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1Q 2022: Bond Market Rout One of the Worst in History

- The bond market, as measured by the Bloomberg US Aggregate Bond Index, was down almost 6% in the first quarter, bringing the total decline from the peak levels seen at the end of July last year to almost 7%. That decline represents the largest peak to trough loss since 1980 and is the third worst result for the index since its inception in 1976.

- This poor performance came as a result of an increase in Treasury rates (as measured by the 10 Year note) that was only the 8th largest over the same period. The combination of a historically long duration and extremely low interest rates, and hence limited coupon income, made this period particularly painful for investors, despite the relatively modest move in rates compared to other major bond market downturns.

- Further compounding the performance lag from higher interest rates was the increase in credit spreads seen in the first quarter, with all sectors, including investment grade credit, high yield, and all parts of the securitized markets underperforming comparable duration Treasuries.

- After such a difficult period, and staring down the barrel of a rapid and sustained hiking cycle by the Federal Reserve, many investors ask themselves "Why am I holding fixed income assets at all?"
    - Longer duration assets, particularly Treasuries, are still the best hedge against credit and equity market volatility, even if the hedge is not as effective as it once was given the low absolute level of rates.
    - Even aggressive hikes by the Fed may not push long-term rates dramatically higher, particularly if the market continues to price in an overcorrection, suggesting the curve could remain flat or invert.
    - If the curve steepens, long-term Treasury rates aren't likely sustainable at substantially higher levels given the large amount of debt across the economy, and as the cost of servicing that debt goes up, it becomes a bigger and bigger drag on economic activity.
    - Maintaining an investment in fixed income rather than cash minimizes the risk that an investor is unable to get that cash reinvested in markets near the bottom and misses out on the subsequent recovery.

Our View: Despite the challenges of the past quarter, there is likely to be further volatility ahead, both in interest rates and in credit spreads. With spreads moving wider, we have been disciplined and added risk commensurate with the additional compensation. Further volatility will likely create even more compelling opportunities and we have ample ability to expand the risk budget further should conditions allow. Current positioning reflects near-neutral interest rate exposure, an overweight to high quality "spread" sectors and an overall yield advantage to the index. While ongoing volatility may result in some short-term periods of underperformance, the portfolio is well positioned for strong long-term performance, while maintaining substantial liquidity to adjust portfolio structure as relative value shifts in the market.

1Q 2022: The Fed Takes a Hawkish Turn

- Inflation continued to march higher in the first quarter, reaching almost 8% on a year over year basis, with more evidence that it is becoming increasingly broad based, rather than concentrated primarily in COVID-impacted sectors.
- Despite the run-up in realized inflation, long-term inflation expectations remain well contained, with the TIPS market implying 10 year breakeven inflation rates are below 3% while 30 year breakeven rates sit just below 2.5%.
- Inflation is likely to remain high for the foreseeable future as the primary drivers of inflation – commodity prices, supply chain challenges, labor shortages, de-globalization and onshoring of critical industries, and rapidly rising home prices are not easily corrected in the short-term.
- Given those factors, the Fed has made it clear that they will use the primary tool they have – higher rates – to bring inflation lower, with the market currently pricing in 11 hikes of 25 basis points (bps) each between now and the middle of 2022. Those hikes are largely front-loaded, with 50 bp increases expected in each of the next two meetings and 25 bp increase in every subsequent meeting.
- Though Fed Chairman Powell has spoken highly of former Fed chair Paul Volcker and his determination to stamp out inflation by lifting short rates into the teens and sending the economy into a long and deep recession, more recent Fed history implies that Volcker's comfort with misery in pursuit of lower inflation might not be present to the same degree in today's Fed. The real test will come if (when?) we encounter a scenario where inflation is still elevated (5+%) but credit and equity markets have begun to price in a recession and are down significantly. It is an open question how the Fed will respond, particularly if labor markets remain tight.
- No modern central banker wants to be the one that lets inflation get out of control, which suggests the Fed will maintain resolve in the face of challenging circumstances, while they also benefit from the currently reasonable expectations for long-term inflation. Volcker needed to squash not only current inflation, but also elevated expectations, making his job much more difficult and likely more damaging to the economy.

Our View: The Fed has an incredibly tiny needle to thread trying to engineer a drop in prices without an equivalent decline in economic activity. While markets are pricing in 11 hikes over the next 12 months or so, we think it's unlikely that all 11 actually get implemented, rather, we expect that conditions will change, i.e. some part of the market or economy will "break" forcing the Fed into a very difficult position. However, if that break is accompanied by increasing unemployment, it may provide the Fed the cover they need to pause or even reverse course on their hiking plan.

1Q 2022: Economic Indicators Starting to Turn Lower

- The yield curve looks less like a curve and more like a plateau, with the front end very steep as it prices in an aggressive Fed and then a long, flat expanse all the way out to 30 years. While different parts of the curve vacillate between mild inversion and slight steepness, the signal remains clear – markets are skeptical of future growth but believe the Fed will be successful at moderating inflation over the medium to long term.

- There are numerous reasons for the market's skepticism about future growth prospects:
    - High current inflation, leading to reduced consumer spending
    - Fading fiscal stimulus
    - Higher short-term rates as the Fed continues hiking
    - Declining real (after adjusting for inflation) wages
    - Tighter financial conditions
    - Geopolitical tensions, including most significantly, Russia's invasion of Ukraine and the subsequent sanctions

- Nominal wages have been rising steadily and headlines continue to show anecdotal evidence of wage pressures across numerous industries and income levels. Even so, once adjusted for current high levels of inflation, it is clear workers have been consistently losing real spending power.

- That is likely one of the reasons consumer sentiment has fallen substantially over the year, and is well below the highs seen pre-pandemic. Current levels around 60 are typically associated with a weak economic environment in which the Fed is easing rates to bolster the economy, rather than one in which the Fed is expected to be lifting rates to dampen economic activity.

Our View: The dangerous confluence of factors has meaningfully increased the odds of recession in the next 12-18 months. Further, we are likely to see stagflationary conditions (slowing growth and high inflation) for at least some period of time, though probably not as long or as painful as the episode experienced in the late 70s or early 80s. Nevertheless, we believe the next 12-24 months could be a challenging period for markets and for fixed income investors especially, though with those challenges will also come significant opportunity.

1Q 2022: Global Upheaval Adds to Uncertainty

- Russia's invasion of Ukraine dominated headlines and spurred quick and unified action on the part of western countries, which introduced heavy sanctions on Russia and Russian oligarchs, essentially locking them out of the global financial system. While sanctions were severe, they could have been worse, as exceptions were made for select banks to allow for the purchase of Russian oil and gas by Europe. Nevertheless, excising the 12th largest economy in the world from global trade overnight is almost certain to have a negative impact on future growth.

- In addition to the negative impact on growth, the aftermath of the invasion is also likely to be inflationary as well, as Russia and Ukraine combined were large exporters of numerous industrial and agricultural commodities such as wheat, nickel, oil, and gas. Interruptions in the flow of those commodities has already created havoc in London based nickel markets, sent the price of oil and gas higher, and raised the specter of much higher food inflation, particularly in Europe.

- China has attempted to avoid choosing sides, calling for a peaceful resolution publicly while continuing to purchase Russian commodities. But, they face their own set of difficulties at home, with more draconian lockdowns impacting various cities and companies as more transmissible strains of the coronavirus make their zero-COVID policies difficult to maintain. Separately, technology stocks have fallen almost 50% from the highs while property markets have slowed dramatically. China was forced to ease recently introduced regulations and introduce programs to support property markets in an effort to support those sectors and maintain growth.

- As inflation has risen around the world, central banks are lifting rates and markets have adjusted long-term interest rates higher. As a result, negative yielding debt around the world has dropped to less than $3 trillion, form a high just over $18 trillion at the end of 2020. The rising cost of debt in a heavily indebted world is almost certain to be an additional drag on growth.

Our View: The Russian invasion of Ukraine has fundamentally changed the world order and could accelerate a longer term trend of de-globalization, leading to somewhat higher structural inflation. More immediately, it is difficult to envision a scenario where global markets welcome Russia back into the fold, suggesting strained relations and export volatility in the future. Infrastructure to replace Russian oil and gas in Europe will take years to put in place implying long term upward pressure on inflation, potentially balanced by the negative growth impacts of Russia's near removal from the global economy.

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1Q 2022: Corporate Credit Markets Repriced Swiftly

- Spreads widened across the board in the first quarter, with the investment grade market widening over 50 bps to a peak of 144 bps in mid-March before recovering to end the quarter at 114 bps. And even this movement understated the actual widening as more liquid credits were wider still, with the index lagging the move of those liquid issues by 15-20 bps.
- High yield spreads showed a similar pattern, with spreads starting the year around 280 bps, before widening in mid-March to just over 400 bps, and rallying to end the quarter around 320 bps. Prices on high yield bonds, however, were more stable than the spread movement would suggest as some of the spread movement, particularly later in the month was due to changes in Treasury rates rather than a repricing of credit risk in the sector.
- Technical conditions have improved in high yield and bank loans with issuance much lower than last year, particularly in March as market volatility kept any opportunistic issuers on the sidelines. Investment grade was a different story, with issuance running just behind 2021 year to date, but well ahead of levels the previous several years.
- One benefit of the volatility is that lending standards have improved somewhat with terms shifting modestly back in favor of lenders. In the last couple of months, bond buyers have been successful at pushing back against certain loose bond covenants favored by underwriters. The new, more restrictive terms were considered necessary to get the deals done, and have been generally well received by markets.
- While fears of higher rates has generally led to outflows for fixed income funds, bank loans have been the exception given their floating rate structures. In the first quarter alone, loan funds saw $64 billion of retail inflows, helping to offset the decline in CLO issuance and bringing the loan mutual fund base to $135 billion, which isn’t far below the all-time high of $154 billion in late 2018.

Our View: Wider credit spreads during the quarter provided opportunities to add high quality issuers at far more attractive valuations, though some of these purchases were subsequently trimmed toward the end of the quarter as spreads tightened. Future earnings releases will be interesting to see how companies respond to rising input costs and the impact on profitability. We expect there to be further divergence in company performance, which should create additional opportunities to add to corporate bond exposures in the months and quarters ahead.

1Q 2022: Securitized Markets Lagged As Well

- Agency mortgages lagged for the quarter given high volatility, increasing interest rates, and growing concerns about the Fed's plan to reduce their exposure to the sector. At this point, however, with a duration north of five years, a threshold that's been reached just a handful of times over the last 20 years, and over 60% of the index in lower coupon mortgages, the sector is approaching fully extended duration, meaning future rate increases aren't likely to see significant further extension.

- Similarly, non-agency spreads were also wider during the quarter as markets moved in sympathy with broader credit markets and began to price in growing risks to the economy. In particular, lower rated tranches in both the non-qualified mortgage sector and the agency credit risk transfer (CRT) market widened materially, with new issue spreads on subordinate CRT tranches 300-500 bps wider than similar issuance in the second half of last year.

- Despite the increase in spreads across securitized sectors, housing fundamentals continue to look favorable, though affordability is likely to come under pressure given rapidly rising home prices and higher mortgage rates. At the most fundamental level, there are simply too few homes available given a massive decline in single-family home starts in the decade following the Great Financial Crisis, leading to current supply/demand imbalance and supporting home values for some years ahead.

- With home prices rising quickly, an analysis by CoreLogic suggested homeowners in total have seen a total equity increase of over $3.2 trillion since the 4th quarter of 2020 with the average homeowner gaining about $55k during 2021. This suggests that as long as rates remain relatively high, rate refinancings will continue to be slow, but cash-out refis will pick up as borrowers look to tap that available equity. Given that most of the mortgage market is now priced at a discount, investors may start to look at deals with underlying loans likely to take advantage of that cash-out opportunity, such as low LTV loans or those with more aggressive servicers, which ultimately will generate faster prepays and potentially more attractive returns.

Our View: We continue to find value in various parts of the securitized markets. Agency MBS looks attractive at current levels, especially considering the liquidity and high quality of the asset class, even with the expectation of less Fed buying in the future. Similarly, wider spreads on recent issues of non-agency MBS provide a greater buffer for adverse events down the road, with compensation now reasonable for the risks undertaken. Legacy non-agency MBS remains a compelling asset class given the ongoing fundamental improvement in borrower profiles, while modestly wider spreads in ABS provide some offset to a potentially softening consumer credit outlook.

1Q 2022 Core and Core Plus Fixed Income Positioning Summary

Volatility allowed for opportunistic additions in the first quarter with ample room to expand risk budgets further going forward should we see continuing volatility.

Characteristic	Positioning	Comments
Duration	Ended the quarter approximately 0.1 years short versus the benchmark	Long-term rates at current levels are close to fair value, and we will be slow to add meaningful duration given the potential for a large, but likely temporary, move in rates materially higher
Curve	Expectations for a steeper curve	• Small overweight to the 2 year part of the curve given large number of hikes already priced in • Modest underweight to the 10 year and 30 year part of the curve due to potential for inflation to push term premiums higher
Governments	Underweight 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 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, while continuing to look for opportunities down the capital structure
Investment Grade Credit	Neutral	• Look to take advantage of volatility and add on weakness and trim into strength • 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	Slowing growth and a tightening Fed has historically been a difficult environment for EM issuers

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