4Q 2021: High Inflation Remained the Primary Headline

- Inflation continued to run higher than expected through the end of 2021, with headline CPI near 7% and the Fed's preferred measure of core PCE running north of 4.5%. The future path of inflation remains uncertain, given that the highest inflation numbers have come in COVID-impacted sectors and as the economy normalizes, there should be some remediation in those statistics.

- On the other hand, even the current elevated numbers may be understating the level of inflation relative to history. If inflation were measured using the same methodology employed in the 1970s, inflation would be even higher than it is now, measuring in the mid-teens. The methodological changes introduced since the 1970s include the use of Owner's Equivalent Rent instead of actual home prices, hedonic adjustments that account for the changing quality/performance of certain goods (think home computers), and the impact of substitution effects that account for consumer behavior to swap one good for another comparable one when prices rise.

- While the initial impact of the COVID shutdown was a demand shock as people quarantined at home, that was relatively short lived and the more lasting impact has been a supply shock with factories and suppliers restricting production or shutting down entirely in efforts to control the spread of the pandemic. Those shutdowns have been exacerbated by transportation challenges such as backlogged ports and a dearth of truck drivers.

- The combination of supply side shocks that continue to ripple through the economy and abundant stimulus on both the monetary and fiscal sides has created the environment for a sustained, high rate of inflation.

Our View: Inflation remains the preeminent risk facing investors around the world today. While there is merit to the arguments that suggest inflation will start to trend lower as the economy normalizes, there are numerous risks to that outcome. In particular, ongoing shutdowns to combat new and evolving variants of the coronavirus will continue to create supply challenges, and the longer inflation remains high, the more likely it is to become ingrained in consumers' expectations and influence their behavior. In many ways, inflation is a self-fulfilling prophecy, and it will be much harder to tame if expectations lose their anchor.

4Q 2021: The Fed Is In A Difficult Position

- With inflation running well above the Fed's 2% target for longer than originally expected, the Fed announced plans to taper asset purchases more quickly than earlier planned, and markets have priced in 3 subsequent rate hikes in 2022, with another 2-3 in 2023. In this environment, the Fed and elected officials are in agreement with the need to bring down inflation, however the Fed must be careful not to withdraw support too quickly and risk market volatility and a potential recession.

- Despite the difficult balancing act of ending purchases and lifting rates while fiscal stimulus also fades, markets appear to have exceptional belief in the Fed's ability to navigate the challenges. The yield curve is abnormally flat at this very early point in the tightening cycle, implying there is very little term premium, and markets are assigning a very low probability to any chance of meaningful rate volatility or ongoing high inflation.

- Similarly, long-term inflation breakeven inflation rates have been well anchored as well, with the 5 year inflation rate 5 years from now still only slightly above the target at 2.2%.

- Although the Fed has no ability to unclog ports, hire truck drivers, or otherwise solve supply chain problems, making monetary policy ineffective for one of the primary causes of recent inflation, longer-term expectations are multi-faceted, with beliefs and confidence playing a significant role. Markets appear to believe that policy actions now and throughout 2022 will be enough to maintain faith in the Fed's ability to manage inflation.

- While long-term expectations of both rates and inflation have been stable, current markets have seen an uptick in Treasury volatility, perhaps reflecting the uncertainty that permeates the environment today.

Our View: The Fed faces a complex challenge trying to manage the withdrawal of monetary stimulus and the lifting of rates at the same time that fiscal stimulus fades and growth prospects in the face of ongoing pandemic restrictions remain suspect. Remove accommodation too quickly, and the risk of deflation and recession rise, while a too slow withdrawal increases the risk of higher inflation and meaningfully higher interest rates. Neither of those potential outcomes is priced into markets at current levels.

4Q 2021: Economic Cycle Indicators Are Sending Mixed Signals

- Growth was robust in 2021 and market valuations suggest another such year in 2022. While it is possible we experience the anticipated "Goldilocks" environment of reasonable growth, controlled inflation, and solid earnings, that optimistic scenario is already being priced in. Risks to that outlook lean heavily negative, with potential drags from slower demand due to depleted consumer savings and less direct fiscal support, higher inflation, higher interest rates, virus-related shutdowns, and ongoing labor shortages.

- This cycle has been unlike any cycle experienced in the past, and the traditional set of indicators used to evaluate the health of the economy all point in different directions, making forecasting particularly challenging.
  - Early Cycle Indicators – Strong corporate earnings and robust economic growth
  - Mid Cycle Indicators – Beginning of a monetary tightening cycle and slowing fiscal support
  - Late Cycle Indicators – High inflation, a flat yield curve, elevated leverage, very tight corporate spreads, record equity market valuations

- Labor markets are similarly muddled. While unemployment levels have dropped dramatically from the highs seen at the height of the lockdowns, the labor force participation rate remains well below pre-pandemic levels, suggesting there are still millions of people who could be working but are not.

- Negative real rates don't make sense in an economy with real GDP growth, and suggest that either real rates have to rise, or growth will slow dramatically. One of the consequences of negative real rates is that people are encouraged to buy things, driving up the price of goods, leading to inflation as well as asset price bubbles. These inflated assets are vulnerable in the scenario where the Fed makes a policy mistake and real rates move meaningfully higher.

Our View: Markets are too confident in the benign outlook for growth, inflation, and interest rates. With all of the uncertainty, it is difficult to have confidence in ANY forecast but the risks to the economy are skewed to the downside. Regardless, given the divergent data, we expect volatility, and the source or direction of that volatility is less important. In addition to greater volatility overall we anticipate cycles that are shorter than the decade-plus cycles we have seen in recent years and we can envision a return to something more akin to cycles experienced in the 70s and 80s.

4Q 2021: Global Markets Face Challenges, Too

- Rising inflation around the world prompted many central banks to take action, with rate increases from the central banks of England, New Zealand, Mexico, Russia, and a slew of other emerging market countries. In the same vein, the ECB started to reduce pandemic related stimulus, while the Royal Bank of Australia suggested rate hikes may be appropriate in 2023, a year earlier than initially contemplated.

- Further complicating the inflation picture in Europe are the ongoing challenges in energy prices, with tight supplies of natural gas to fuel power plants pushing electricity prices to new records. Both German and French futures markets anticipated power prices near 200 Euros per megawatt-hour (MWH) next year, more than double the 86 Euros per MWH paid by Germans for power in 2021.

- Turkey demonstrated the downside of letting inflation remain unchecked, posting a 36% annualized consumer inflation rate for the month of December, up sharply from the 21% reported in November. The Lira fell almost 80% relative to the U.S. dollar in 2021 as President Erdogan continues to defy monetary orthodoxy and push for lower rates.

- The Chinese property sector also continued to struggle in the 4th quarter as more developers succumbed to market pressure and saw bond and equity valuations tumble. Thus far, the dislocation has been reasonably well contained, and Chinese authorities have tried to mitigate some concerns with efforts to provide additional liquidity and ease certain restrictions on developers, but investors worldwide remain wary of potential spillover effects.

Our View: Rising rates, less monetary accommodation, and higher inflation around the world make it that much more difficult for central banks to manage the tightening process effectively given all of the moving pieces. With more central bank policies in flux, the potential for mistakes, both on the upside and downside, grows. While the difficulties in Turkey and China have remained isolated for now, those could certainly be sources of downside volatility in 2022.

4Q 2021: Corporate Credit: Remarkably Stable in 2021

- With the abundant support of QE and expansionary fiscal policy, corporate credit generally performed well in 2022, with the most noteworthy factor being the relative stability of both investment grade and high yield spreads during the year. IG credit traded within an 18 basis point range for all of 2021, while HY covered 100 bps, but spent almost all of the last 9 months of the year within a range of about 50 bps.

- On the ratings front, 2021 was a good year, with upgrades in the investment grade space outpacing downgrades after a very challenging 2020. High yield posted even better results, with the default rate for high yield issuers below 0.5%, the lowest pace in a calendar year since 2007.

- Wide open new issue markets, burgeoning growth, and ratings upgrades saw the gradual reversal of fundamental balance sheet deterioration that occurred in 2020 as corporate leverage came off the all-time highs seen during the pandemic, though still remained elevated near previous highs.

- The bank loan market also performed well, with record loan issuance twice the level seen in 2020 as demand from CLO issuers remained robust. December saw a rush of activity as issuers tried to complete deals before the mandated switch from LIBOR to SOFR, and it is expected that the first few weeks of January will be slow as markets gradually digest the implications of the change and begin to settle on pricing levels.

Our View: Although credit fundamentals have improved, both high yield and investment grade spreads remain near historic tights, especially considering the lower ratings and the longer duration of the investment grade universe and the likely headwinds of tightening monetary policy, less fiscal stimulus, and high inflation. Credit spreads provide no cushion for a policy misstep or an inflationary surprise, particularly considering all of the unknowns facing investors. Given the limited upside, we remain cautious on credit overall, with the recognition that potential rating upgrades and issuer specific events may create attractive idiosyncratic opportunities.

4Q 2021: Residential MBS: Faster Prepays and Stronger Credit

- The residential MBS market was a mixed bag in 2021, with agency MBS lagging comparable Treasuries despite slightly tighter spreads as rising volatility, faster prepays, and fears of the Fed stepping back from the market drove underperformance. Non-agency MBS, however, posted solid results given stronger borrower performance and dramatically higher home prices.

- With the Fed withdrawal from new purchases in the agency MBS market now expected to happen at a much earlier date than previously thought, agency MBS has lagged as investors have shied away given the anticipated decline in demand. However, even if the Fed were to stop all new purchases, as long as they continue to maintain the size of their balance sheet, they will have to reinvest paydowns from their existing MBS holdings, suggesting they'll be sizable players in the market for some time to come. Additionally, bank demand increased in 2021, and is anticipated to be solid in 2022, helping to offset some of the loss of demand from the Fed.

- Home prices rose considerably in 2021, with the Case Shiller 20 City Composite Index up almost 18.5% year over year through October, which was off the peak of just over 20% seen in July. With the impressive jump in prices, there are natural connections to the pre-GFC period when homes were up similar amounts. While there are similarities, there are key differences as well, including new structural demand for homes given the rise of work from home and the desire for more open spaces and chronic under-building in the sector for a decade. Critically, the current environment lacks the aggressive affordability products (negative amortization loans, piggyback loans, teaser rates, etc.) that were prevalent in 2006 that allowed overall leverage in the system to rise to dangerous levels.

- The rise in home prices has had positive effects on the non-agency MBS market as well. Not only are home equity levels higher, making foreclosures less likely, but the possibility of a loss in the event of a default are meaningfully lower. The last two years have seen a dramatic increase in the percentage of liquidations that result in no loss, from around 10% at the end of 2019 to near 50% at the end of 2022.

Our View: Agency MBS remains an attractive opportunity, despite relatively tight spreads as a liquid, high quality alternative to credit spreads. Within agency MBS, the TBA market continues to benefit from Fed purchases, which we expect to last for several more quarters, albeit to a lesser extent. The pace of home price appreciation isn't likely to sustain at recent levels, nor is it likely to fall substantially given the much better underwriting we see relative to the 2006 era. As a result, non-agency MBS issues are expected to perform well through 2022, with some potential to invest in new issue non-agency security types given the stronger collateral performance.

4Q 2021: CMBS & ABS: Strong Consumers Balance Commercial Risks

- The pandemic saw a host of programs created to support consumers whether through direct payments or forbearance on things like student loan and mortgage obligations. The impact of that support has filtered through to the numbers, with decade lows being seen in consumer ABS delinquencies and charge-off rates.

- Similarly, spreads have tightened to levels narrower than those that existed pre-pandemic across a wide range of sectors. Somewhat surprisingly, those tight spread levels have come at a time when issuance is also at a post-GFC high of over $250 bn.

- CLOs have also had a banner year, with over $1 trillion of new issuance globally. In addition to the record issuance, secondary trading, overall market size, number of managers, and investor participation all reached all-time high numbers as investors clamored for high quality yield at the top of the capital structure and attractive yields at the bottom.

- Commercial property prices were generally up around 18% in 2021, in line with the residential real estate market. Net Operating Incomes (NOI) were also higher in 2021, and were reflected in strong CMBS performance for the year.

- Delinquencies in CMBS remain elevated however, with retail above 40%, lodging around 31%, and office at nearly 14%. Stress is still clearly evident in the underlying loans, but sponsors and servicers have thus far done an effective job at extending loans and managing the process to mitigate the damage to investors.

Our View: Overall tight spreads in both ABS and CMBS make large, generic allocations difficult at this point, but the complexity and diversity of both asset classes means there are ample opportunities to identify attractive specific opportunities across the capital structure. In particular, higher quality CLOs represent good value when considering reasonable spreads, robust structures, and good liquidity. Commercial real estate backed CLOs and select single asset single borrower CMBS are also potential sources of opportunity.

4Q 2021 Core and Core Plus Fixed Income Positioning Summary

Defensive positioning overall given historically tight spreads and abundant risks, while an ample level of liquidity is maintained to respond to potential volatility.

Characteristic	Positioning	Comments
Duration	Ended the year approximately 0.4 years short versus the benchmark	Remain shorter than the Index with yields still relatively low
Curve	Underweight intermediate and longer maturities	Fed hikes are largely priced in to the front end of the curve, while longer term rates could go higher, particularly if inflation remains elevated
Governments	Neutral with an emphasis on on-the-run securities	• On-the-run Treasury securities provide much greater liquidity • Maintained a small position in long TIPS
MBS	• Agency MBS – overweight • Non-Agency MBS – maintain allocation, with bias to add on pricing dislocations	• Preference for current coupon agency MBS TBAs which remain attractive given relatively high carry of TBAs versus specified pools • Maintain emphasis on higher quality, shorter duration, currently amortizing non-agency MBS bonds • Look to add exposure in heavily discounted senior legacy non-agency MBS bonds with solid fundamentals
ABS	Small overweight	• Prefer AAA and AA rated CLOs given better liquidity, robust structures and reasonable spreads • Maintain modest position in select FFELP student loan ABS
CMBS	Neutral	Emphasis on non-agency CMBS holdings, including CRE CLOs and super senior single asset single borrower deals, but beginning to look down the capital structure for opportunities
Investment Grade Credit	Underweight	• Remain underweight given historically low yield premiums • Positioning remains concentrated in high conviction names, intermediate banks, and defensive sectors like communications and non-cyclicals, particularly healthcare • Minimal exposure to cyclical credit sectors and non-corporate credit
High Yield	Small allocation	Emphasize defensive credits and select, high conviction idiosyncratic issuers
International	Small allocation	Potentially rising rates and risks of slowing growth make relative value unattractive in most cases

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