Eaton Vance

Forward Thinking

Navigating the Curve

INVESTMENT INSIGHT | FIXED INCOME TEAM | OCTOBER 2023

Today's bond market offers investors a rare set of opportunities to suit a wide range of portfolio objectives. Rates have risen across the yield curve in many markets, but the short end has increased more. Our investment managers outline strategies for seeking higher current income or capital appreciation during this unusual yield curve inversion, with more attractive choices than we have seen in over a decade.

ANDREW SZCZUROWSKI, CFA
Head of Agency MBS Portfolio Manager

AGENCY MBS | MUNICIPAL BONDS | HIGH YIELD BONDS

1 **Today's spread and yield levels for agency MBS signal attractive valuations on a relative and historic basis**

2 **We expect renewed interest for agency MBS to lead to outperformance among investment grade options**

3 **The U.S. government's backing of the agency MBS sector can underpin strong performance in times of stress**

This year's agency MBS market offers investors a rare opportunity

"U.S. mortgage rates recently surged to 23-year highs at just shy of 8%, causing many prospective home buyers to pause their search. However, the spike in rates has created an attractive opportunity to lend to the diminished pool of active borrowers, and the agency MBS market is one way that investors can cater to this demand. The agency MBS market has recently experienced a "buyers strike" of its own, which has kept U.S. banks, overseas investors and money managers on the sidelines. As a result, U.S. Government-guaranteed agency MBS spreads are now wider than BBB-rated corporates, and yields are nearing 6.5%.[1] While demand has been weak, home sellers are holding back listings too, which is creating a substantial decline in supply and thus technical support for the MBS sector. We believe buyers will be lured back by today's attractive valuations and yields and, as more buyers come back in, that the sector will outperform other investment grade options."

Note: The returns referred to in this document are those of representative indexes and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

[1] Bloomberg. As of September 29, 2023.

CRAIG BRANDON, CFA
Co-Head of Municipals
Portfolio Manager

AGENCY MBS | **MUNICIPAL BONDS** | HIGH YIELD BONDS

1 **The Fed will likely keep policy rates "higher for a longer"**

2 **Taking on duration in municipals can offer higher income and potential upside over the long term if rates come down**

3 **When the outflows that left the municipal market in 2022 ultimately return, the reversal could prove to be a technical tailwind over the next 12 months**

Given the Fed's positioning, taking on duration in municipals may benefit client portfolios

"In our view, the Fed is poised to keep policy rates at their current elevated level for longer as the economy appears to remain resilient. If economic activity does soften, rates should move lower, which would be beneficial for investors who took an opportunity to extend duration and lock in higher yields. This could prove worthwhile over the longer-term from a total return perspective and if even some of the municipal bond fund outflows from 2022 reverse, that could prove to be a nice tailwind to performance."

JEFFREY D. MUELLER
Co-Head of High Yield
Portfolio Manager

AGENCY MBS | MUNICIPAL BONDS | **HIGH YIELD BONDS**

1 **Yields, on average, are sitting within the highest decile relative to the trailing 10-year period**

2 **Average bond prices remain below ...par, signaling attractive value**

3 **Elevated yields provide investors ample compensation, even in light of elevated credit risk**

High yields resilient as spreads contract

"Global demand for high yield credit remains robust, despite continued hawkish rhetoric from multiple global central banks and growing dispersion in the earnings and forward guidance of high yield companies. We believe the further bifurcation between the "haves and have-nots" in leveraged credit screams for active management. Skilled bottom-up credit selection is imperative and investors would behoove themselves to look for managers with a proven track record of effectively navigating a volatile landscape."

Investor Implications

GOOD ENTRY POINTS

Last year's rout in fixed income markets has left starting yields sitting at, or close to, historic highs. From current levels, we see an opportunity to earn respectable income and capital appreciation across the duration spectrum from agency MBS to municipal bonds and longer duration high yield securities.

ALWAYS ACTIVE

While opportunities are emerging, an active approach is warranted for navigating fixed income in the current market conditions. Whether in sovereign debt, corporate bonds or structured securities, we believe that capitalizing on opportunities will require a combination of skilled expertise, careful risk management and the nimbleness and flexibility to adjust positions as market conditions change.

SWEET SPOTS

No two investors will seek to capitalize on the curve in the exact same way. However, broad opportunities exist across several fixed income sectors. This should grant each investor a degree of choice as they seek the sweet spot that best serves their unique aims, objectives and risk tolerance to complement their portfolio.

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Source of all data: Morgan Stanley Investment Management, as of September 29, 2023, unless otherwise specified.

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