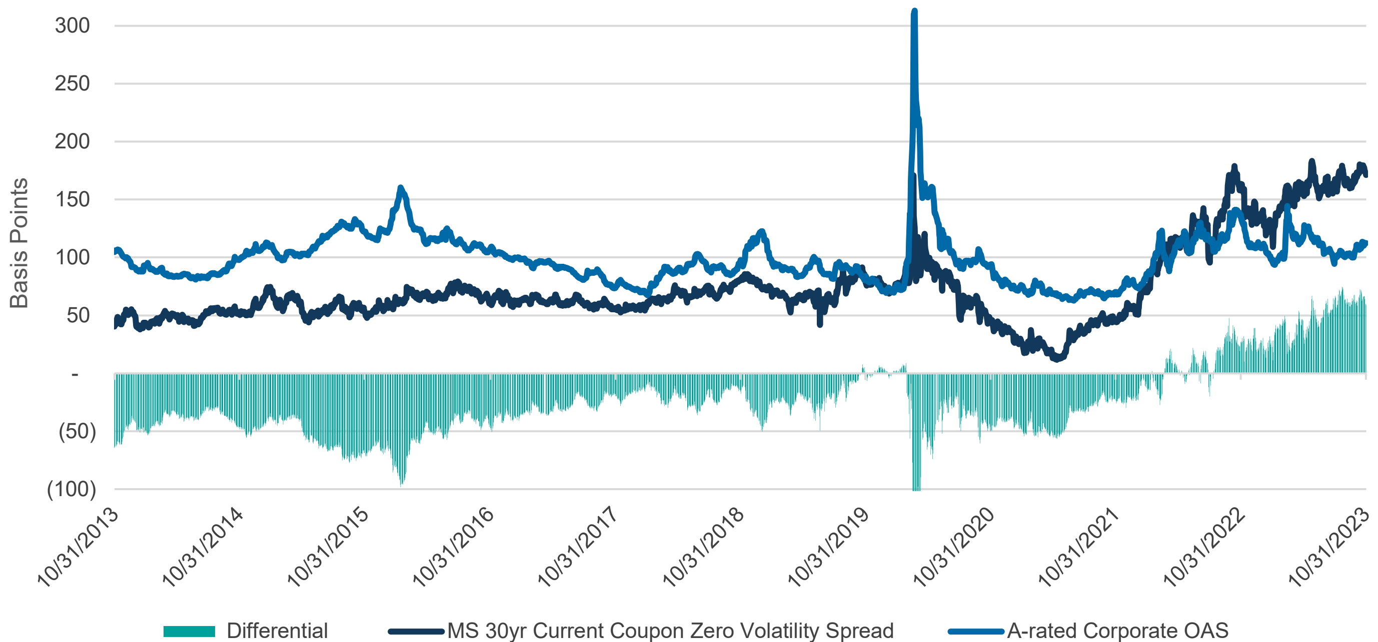
Residential Mortgage-Backed Securities (MBS)

Historically we have not liked the risk/reward profile of MBS because we did not believe the potential gains were worth the risks. Specifically, we felt that they didn't offer protection when it came to the possibility of the loans being paid back early (negative convexity).

Prior to 2022, spreads had been tight in the MBS market because large segments of the MBS buyer base were “non-economic” buyers. The three largest non-economic buyers of MBS were: 1) banks, who buy MBS to meet capital requirements and for other regulatory reasons, 2) the Fed, which purchased large amounts of MBS as economic stimulus during the Global Financial Crisis (GFC) and the Covid Pandemic, and 3) index funds, which purchased MBS to match the issuance-weighted indices like the Bloomberg Aggregate Index.

Banks and the Fed stepped away as buyers in 2022 and 2023 and became net sellers of MBS in 2023. The marginal buyers for MBS are now money managers, who tend to require wider spreads as they compare the relative value of MBS to other parts of the fixed income market. As a result, MBS spreads have widened enough relative to corporate bonds that we think the risk/reward is finally in favor of incrementally adding to MBS. Although we don’t see a catalyst for MBS spreads to tighten in the near term due to the current supply/demand imbalance in the market, we think current spreads represent an attractive entry point for MBS as we head into 2024. We particularly like the Ginnie Mae part of the MBS market because, due to capital charge constraints, that is the first place banks will return to as buyers.



Source: Bloomberg. The A-rated corporate OAS represented is the OAS of the Bloomberg A-rated Corporate Index. The Morgan Stanley 30Y Conventional Current Coupon Zero Volatility Indicator represents the ZV (zero volatility spread) for the hypothetical $100-priced 30yr conventional mortgage over time. The aforementioned Indicators are for tracking data and are the property of Morgan Stanley & Co. LLC and its affiliates (“MS Group”). The Indicators should not be used as or treated as an Index or benchmark. Any use requires the consent of MS Group.

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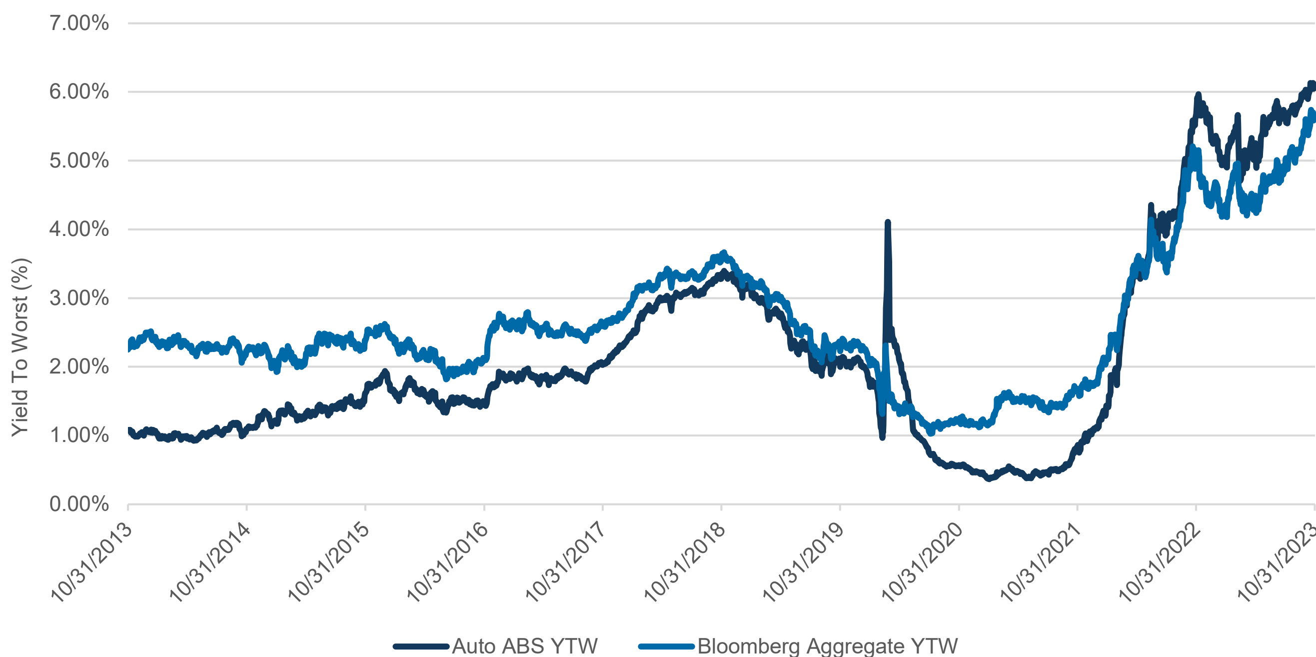
Asset-Backed Securities (ABS)

We have historically favored the non-mortgage ABS sector of the fixed income market due to its attractive spread pickup (potential for higher yields) relative to short duration corporate bonds. The ABS that we focus on have robust structures with substantial credit support which have been able to withstand severe recessions like the Global Financial Crisis (GFC). Many ABS structures also de-leverage (reduce debt outstanding) over time which can make ABS a good defensive play and can result in predictable upgrades to credit ratings as deals mature.

We prefer the parts of the ABS market that have been around for multiple cycles and have proven to be prioritized by consumers paying off their debts. These sectors include ABS backed by auto loans, credit cards, or essential equipment used in the borrower's business like small and large ticket equipment. We tend to avoid the more esoteric parts of the ABS market that have not proven their resilience through multiple cycles or have weaker structural features. Subsectors of the ABS market that fall into those two categories are unsecured "fintech" consumer lending, music royalties, solar ABS, and container ABS.

As we look ahead to 2024, we view ABS as offering compelling relative value as ABS spreads continue to look attractive relative to corporates. Additionally, because ABS is almost exclusively a short duration sector, the inverted Treasury yield curve means ABS now provides a higher yield than the longer duration Bloomberg Aggregate Index.



Source: Bloomberg. Indices represented are the Bloomberg ABS Auto Index and the Bloomberg US Aggregate Index.

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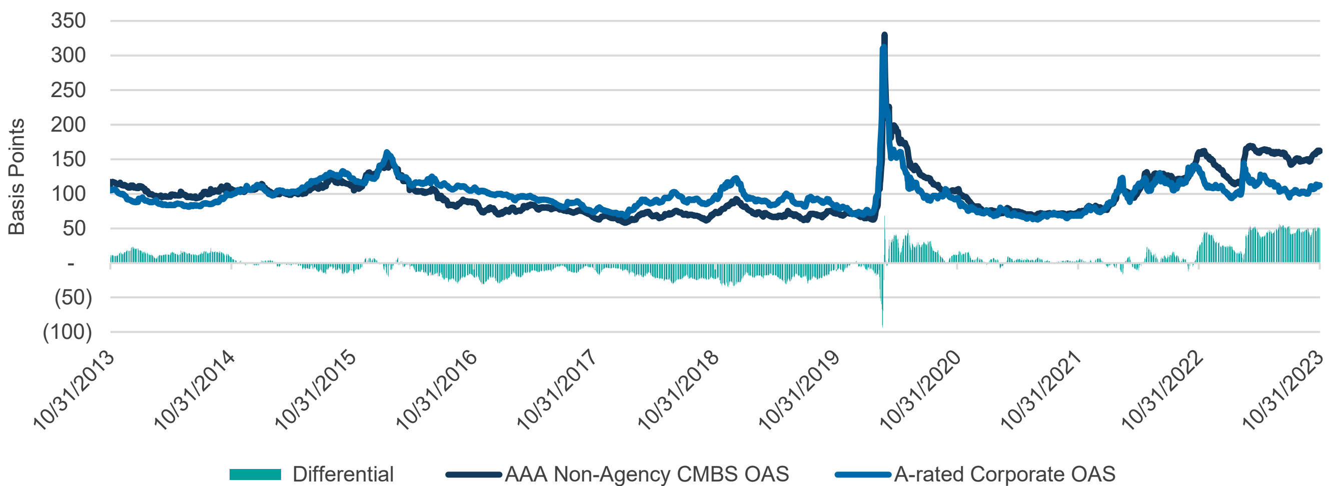
Commercial Mortgage-Backed Securities (CMBS)

Commercial real estate (CRE) was constantly in the headlines the past 12 months due to struggles from higher interest rates, tighter lending standards, and Covid's acceleration of the bifurcation of the "haves and have nots." Market sentiment around the combination of those three factors caused CMBS spreads to widen relative to corporate bonds during 2023. We think wider spreads create opportunities in the CMBS market, but we recommend investors focus on quality. Security selection will be paramount.

Higher interest rates and tighter lending standards caused a significant reduction in year-over-year CRE transaction volume and caused CRE prices to fall 10-19% from the peaks seen between March and July 2022. Covid accelerated the gap between the "haves and have nots" of real estate, creating a flight to quality across all CRE sectors. By property type, multifamily and industrial have been the darlings due to tailwinds from a shortage in housing and the boom in ecommerce. The office sector has struggled due to the proliferation of hybrid work from home (WFH) business strategies which caused a decline in the demand for space.

Chart 16: CMBS vs. A-Rated Corporate Bonds



Source: Bloomberg. Indices represented are the Bloomberg Non-Agency Investment Grade CMBS: AAA Total Return Index (I31070US) and the Bloomberg A-rated Corporate Index

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While office-related CRE will continue to face headwinds, we think dynamic office markets like New York will unfold similarly to how retail played out over the last several years. Instead of the "the death of all malls" due to the growth of ecommerce, which was the consensus opinion at the time, the best malls thrived at the expense of the lower quality properties. Retailers eventually pivoted to use brick-and- mortar stores to complement their ecommerce strategy. A strategy focused on the highest quality properties owned by sponsors with deep pockets was a winning strategy for retail and we think it will be a winning strategy for the office sector, though it may take years to play out. We are more cautious about lower quality office properties and office markets that have tech-related tenant bases or that are struggling with crime/safety issues.

We plan to maintain an up-in-quality bias as we head into 2024. We will likely focus on deals at leverage points that are can stomach financing their debt at higher rates and that can withstand a potential economic downturn where property prices and cash flows could decline further.

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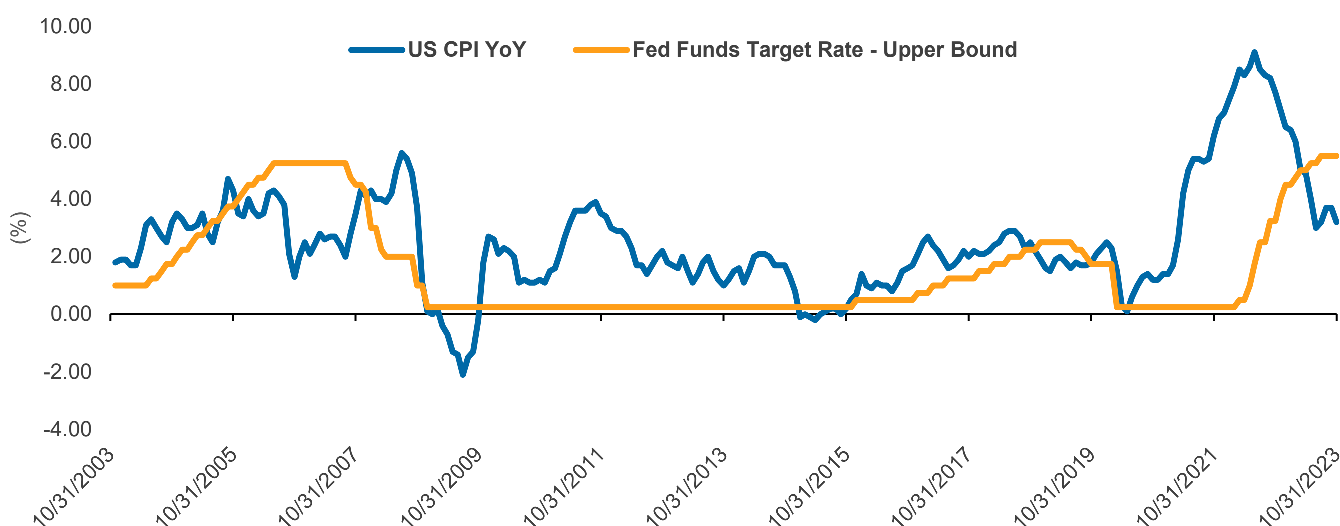
Money Markets

Money market funds, or “cash”, received renewed interest in 2023 thanks to a series of Federal Reserve rate increases that began in 2022. With yields now hovering around 5% investors have poured money into the sector, resulting in a record $5.7 trillion in assets currently being held in money market funds. For the time being, cash is seen as an attractive alternative to risk assets, defined as any asset that carries a degree of risk vs treasuries, thanks to competitive yields, but will that hold? While it’s difficult to know with certainty the direction of the Fed’s course going forward, we do know that inflation has begun to moderate but it is still above the Fed’s 2% target. Further rate hikes can’t be ruled out entirely though it seems as if the Fed has shifted from rate hikes to a “higher for longer” stance. However, it’s hard to imagine that the Fed wouldn’t begin cutting rates in 2024 if inflation begins to ebb significantly or the economy enters a downturn. In terms of forward guidance, the Fed has stated that it “will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments.”

Chart 17: Fed Funds vs. CPI



Source: Bloomberg

U.S. CPI: The Consumer Price Index measures the monthly changes in prices paid by U.S. consumers. The Bureau of Labor Statistics calculates the CPI as a weighted average of prices for a basket of goods and services representative of aggregate U.S. consumer spending.

Fed Funds Target Rate – Upper Bound: Shows the upper limit of the federal funds target range established by the Federal Open Market Committee

Our current assessment of the cash sector is that it offers stability, security and very short duration. These three factors persist and have been a feature of money market funds for decades. What can be more transient is yield since this is determined by current market rates.

Since shorter term instruments pay better now, should investors keep a significant portion of their fixed income holdings in a money market funds? History tells us that longer-duration fixed income outperforms money markets as rates decline. This is because investing in money markets requires continuous repurchase of securities since the instruments they invest in mature within days or weeks of issuance in most cases. This requirement to reinvest proceeds is called “reinvestment risk” and is an inherent risk in all short-term instruments. Longer term bonds, in contrast, do not face immediate reinvestment risk because they mature over the course of years and their prices can appreciate with falling rates. While we still like the cash sector heading into 2024, we would caution against allocating a significant proportion of investors’ portfolios in money market funds.

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Disclosures

All investing involves risk, including the potential loss of principal.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. Bonds and bond funds will decrease in value as interest rates rise and vice versa. Credit risk refers to the possibility that debt issuers may not be able to make principal and interest payments or may have their debt downgraded by ratings agencies. High yield securities may be more volatile, be subject to greater levels of credit or default risk, and may be less liquid and more difficult to sell at an advantageous time or price than higher-rated securities of similar maturity. Mortgage-backed securities (“MBS”) and asset-backed securities (“ABS”) are subject to credit, prepayment and extension risk and may react differently to changes in interest rates than other bonds. Small movements in interest rates may quickly and significantly reduce the value of certain MBS and ABS. Municipal securities can be more vulnerable to unfavorable economic, political and regulatory changes affecting issuers in specific municipalities. Some income may be subject to local taxes and could be declared taxable and/or subject to the federal alternative minimum tax if federal or state tax laws change. The value of your investment is also subject to geopolitical risks such as wars, terrorism, environmental disasters, and public health crises; the risk of technology malfunctions or disruptions; and the responses to such events by governments and/or individual companies.

Credit spread is the difference in yield between a U.S. Treasury bond and another debt security of the same maturity but different credit quality. Credit spreads are the additional compensation (potentially better returns) that investors require to hold securities that are not as safe and liquid as those issued by the US Treasury.

This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding, or a recommendation of, any security or market sector, but as an illustration of broader themes.

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