Truist Advisory Services, Inc.

Fixed income perspective from the Investment Advisory Group

Think fast – exploring fixed income's rousing start to '22

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Chip Hughey, CFA
Managing Director
Fixed Income

Evan Moog, CFA
IAG Associate

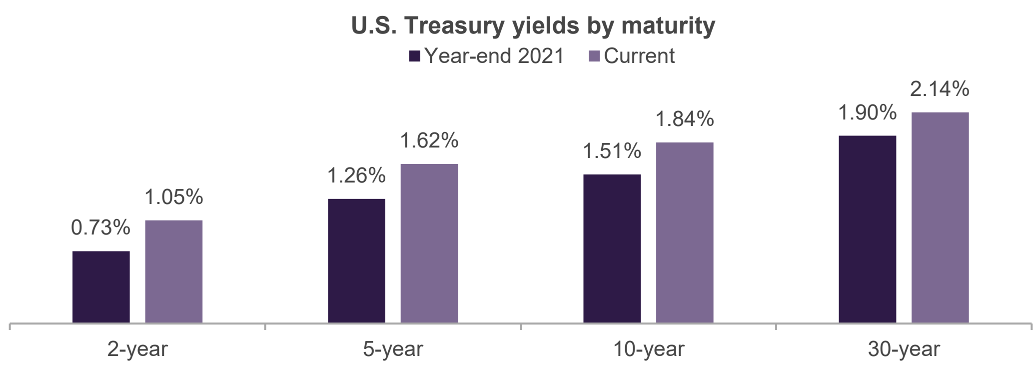
Key takeaways

- **Interest rate outlook –** For 2022, our base case is for the 10-year U.S. Treasury yield to move above 2% for the first time since mid-2019, and ultimately test 2.25%. Rate volatility will remain elevated as Fed tapering reduces available liquidity and supply chain challenges obscure inflation and Fed policy outlooks.
- **Federal Reserve (Fed) –** We anticipate 3 Fed funds rate hikes in 2022, below the 4 or 5 hikes currently projected by futures markets. Cooler inflation readings and the Fed's desire for a healthy yield curve support a slightly more cautious approach this year.
- **Portfolio positioning –** A below benchmark duration profile remains prudent. High yield corporate bonds and leveraged loans continue to offer relative value given lower rate sensitivity and yield advantages. Investment grade tax-exempt municipals should deliver portfolios less volatility and relative outperformance to U.S. government debt in a rising rate environment.

What happened

U.S. fixed income markets kicked off the New Year with an eventful start. Traders have rapidly positioned for stickier inflation and a far more aggressive response from the Fed than anticipated just a few months ago. This recalibration pulled yields higher across the curve.

Evolving Fed policy and inflation outlooks have fueled higher yields across the curve this month.



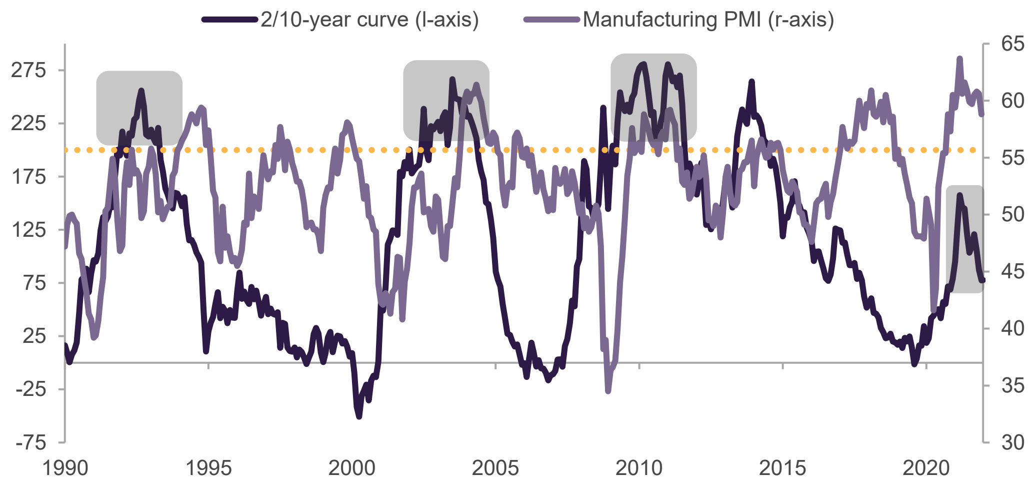
Data source: Truist IAG, Bloomberg

Our take

Interest rate outlook – In a matter of a few short months, fixed income market participants have positioned at break-neck speed for a far more hawkish Fed reaction function. Despite their recent move higher, U.S. yields remain too low relative to current inflation readings, our global growth outlook, and robust economic activity. Therefore, we expect yields to continue their ascent, albeit more gradually relative to the past few weeks. Additionally, the Fed is just two months away from ending its monthly asset purchases. The Fed's massive quantitative easing in response to the pandemic provided a powerful yield suppressant for almost two years. The removal of this demand source should contribute to yields drifting higher.

The U.S. yield curve remains disconnected from strong domestic activity, even after its recent rise.

2/10-year U.S. Treasury curve and PMIs



Data source: Truist IAG, Bloomberg

Additionally, the Fed's scheduled purchases injected a great deal of liquidity into U.S. fixed income markets that smoothed over most rough patches. It's reasonable to expect any fluctuations in U.S. yields — up or down — to be exacerbated by the Fed's reduced role. Thus, we expect the rising yield bias to unfold against a more volatile backdrop than markets grew accustomed to in the wake of the pandemic.

While the overall bias for yields appears higher, a tug of war will likely play out. On the one side, sturdy growth and elevated inflation data should encourage rising yields (and ultimately win out in 2022). However, omicron and virus concerns, monetary policy uncertainty, and foreign demand for U.S. yields will challenge their ascent along the way. The sum of these factors informs our more subdued yield outlook compared to the most bearish forecasts. Our base case calls for 10-year U.S. Treasury yields to break above 2% for the first time since July 2019, and ultimately test 2.25% this year. As we have stated before, the wide range of potential outcomes in global markets are at their highest since the financial crisis. The risk of overshoots to this forecast are real given the uncertainty surrounding the durability of inflation and the subsequent response from the Fed.

Fed – Much of the recent weakness in fixed income is attributable to intensifying Fed hike expectations among participants. As recently as October, Fed funds futures priced in less than one rate hike in 2022. Today, the consensus expects liftoff to begin in March with 3 or 4 additional rate hikes by year-end. Additionally, the perceived probability that the Fed will begin reducing its balance sheet around mid-year — by electing to not reinvest maturities — is rising quickly. That is a dramatic shift in Fed expectations.

Since late 2021, Fed guidance and public appearances by Fed officials have transformed rate hike expectations for 2022.

Number of Fed rate hikes priced in by year-end 2022

Data source: Truist IAG, Bloomberg

We believe the Fed is more likely to use a multi-pronged approach to normalize policy. From a policy rate perspective, we currently foresee three Fed rate hikes in 2022, below the four or five hikes currently projected by futures trading. Our slower rate hike expectation is informed by two key factors: 1) headline inflation readings should begin falling in the first half of 2022 as supply chain pressures ease and year-over-year comparisons dampen future data points; and 2) the Fed will want to avoid hiking the yield curve into inversion, where short yields are higher than long yields, as it did during 2018 and 2019. As it stands today, just 79 basis points (0.79%) separate 2- and 10-year U.S. Treasury yields. Curve inversions, particularly between 2- and 10-year yields, are a reliable indicator of recessions 6-18 months in advance. This is not an alarm the Fed will be eager to sound.

To assist in that endeavor, the Fed may look to other policy tools for help if initial rate hikes flatten the curve. To encourage a healthier curve, the Fed could passively reduce its balance sheet via runoff or even use targeted sales of government debt on its balance sheet with the goal of raising longer rates. Putting this together, we expect the Fed will raise rates somewhat slower than the current consensus and look to other policy tools that would help preserve a more normal yield curve. Ironically, slower-than-expected rate hikes may also help steepen the curve by 1) suppressing short yields; and 2) fueling higher longer rates as investors price in a more accommodative stance from the central bank.

Portfolio positioning – The low yield environment over the past decade has caused portfolios to generate less income than in previous cycles, reducing the buffer to help offset the price impact of rising rates. In light of our higher and more volatile rate expectations, a below benchmark duration profile remains prudent to mitigate potential negative price performance. However, following the 60 basis point rise in the 10-year U.S. Treasury yield since August, core fixed income's risk/reward profile has incrementally improved.

From a sector perspective, high yield corporate bonds and leveraged loans continue to offer a valuable complement to a core fixed income portfolio. For one, these sectors should benefit from a growing economy that suppresses default rates and preserves today's tight credit spreads. Their incremental yield advantages tend to support outperformance in a rising yield environment and their lower rate sensitivity offers some insulation as well. For investors seeking some protection from rising taxable yields, investment grade tax-exempt municipals should see a lesser degree of volatility given strong demand; however, the smoother rise comes with the cost of accepting historically rich valuations relative to U.S. Treasurys.

Bottom line

The rapid ascent in U.S. yields to start the year has incrementally improved the risk/reward profile in high quality bonds. Still, we expect U.S. yields to continue their climb, reflecting strong U.S. economic activity, elevated inflation, and the evolving Fed policy outlook. We maintain our bias toward below benchmark duration within fixed income portfolios. Measured sector-specific exposure to high yield corporates and leveraged loans can offer a valuable complement to high quality fixed income portfolios given their yield advantages and lower rate sensitivity. For those investors seeking some shelter from rising taxable yields, investment grade tax-exempt municipals should inject a lesser degree of volatility into portfolios, though valuations appear historically rich for new purchases.

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