MONTHLY FIXED INCOME MARKET UPDATE

VICTORY income investors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

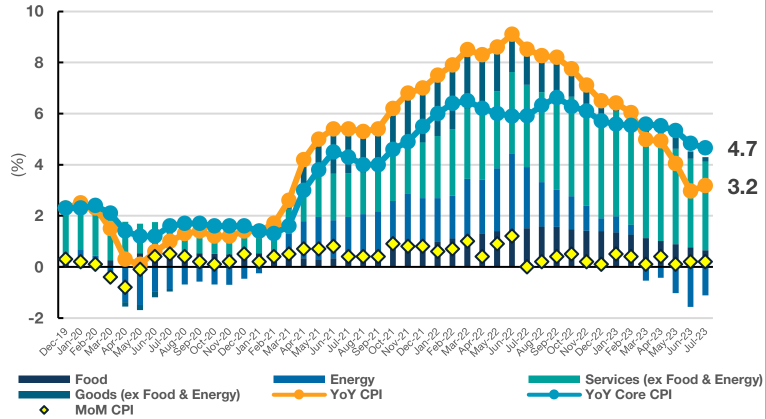
As of August 31, 2023

Key Takeaways

1. A resilient Nonfarm Payrolls release on August 4th and a higher-than-expected Consumer Price Index release on the 10th indicated that, despite repeated interest rate hikes by the Federal Reserve (the Fed), the U.S. economy was still running hot.
2. Fed Chairman Jerome Powell emphasized at the Jackson Hole Economic Policy Symposium on August 25th the Fed's unrelenting determination to reduce inflation to its longstanding target of 2%. In dismay, the intermediate- to long-end of the curve shifted higher, causing fixed income returns to go negative.
3. But the U.S. GDP and the ADP National Economic Employment Reports, both released on the 30th, and the core Personal Consumption Expenditure Price Index, released the next day and one of the Fed's preferred measures of underlying inflation, both suggested the economy could be slowing. In the final days of the month, the market rallied on hopes the Fed may not have to raise rates further to reach its 2% target after all.

The Month in Charts

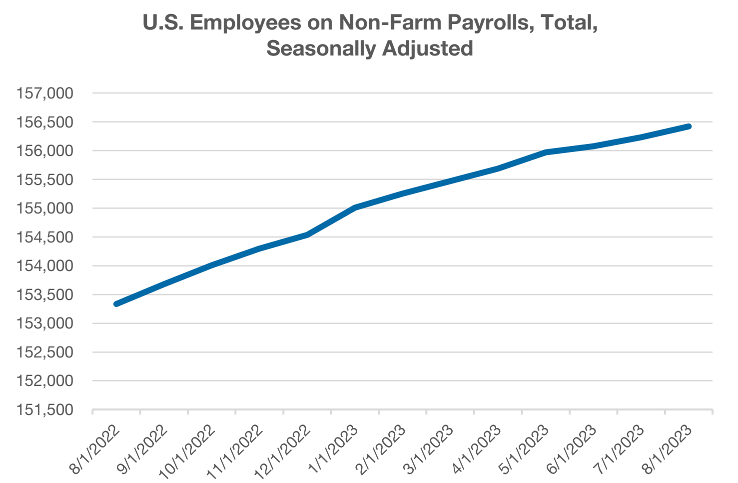
Core CPI trended lower by 18 basis points (bps)* to 4.7% in the report of August 10th. While it has declined considerably from its peak of 9.1% in June 2022, it's still far above the Fed's 2% target.



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

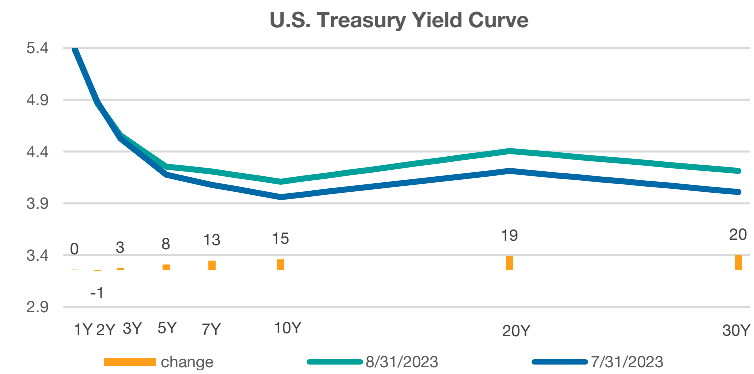
Source: Bloomberg

That the Nonfarm Payrolls report of August 4th came in only slightly below estimates and that the unemployment rate stood stable at 3.5% left market participants with the sinking feeling that the Fed may have to raise rates higher to bring inflation back under its long-standing 2% target.



Source: Bloomberg

When Chairman Powell, in his keynote address to the Jackson Hole Symposium on the 25th, reiterated his determination to meet this goal, market participants glumly concluded the Fed Funds rate would stay higher for longer. The entire U.S. Treasury yield curve shifted upward, the move most pronounced in the 7- to 30-year tenors.



Source: Bloomberg

Credit spreads over the month widened on gathering fears of a recession from ever higher interest rates. U.S. corporate spreads widened 5 bps and high yield spreads 3 bps.

				Quarter		Change		
Asset Class	Yield	Spread	Trend	Tight	Wide	MoM	QoQ	YoY
U.S. Treasury	4.51							
U.S. MBS	5.02	53		48	60	5	-2	13
U.S. Corporate	5.61	117		112	138	5	-20	-23
U.S. Corporate High Yield	8.49	370		368	465	3	-94	-112
CMBS	5.79	133		129	136	1	-4	31
ABS	5.49	63		59	79	2	-15	1
A	5.46	102		97	119	5	-16	-12
BBB	5.86	143		138	168	5	-25	-30
BB	7.16	247		238	300	9	-54	-87

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. MoM/QoQ/YoY as of 8/31/23

Source: Bloomberg

Bonding over Bonds

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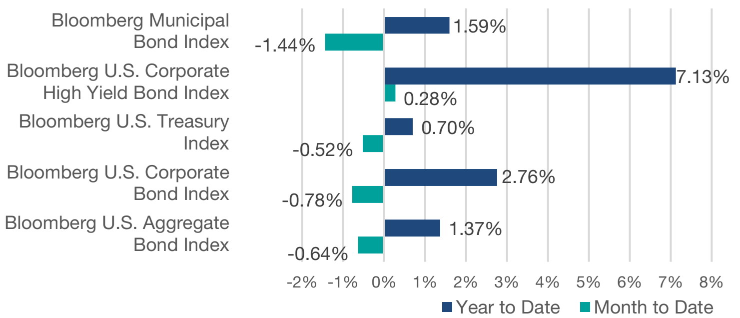
The overall upward shift in the Treasury curve combined with widening spreads sent returns for nearly all fixed income indices into negative territory for the month. Only the high yield index eked out a meagre 0.28% gain on its overall higher coupons.

Returns (%) for Fixed Income Indices



Performance as of August 31, 2023

Past performance is no guarantee of future results. *Source: Bloomberg*

Our Current Thinking

It's always risky calling a turn in the economy. Economic releases, even at monthly intervals, offer only snapshots of how an economy as complex and intricate as that of the U.S. is evolving. But a long, hard look at the economic releases from the final days of August suggest to Victory Income Investors that changes could be in the economic winds. Moderating personal consumption expenditures point to subsiding inflation; plateauing employment suggests a slowing economy. Taken together, could these two reports signal that the Fed is taming inflation even as employment growth is finally moderating, meaning an end may be at hand to one of the harshest and steepest hiking cycles ever?

The Nonfarm Payroll report released on September 1 for the month of August provided further evidence that this may be the case. Although more jobs than expected were added in August, on a higher labor force participation rate, the unemployment rate ticked up to 3.8%. This suggested wage pressures may ease. Further substantiating that inference, the increase in hourly earnings moderated to 0.2%, the smallest increase since February 2022. These statistics lend credence to the contention that, at least as of the late August snapshot, the Fed may be achieving its dual mandate of price stability and high employment and it may pause on further hikes, at least for a while. As we highlighted in our July commentary and reproduced at right, following a pause in a hiking cycle, average annualized returns for fixed income—particularly for corporate bonds—have historically ranked well against other major investment asset classes. We believe that the moment could be ripe for an investment in fixed income to potentially see compelling returns.

Annualized Returns after Pause in Fed Rate Hikes

1-Year	2-Year	3-Year	4-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%

Source: Bloomberg

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.

What We'll Be Watching in the Month Ahead

Those who follow the decisions of the Federal Reserve Open Market Committee, which sets rates, know that future rate actions are data dependent. During September, we'll be watching the following releases for updated insight into the broader economy and overall financial conditions:

- **September 13:** The next CPI figures, which should indicate in which categories and by how much inflation remains over the Fed's targeted rate.
- **September 20:** The next Federal Open Market Committee (FOMC) rate decision. Will the Fed pause, as the growing consensus is expecting? What might the press conference emphasize afterwards?
- **September 28:** The Gross Domestic Product release and initial jobless claims, which may provide further indications of whether the economy is indeed cooling.

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.

Index returns are provided to represent the investment environment during the periods shown. Index performance includes reinvestment of dividends and other income. Index returns do not include transaction costs, management fees or other costs. Non-US indices are net of withholding taxes, if any.

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. **Personal Consumption Expenditure Price Index** is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services and is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

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