Congress Asset Management Company

Fixed Income Outlook

John Beaver, CFA | Jeffrey R. Porter, CFA

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In 2021, equity markets cheered a strong economic recovery while fixed income markets looked ahead to looming changes in monetary policy. Rising inflation has caught the eye of policy makers, prompting them to accelerate their plans to end the current era of easy money. Bond markets, understandably, took a breather as yields rose along the long end of the curve. The losses incurred for the year were quite small, but they did reflect the markets' concerns over the pace of changes to come. 2022 will be a year focused on monetary policy and how fast and how broadly the Federal Reserve will engage in tightening activities.

The U.S. economy sustained its recovery though the end of calendar 2021. Broadly speaking, the economy showed strength in GDP data, rising retail sales figures, and a resilient housing market. That these strong data points came in the face of less than full employment and regional COVID disruptions highlights the underlying strength of the economy. Recent anguish over supply chain issues furthers this point as consumer demand has been persistent even when the desired products are not on the shelves.

Figure 1 Retail Sales Since Year-End 2019

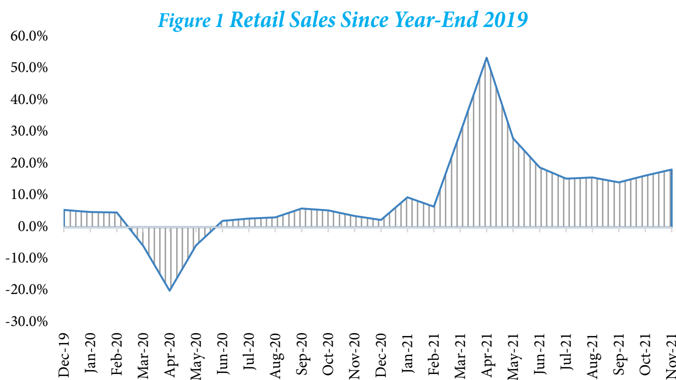

Figure 1- Retail Sales December 2019 through November 2021. Source: FactSet

As the economy has improved, so have indications of rising inflation. While formerly a dormant issue, price increases came to the forefront in the second half of 2021. Economists saw a distinct upturn in both consumer price and producer price indexes, signaling to all that the Federal Reserve (the Fed) was very likely going to begin earnestly reining in its loose monetary policy. The most recent reading for the Personal Consumption Expenditure price deflator (which excludes food and fuel increases) was up 4.7% on a year-over-year basis at the end of November. This time series is the Fed's preferred measure of inflation and serves as their bellwether indicator.

Figure 2 Inflation measures PCE Deflator and Core PCE Deflator

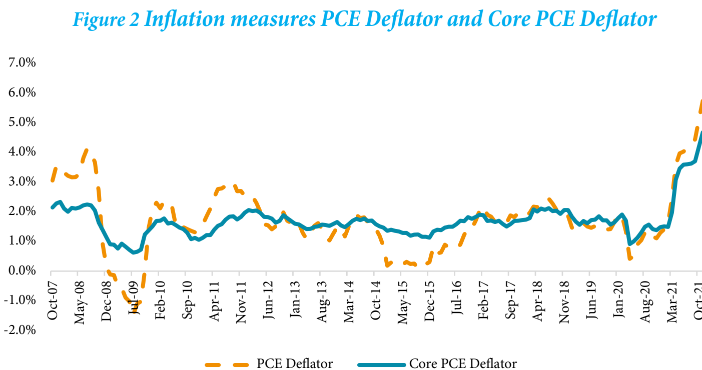

Figure 2 PCE Deflator and Core PCE Deflator, monthly figures Source: FactSet

The Fed stepped firmly to the challenge and made its intentions quite clear. In June, they announced that they would begin tapering asset purchases of U.S. Treasury and Mortgage-Backed Securities. In mid-December, the Fed said that it would increase the pace of the tapering, effectively ending its purchase program by mid-2022. All of this came with some very strategic, sculpted messaging by Fed Chair Jerome Powell and his fellow board members.

These changes to the Fed's quantitative easing programs have led to market expectations of outright fed funds rate increases as early as March 2022. Further still, the fixed income markets are most recently expecting three 25 basis point hikes in 2022. These expectations are based on movements in futures markets and short-term interest rate fluctuations on the yield curve.

We find this to be an aggressive set of assumptions given that the Fed has yet to sell any of the securities purchased though its quantitative easing program. At the same time, we acknowledge that inflation has moved away from the once fitting "transitory" label. For sure, the impact of raising short-term rates will be most effective in fighting inflation in the near term. Waiting to trim their bloated balanced sheet will afford the Fed an additional lever to pull down the road if it finds it needs to act with more vigor. The data suggests that the Fed is more likely to act than not and we await more so-called "Fed speak" as to the exact nature of their moves. Either way, the end result will be higher interest rates, most likely at the longer end of the yield curve.

The ever-discerning markets have already begun to act on the expectations of a Fed policy change. Interest rates in the middle of the yield curve swung higher in the fourth quarter of 2021. The yield on the U.S. Treasury ten-year note ended 2021 at about 1.67%, up from approximately 0.93% a year ago. Moves higher in longer maturity, more interest rate sensitive issues are to be expected if the Fed continues on the expected path towards a tighter monetary policy.

Figure 3 US Treasury Yield Curve at Year End 2020 & Year End 2021

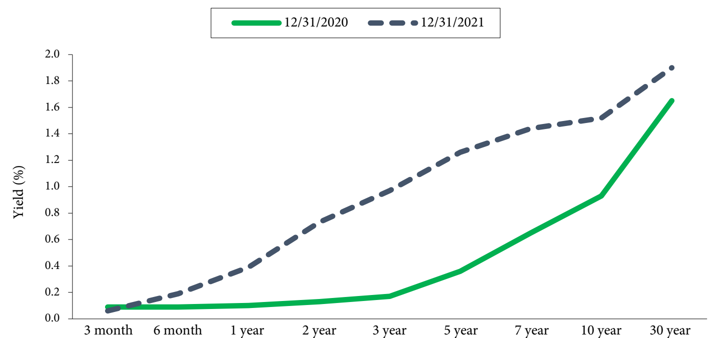

Figure 3 U.S. Treasury Yield Curve at Year End 2020 and at Year End 2021 Source: FactSet

Credit spreads, or the additional yield investors require to compensate for default risk, inched higher over the quarter but remain near historic lows. Investor demand remains white hot for securities that can offer any incremental yield over Treasury issues. The Corporate new issue market has been consistently strong throughout 2021, demonstrating the enormous demand for this paper. In the end, higher yielding, low-quality issues outperformed high grade issues over the past quarter as well as over the past year.

Figure 4 Intermediate Corporate Bond Spreads by Credit Quality

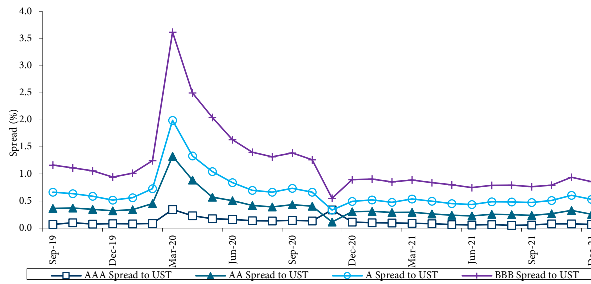

Figure 4 Intermediate Investment Grade Credit Spreads (OAS) 2019 to 2021 (Source: Bloomberg)

The majority of total returns for the last quarter were driven by a steepening yield curve. Yields on longer dated issues rose, pushing down prices for those issues. The shorter end of the yield curve saw a smaller move and was less affected by the change. Corporate bond returns edged the returns of U.S. Government-guaranteed issues by a slim margin. Overall, returns for the last three months were in negative territory, as were returns for the full calendar year.

Looking forward, we do expect the Fed to make changes to their current, loose monetary policy. The most expedient and likely course appears to be hiking short term interest rates. If inflation does dramatically diminish in the first part of 2022, the Fed could certainly pivot to reducing the size of its balance sheet first. Either course of action by the Fed should prompt long term rates to move higher as investors adjust their portfolios.

We believe our duration neutral strategy will serve investors well throughout interest rate cycles. It's imprudent to attempt to correctly guess the direction of future interest rates, which have repeatedly foiled forecasters throughout the years. We prefer to accept a certain amount of risk in exchange for a reasonable stream in income over time. Bond portfolios should be used for capital preservation, not capital appreciation. To be clear, other asset classes serve as much better vehicles for asset growth than investment grade fixed income. Our clients' portfolios hold high quality, liquid, investment-grade bonds with a modest amount of interest rate risk. As we have noted so many times, we are committed to this strategy over the long term.

We hope that you all remain safe and healthy in these unpredictable times.

Two Seaport Lane ▪ Boston, MA 02210 ▪ 800.234.4516 ▪ www.congressasset.com

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