VICTORY income investors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

MONTHLY FIXED INCOME MARKET UPDATE

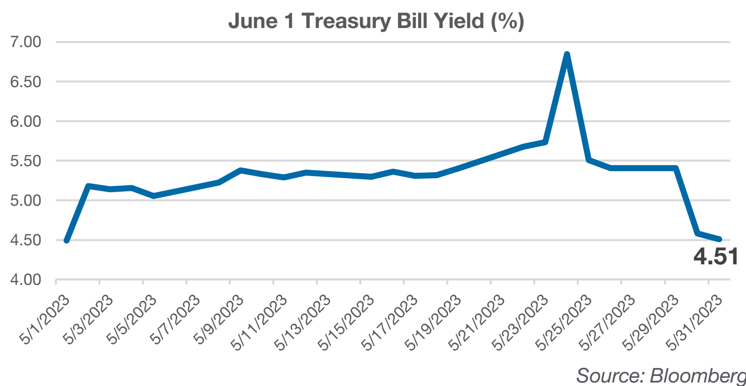
As of May 31, 2023

Key Takeaways

1. On the market's mind in May was whether the US debt ceiling would be raised and when. When negotiations were reported as tending towards resolution, the markets would surge, but when talks were understood to be faltering, the markets would slump. As of this writing, an agreement has been hammered out, but it still needs to pass Congress and some members have deep reservations.
2. Treasuries and corporate spreads have taken their cues from the negotiations over the debt ceiling, and this has driven the performance of fixed income indices, which was down for most of the month, only to reverse in the past days.
3. Amidst the *Sturm und Drang* of the debt ceiling, market participants have debated if the Federal Reserve ("The Fed") would raise interest rates at its next meeting, scheduled for June 13-14. Notes from the May 2-3 meeting revealed disagreement on the need to hike again, with some opposed, citing tighter bank credit, and others in favor, arguing for urgency in moving inflation back towards a long-standing objective of 2%.

The Month in Charts

Worries over the standoff on the debt ceiling dominated May. Throughout the month, spreads and valuations were hostage to news on the progress of negotiations. As the "X-date"—the day at which the US Treasury believes it may run out of money to meet its obligations—crept closer, and still without word of progress, the yield on the June 1 Treasury Bill spiked at well over 6.5%. On the news over the Memorial Day weekend that an agreement had been reached, the yield plummeted:



Source: Bloomberg

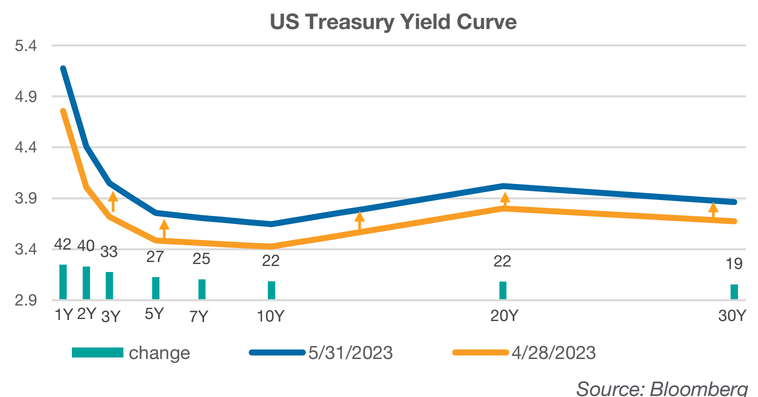
Spreads in corporate bonds widened over the month, after first being wider, then tighter on news of a debt ceiling deal, and then widening again (!) on the final day of the month on worries over an economic slowdown. Corporate high yield bonds, inhabiting the riskier regions of credit, especially suffered, widening by ~18 bps*. Structured product (CMBS, MBS, and ABS) performed well, though, highlighting the benefit of being able to invest in a broad spectrum of fixed income and in wherever one sees value, rather than being tied to an index:

				Quarter		Change		
Asset Class	Yield	Spread	Trend	Tight	Wide	MoM	QoQ	YoY
U.S. Treasury	4.07							
U.S. MBS	4.61	56		47	69	-10	10	21
U.S. Corporate	5.38	137		119	163	2	14	8
U.S. Corporate High Yield	8.90	465		388	516	18	53	63
CMBS	5.36	136		101	143	-4	34	36
ABS	5.21	77		51	86	-5	22	-8
A	5.19	118		100	144	1	14	13
BBB	5.67	167		145	190	3	16	6
BB	7.26	300		246	350	18	32	40

*Basis point "bps" is 1/100th of a percentage point.

Source: Bloomberg; Asset Classes represented by: ICE BofA US Treasury & Agency Index, Bloomberg US Agg Total Return Value Unhedged USD, ICE BofA US High Yield Index, ICE BofA US Fixed Rate CMBS Index, ICE BofA US Fixed Rate Asset Backed Securities Index, Bloomberg US Agg A Total Ret Index, Bloomberg US Agg Baa Total Ret Index, Bloomberg Ba US High Yield TR Index.

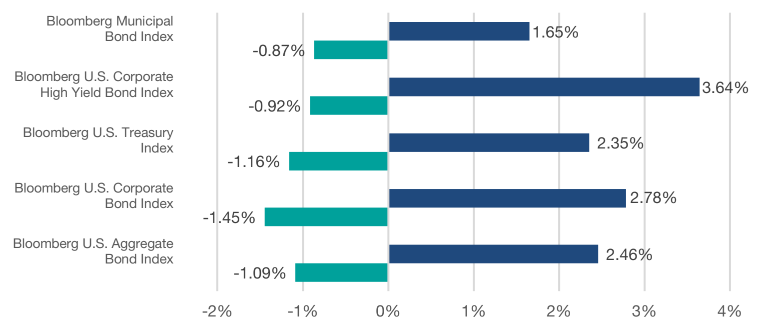
The Treasury curve shifted up as investors worried over the debt ceiling deal and weighed the possibility of further hikes, perhaps even at the June meeting. Minutes from the Fed's May meeting, released May 24, disclosed that policymakers were no longer unanimous on the need for immediate further hikes. Some argued that the turmoil in regional banks (see our March and April monthly commentaries) would itself tighten credit conditions, meaning that additional Fed tightening was premature. Others, though, thought inflation remained too high and that it must be tamed before expectations became entrenched. Many market participants wondered privately what the Fed would do if the US actually did default on its debt, as some fear could happen after the "X-date."



Source: Bloomberg

On the shift in the Treasury curve, and along with the tightening spreads, fixed income indices had negative returns in May. Returns were still positive for the year-to-date, though:

Returns (%) for Fixed Income Indices



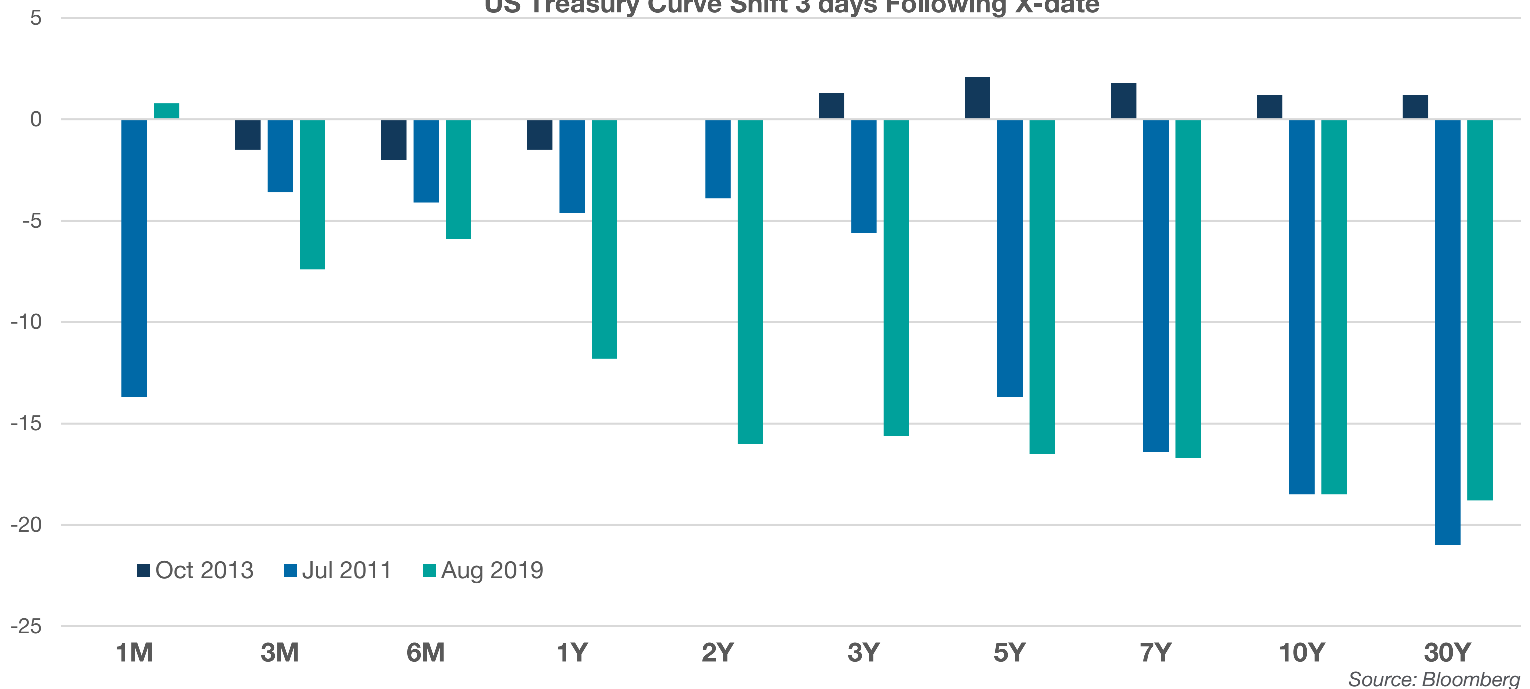
Performance as of May 31, 2023

Source: Bloomberg

Past performance is no guarantee of future results.
Index returns do not reflect management fees, transaction costs or expenses; one cannot invest directly in an index.

Our Current Thinking

Market reactions to previous debt ceiling crises have been mixed. In two of three (2011 and 2019) of the most recent instances in which the country neared the debt ceiling, in the immediate days following a deal, the Treasury curve shifted downwards. In a third example, in 2013, the shift was slightly higher in certain portions of the curve. See the graph below, which plots the change in the Treasury curve along its length for all three instances. Of course, each time Congress and the president confront this situation, the circumstances are different, but the graph of the shift in the Treasury curve, above, and the sudden and dramatic drop in the June 1 T-bill, also above, suggest we could see the same again, which would benefit fixed income.



Source: Bloomberg

What next?

As of this publication, Congress had only begun debating passage of the debt ceiling bill. Though success is not assured, markets were optimistic, and Treasuries were rallying on expectations of a passage. Clearly, and yet again, the folly of predicting markets has been demonstrated! Beyond the debt ceiling, and in the back of the market's mind, are rising fears of a recession. Data releases, and their interpretation by the Fed and markets will be extremely important in estimating the likelihood of an economic downturn and how economic policy makers may react to it.

Bonding over Bonds

Our video series on the fixed income markets

In our #BondingOverBonds video series, experts discuss notable activity in the fixed income markets: Watch Now

What to Watch in the Month Ahead

We'll be monitoring closely the upcoming events in June for further insight into financial conditions:

- The debate surrounding passage of the federal government's debt ceiling.
- The release of the next CPI figures on June 13, which will provide further clues on if inflation remains high.
- Market reactions to the Fed's next decision on rates on June 14, as well as the press conference following.
- Further economic data on if the country may be headed for a recession.

All investments carry a certain degree of risk including the possible loss of principal, and an investment should be made with an understanding of the risks involved with owning a particular security or asset class. Interested parties are strongly encouraged to seek advice regarding the best options for their particular circumstances from qualified tax and financial experts.

The opinions are as of the date noted and are subject to change at any time due to changes in market or economic conditions.

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. **The Treasury Yield Curve** shows the relationship between the US bond yield and the time to maturity. Yield and price have an inverse relationship. As the yield curve lowers, the price of bonds increase.

Tenor: the length of time until a debt is due.

Core CPI: CPI excluding food and energy.

Consumer Price Index (CPI), a popular measure of inflation and deflation calculated by the Bureau of Labor Statistics, measures the monthly change in prices paid by U.S. consumers.

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V21.047 // May 2023 VINC Fixed Income Monthly Update COM

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