Interest Rates are Interesting Again
By Eduardo Cortes, CIO
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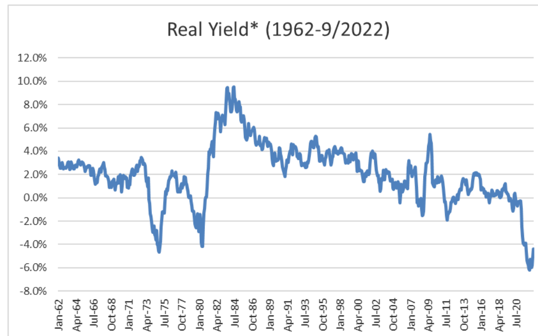
Financial market returns have been abysmal in 2022. Through September, the S&P 500 was down 24.8%, the Nasdaq was down 32.4%, small caps down 25.9%, non-U.S. equities lost 28.9%, and emerging markets stocks were down 28.9%. These are painful numbers, yet none matches the torching fixed income delivered, in relative terms. U.S. treasuries declined 13.1%, investment grade corporate bonds fell 18.7%, mortgage-backed securities declined 13.7%, and global inflation-linked instruments gave up 26.0%. While these appear "less bad" than equities, they all suffered the worst nine-month result on record. An article in the October 2, 2022 New York Times Business section was titled "Bonds May Be Having Their Worst Year Since 1794." Analysts observed that through nine months, 2022 now holds the record for the worst negative performance for portfolios thought to be diversified by holding both bonds and stocks.

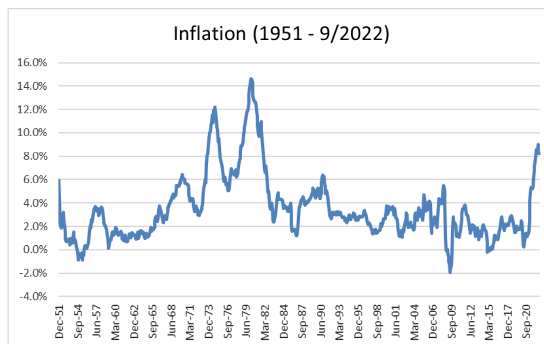
The year has indeed been painful for investors. However, there may be a few reasons to look favorably at the future of bond investing, due most notably to the likely re-emergence of real yield! Since the global financial crisis and recession of 2008 – 2009, bonds have not offered much real return. Fixed income Investors anticipating meager, if any, return on their bond investments were forced to take higher risk in search of additional yield. With low yields, bonds have not held a competitive slot in global asset allocation decisions.



*Difference between UST 10-yr yield and monthly year-over-year CPI
Source: Bloomberg

History

After years in the background, inflation returned in 2021 and began to spike after Russia's invasion of Ukraine stoked a commodity shortage and exacerbated already strained supply chains. Like some of the ruinous inflationary periods in the past, we believe the damage was set up by flawed policy. Despite a known and painful history, policy makers appear to have disregarded the lessons.



Source: Bloomberg

The period between 1965 and 1982 was dubbed the Great Inflation. In an essay with that title, Michael Bryan of the Federal Reserve Bank of Atlanta wrote the following, "It was, according to one prominent economist, "The greatest failure of American macroeconomic policy in the postwar period." (Siegel 1994)." [1] Like today, there was no single factor that explains the inflation creep that culminated in year-over-year rates exceeding 14%.in 1980. Fiscal and monetary policies played a key role, particularly in establishing conditions that embedded inflation into expectations. Well-intended laws and processes like the Employment Act of 1946, and a dogged adherence to the "Phillips curve," had consequences few recognized in time to alter the script. An additional flaw was the central bank's effort to coordinate policy actions with the Treasury to avoid interfering with the government's funding needs. Sound familiar?

A particularly flawed development toward the end of the war was the Bretton Woods Agreement which provided for the U.S. dollar's link to gold, and fixed currency exchange rates against the dollar for other nations. While the dollar's attachment to gold had beneficial effects for the U.S. as a monetary anchor, the concept was unsustainable because other nations could print currency, exchange it for dollars and request conversion into gold. Ultimately, other nations' U.S. dollar reserves exceeded the U.S. holdings of gold. Nixon ended the gold link in 1971, which unleashed a major devaluation of the dollar

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[1] The Great Inflation, Michael Bryan, Federal Reserve Bank of Atlanta, November 22, 2013

and a spike in the money supply. Already high unemployment and inflation led to a brief attempt at price controls which was a total failure.

Where are we now?

It is ironic that after the destructive experience of the 1970s and 1980s, concepts like "Modern Monetary Theory" and "deficits do not matter" gained traction and advocacy among respectable economists. The Covid-19 pandemic was a truly unique event that called for extraordinary measures. The problem is sometimes authorities believe extraordinary means unlimited and fail to grasp the necessity of ending temporary programs or withdrawing stimulus once conditions stabilize. Like Johnson's Great Society programs, which were broad and expensive, the Covid emergency launched $5 trillion worth of emergency assistance and handouts that were extended well beyond the end of the emergency. Like the late 70's, in just two years the government's intervention resulted in expanded deficits, the explosion of government debt, and excessive growth of the money supply. Given the Covid-induced labor distortions and a populace eager to be unshackled from the pandemic, conditions were ripe for a price spiral. When viewed through the lens of history, the Fed's vocal intransigence on inflation containment makes sense.

What Happens Next?

Since March 2022, the Fed has hiked rates at the fastest pace since 1980, and, if rates rise an additional 125 to 150 bps before year-end as the markets expect, short-term interest rates will have risen over 400 bps in nine months. An important reason for the inflation spike has been product and commodity shortages, each a consequence of separate, supply driven events. The implication is that the Fed will likely succeed at softening consumer demand which should ease the pressure on prices even if the supply side remains constrained. A shallow recession or very slow growth will likely ensue, and inflation should slowly trend lower. Barring unexpected disturbances, interest rates should remain elevated compared to what fixed income investors have experienced since the financial crisis that began in 2008.

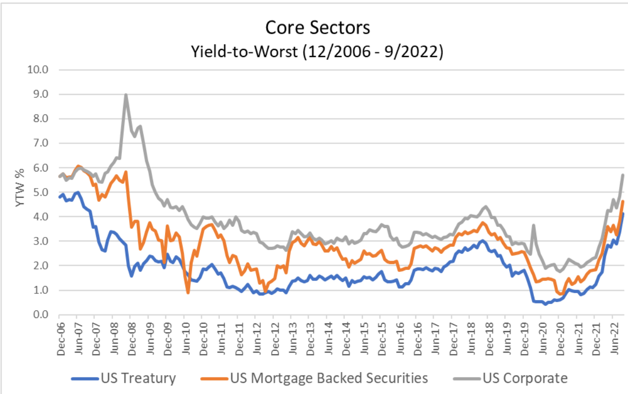
After Chairman Volcker's aggressive 1979-1980 rate hikes, it took two and a half years for year-over-year inflation to fall below 5.0%, and longer to allay fixed income investors regarding its resurgence. During the decade of the 1980s, the average real yield (measured as the difference between the ten-year U.S. treasury yield and the trailing year-over-year inflation rate) exceeded 5.0%, to an extent justifiably because inflation surpassed 6.0% again in 1990. For context, though, the Volcker central bank confronted an inflation rate exceeding 13% at the end of 1979.

While today's inflation remains elevated, the Powell Fed does not yet face embedded inflation expectations. In fact, recent consumer surveys indicate longer term concerns have abated with the decline in oil prices. However, they do face a challenge getting core inflation back to their target level. During September and October 2022, Fed officials repeatedly insisted that once 2022's additional hikes are in place, they will watch the impact of their actions on the economy. It is likely the bond market will also pay close attention to the resulting trend in prices.

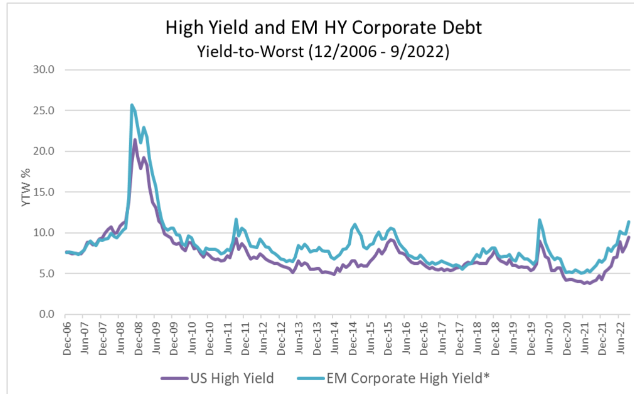
In addition to hiking rates, the Fed will likely continue to runoff and possibly sell bonds it purchased as part of its pandemic support actions (Quantitative Tightening). Combined with the rate hikes, financial conditions will likely remain restrictive through 2023. For bond investors, the implication is that yield will likely remain compelling for some time.

Yields Worth Considering

The combination of higher yields and wider spreads across fixed income sectors permits the construction of portfolios with reasonable absolute yields and higher implied income returns than investors have seen since 2008. The graphs on the next page show the yield-to-worst of various fixed income sectors including the components of the core market (treasury, corporate and securitized) along with high yield and EM HY corporate debt. As can be seen, nearly every sector had a greater or comparable yield at the end of September 2022 as yields available at the time of the 2008 financial crisis.



Source: ICE Data Services. YTW data from respective ICE BofA Indexes.



*EMHY is the High Yield US Emerging Markets Liquid Corporate Plus Index
Source: ICE Data Services. YTW data from respective ICE BofA Indexes.

As the Fed works hard to engineer a slowdown, a unique dynamic in the U.S. is that private sector creditworthiness remains strong. Away from isolated pockets, few industries have excess leverage and/or confront conditions that will likely cause financial anguish. As mentioned in our June 2022 quarterly, the high yield market has suffered from poor liquidity and a nearly dormant new issue market. While that raises refinancing concerns, many analysts remain constructive on the path for default rates and leverage in the sector.

Fixed Income Yields
as of September 30, 2022

		Hypothetical Allocations			
Sector	**Yield***	**Core**	**Core Plus**	**Global Credit**	**Global High Yield**
Government	4.13%	41.80%	30.00%	0.00%	0.00%
Mortgage	4.83%	29.90%	20.00%	0.00%	0.00%
IG Corporate	5.69%	28.30%	30.00%	60.00%	0.00%
High Yield	9.58%	0.00%	10.00%	20.00%	60.00%
EM Corporate HY	11.39%	0.00%	10.00%	20.00%	40.00%
Total Hypothetical Yield		**4.78%**	**6.01%**	**7.61%**	**10.30%**

*Yield data from respective ICE BofA Indexes. Source: ICE Data Services.

With inflation expectations remaining well-anchored and the Fed likely to reach a near-terminal Fed Funds rate by the end of 2022, we believe financial market volatility should decline. Such a decline should be associated with stable rates and the return of retail investor flows. While performance may be limited to earning a better coupon, the restoration of fixed income's role in global asset allocation should be welcomed by investors.

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We have a thorough understanding of fixed income investments and their role in a globally diversified portfolio, which has rewarded our clients throughout market cycles.

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