



Investment Perspectives

Multi-Sector Fixed Income: Flexibility Post-Fed Easing and Beyond

An active bond management approach can tap the breadth of the credit markets for potential opportunities as the investment environment shifts.



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Key Points:

- Still-elevated market expectations of rate volatility, when compared to risk-asset volatility, keep us focused on credit markets where a skilled manager can allocate along multiple dimensions in pursuit of investible themes that can work as the U.S. Federal Reserve (Fed) embarks on easing.
- Within corporates, our favor lies with high yield, as history suggests the potential for strong quarterly returns even as real gross domestic product (GDP) moderates. Meanwhile, in longer duration, we favor agency mortgage-backed securities (MBS) modestly over investment-grade corporates given the still-present carry advantage.
- In structured markets, the current stabilization and future expectation of a recovery in commercial real estate leave opportunity in commercial mortgage-backed securities (CMBS) in multi-sector portfolios.

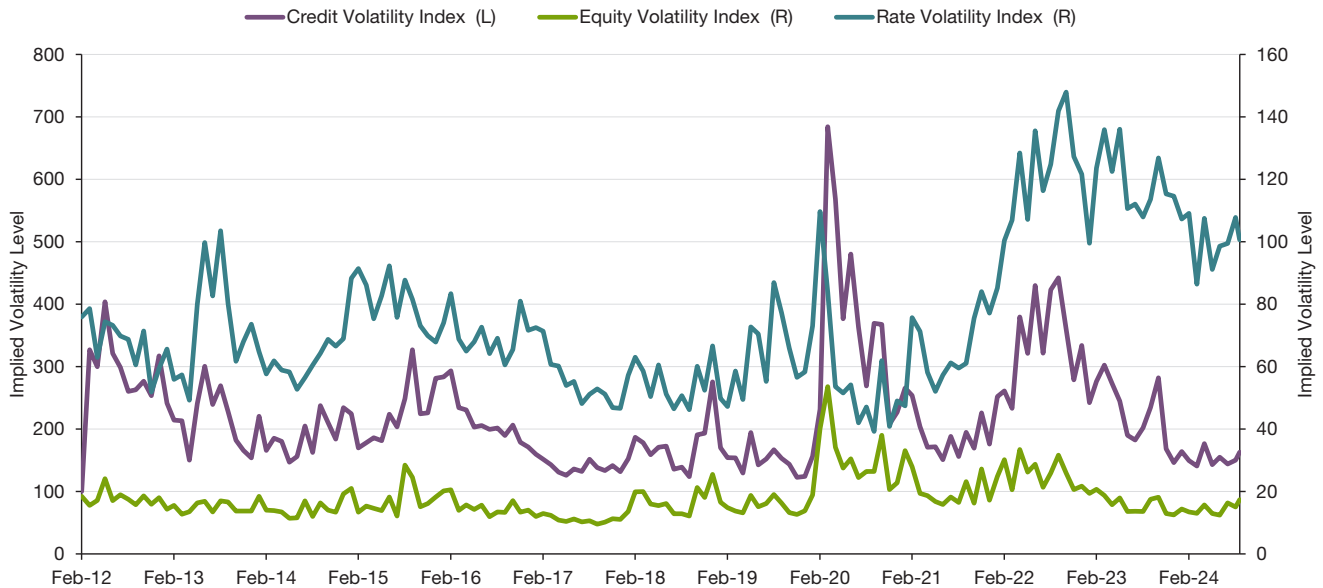
The Fed's long-awaited kickoff to the easing campaign is now in the rearview mirror. With some budding clarity, investors may now finally shift their mindset from debating every minutia of when, by how much, and how quickly the Fed will ease, to better understanding the fundamental impact this new monetary policy regime could have on asset fundamentals themselves. We believe the current environment is particularly well-suited to a multi-sector approach, given the potentially uneven impacts across fixed income.

But one source of confusion for many investors over the course of the year that remains is the still-elevated level of interest-rate volatility expectations, when compared to a much more subdued picture of volatility expectations for corporate risk assets. More specifically, in Figure 1, we contrast the large recovery in expected volatility of credit and equities with still-elevated expectations of interest-rate volatility itself.



Figure 1. A Decline in Risk-Asset Volatility Contrasts with Still-Elevated Rate-Volatility Expectations

Expected volatility for credit, equity, and rates, as represented by the Three-Month High Yield VIX, VIX, and MOVE Indexes, respectively, February 28, 2012 – September 16, 2024



Source: Bloomberg. Data as of September 16, 2024. The MOVE Index measures U.S. bond market volatility by tracking a representative basket of over the counter (OTC) options on U.S. interest-rate swaps. The index tracks implied normal yield volatility of a yield-curve weighted basket of at-the-money one-month options on the two-year, five-year, 10-year, and 30-year constant maturity interest-rate swaps. The VIX Index is the Chicago Board Option Exchange's (CBOE) Volatility Index that tracks the stock market's expectation of volatility over the coming 30 days based on S&P® 500 index options. The VIXHY3M Index is the CBOE Three-Month High Yield Volatility Index that measures the expectation of high yield bond volatility over the coming three months. **Past performance is not a reliable indicator or guarantee of future results.** The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett.

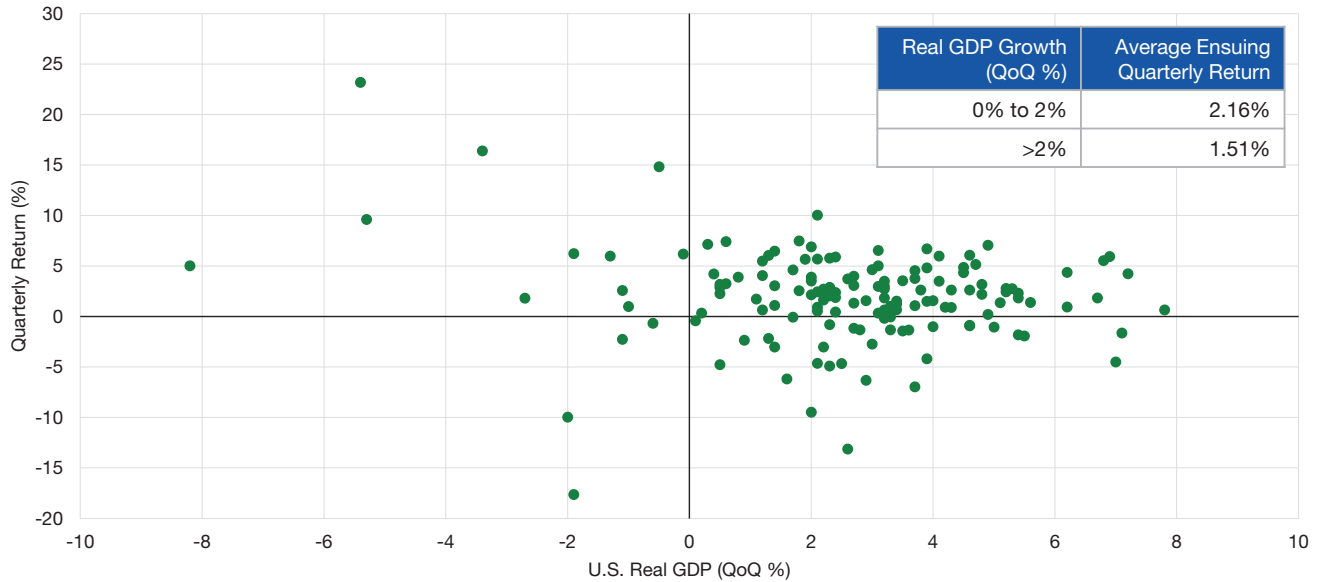
This observation rings true to our investing philosophy: predicting the path of interest rates can be a far more challenging endeavor than successfully positioning within credit markets that offer a variety of independent dimensions that allows a credit manager to demonstrate skill (see Active Management in Fixed Income: Two Approaches with Different Results). And therein lies the appeal of a multi-sector approach to fixed income, where a skilled manager with a holistic view across markets can allocate to credit asset classes that best fit desired investible themes and attractive risk-reward profiles. What follows below are some of the common positioning themes across our multi-sector portfolios today.

High Yield Corporate Still Works When Growth Slows: We remain constructive on high yield. For brevity, we won't go through a full supportive thesis on high yield here nor argue credit spreads aren't as tight as they may optically seem at first glance. But we know there is some skepticism on credit generally as growth decelerates. In Figure 2, we map quarterly real GDP versus the ensuing quarterly total return for the ICE BofA U.S. High Yield Index. Two points are worth noting. First, there is hardly a tight fit to the relationship: there were plenty of periods of negative quarterly returns when growth over the prior period was strong and vice versa. But when focusing on the period of 0-2% growth specifically—relevant today as consensus sees GDP decelerating to the 1.5-2% area in the year ahead—we find a lower percentage of negative return quarters than when GDP exceeds 2%. Every period would have its own nuances to consider, but slower growth alone is hardly a reason to be cautious on high yield corporate credit, in our view.



Figure 2. High Yield Total Returns Can be Strong Across Growth Environments

Quarterly real GDP and ensuing U.S. high yield bond index quarterly return, December 31, 1986-March 31, 2024



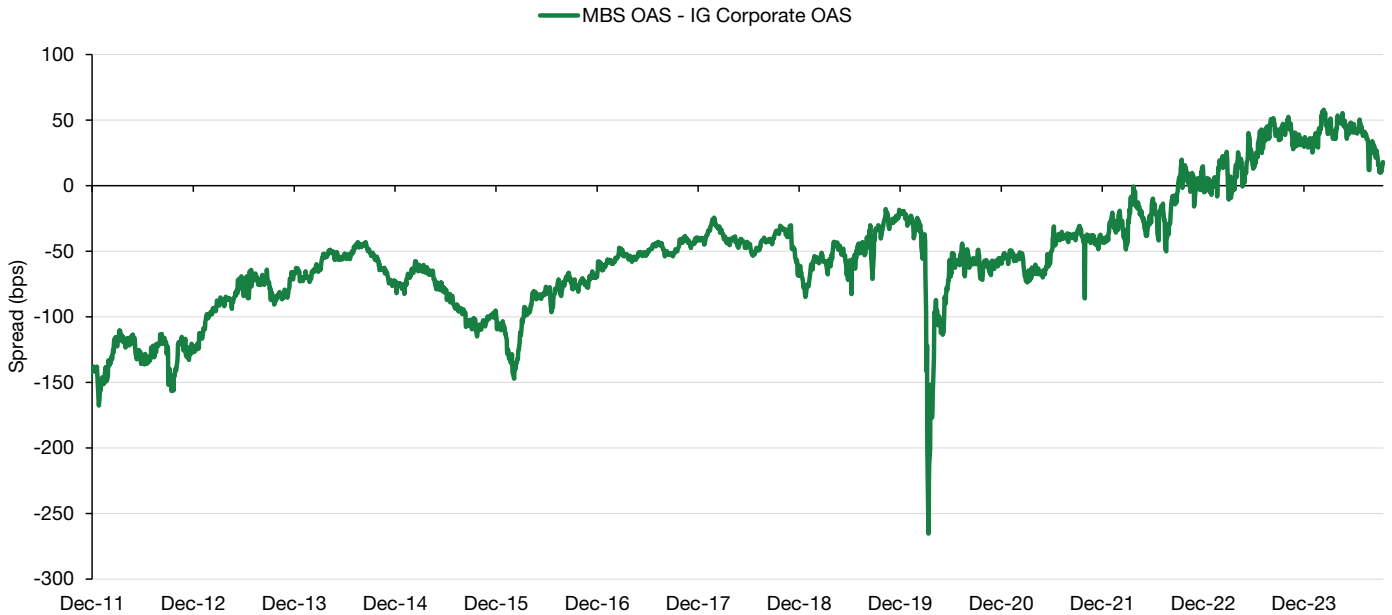
Source: Bloomberg. Data as of March 31, 2024. Most recent data available for ensuing quarterly index return. **Past performance is not a reliable indicator or guarantee of future results.** The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett.

Agency MBS: Attractive Relative Value to Investment-Grade Corporates: As suggested above, we remain firmly in the camp of the macro environment being supportive of corporate credit exposure. However, higher up in the quality spectrum of longer-duration fixed income, we still see good relative value of agency MBS versus investment-grade corporates. In Figure 3, we note that agency MBS still trade at an approximate 20-basis point (bp) premium to the Bloomberg U.S. Corporate Index, when quoted on a zero-volatility, option-adjusted-spread basis. Yes, this basis is not as attractive as it was earlier this year. But with a decline in rate volatility potentially to come, as the Fed provides some greater transparency, we see continued compression in this basis. That's particularly attractive as we have viewed agency MBS as a more liquid asset class with essentially no credit risk when compared to investment-grade corporates. And even if we don't see this basis compress further, the asset class continues to provide attractive risk-adjusted carry potential in our portfolios.



Figure 3. Agency MBS Still Looks Attractive to Investment-Grade Corporates

Citi Velocity MBS Index spread premium over Bloomberg U.S. Corporate Index, December 31, 2011 - September 16, 2024



Source: Citi Velocity 30-Year Current Coupon Agency MBS Index and Bloomberg U.S. Corporate Index. IG Corporate=investment-grade corporate. Data as of September 24, 2024. The zero-volatility spread is the consistent spread, or difference, between the present cash flow value and the U.S. Treasury spot rate yield curve. **Past performance is not a reliable indicator or guarantee of future results.** The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett.

A Beneficiary of Easier Monetary Policy in Structured Markets – Commercial Real Estate: When looking high level at an asset class, we are cautious not to paint it with a broad brush. And that certainly applies to commercial real estate after several years of a higher-rate environment and secular challenges that have had uneven effects by property type. However, in Figure 4, we note that a broad index of commercial real estate (CRE) is seeing year-over-year (YoY) post-pandemic declines now flatline, much as it did in 2010 after an even more severe pullback during the Global Financial Crisis (GFC).

In the most recent monthly release, we find industrial and retail property prices gained 0.8% and 0.2%, respectively, while office prices were flat, and apartment prices were down 0.7%. Industrial prices continued their march higher and posted their 15th-consecutive positive month. Retail posted its third-straight positive month.

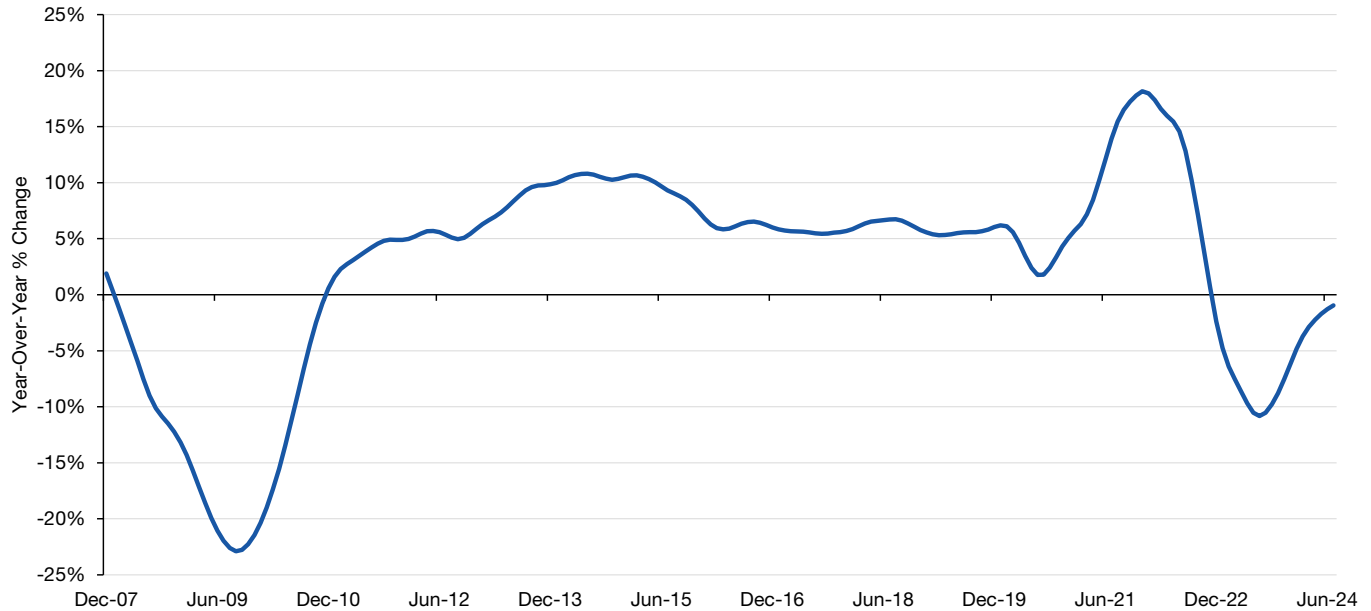
Digging into the details, we note the divergence between retail prices versus multifamily over the last few months. The pace of multifamily price declines has been slow to recover, and the subsector has posted 24 months of consecutive monthly declines. During the GFC, prices were down for 40 consecutive months until they crossed over into positive territory. We suspect multifamily will decline ~25% from peak to trough (currently down 21%), and prices should start recovering in Q3 2025. Given the affordability challenges in the single-family-for-purchase market and slowdown in multifamily deliveries (Costar estimates 40% lower multi-family deliveries in 2025), this sets up 2025 as a year of stabilization/absorption with improving fundamentals.

Further, the Fed pivot should spur transaction activity and support CRE prices from falling much further post-election, with the exception of obsolete office buildings affected by secular changes. Given these crosscurrents in the asset class, we believe selection will remain key, offering active managers a source of potential alpha in CMBS.



Figure 4. Commercial Property Rebounding – Redux of 2010?

RCA National All-Property Price Index year-over-year percent change, December 31, 2007-July 31, 2024



Source: Real Capital Analytics and Bloomberg. Data as of July 31, 2024. Real Capital Analytics (RCA) All-Property Price Index measures the actual price movements for properties based on transaction data using repeat-sales regression methodology. Historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett.

Summing it up

The expected volatility in rates remains elevated, while the expected volatility in credit has declined. Investors concerned that slowing economic growth may hamper the return potential of high yield bonds should also know that the asset class has historically produced strong results during periods of modest or even sluggish GDP growth. We think the securitized sector also offers an area of opportunity, including high-quality agency MBS with attractive carry and essentially no credit risk, and a developing recovery in CRE that creates opportunities in CMBS.

Credit markets offer abundant possibilities for an adept credit manager that employs rigorous and deep fundamental research across the credit spectrum. We think focusing primarily on rate-oriented bonds limits these opportunities in fixed income, as well as the potential to tap into the multiple dimensions credit has to offer.



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The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

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The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

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Agency mortgage-backed security (MBS) is a security backed by mortgages that are deemed to meet U.S. agency standards, such as those issued by federal agencies like Fannie Mae, Freddie Mac and Ginnie Mae.

At-the-money is a term used to describe an option's price that is the same as the market price of the underlying security.

Carry is the difference between the yield on a longer-maturity bond and the cost of borrowing.

Commercial mortgage-back security (CMBS) is a type of mortgage-backed security backed by commercial and multifamily mortgages or mortgages on commercial property.

A **basis point** is one one-hundredth of a percentage point.

Duration of a security that consists of fixed cash flows, such as a bond, is the weighted average of the times in years based on the present value of all future cash flows that it takes to receive a bond's cost.

The Federal Reserve (Fed) is the central bank of the United States. The federal funds (fed funds) rate is the target interest rate set by the Fed at which commercial banks borrow and lend their excess reserves to each other overnight.

Prepayment risk is the risk involved with the premature return of principal on a fixed-income security. This risk is generally associated with mortgage-backed securities as borrowers pay off the loan amount.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

Zero-volatility spread is the constant spread that makes the price of a security equal to the present value of its cash flows when added to the yield at each point on the spot rate Treasury curve where cash flow is received.

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