First Quarter 2022 Economic & Fixed Income Outlook

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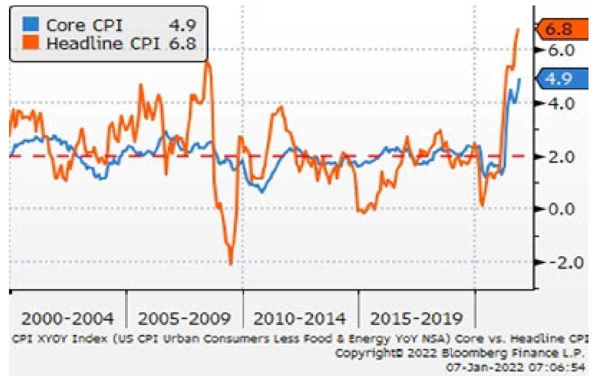
Economic Outlook:

The last two years have been extraordinary by any measure, including for the global economy. The lockdown measures imposed by governments around the world in 2020 resulted in the largest drop in global economic activity since World War II. What followed in 2021 – with the support of monetary and fiscal stimulus – was the fastest growth rates experienced in 50 years. The staggering speed of the rebound, combined with the lingering impacts of the pandemic, has exerted significant pressure on supply chains, triggering a rise in consumer prices unseen in decades.
Overall, we expect 2022 to be a year of transitions, with growth moderating, central banks 'normalizing' monetary policy, worker compensation superseding government transfers as the main driver of income, and inflation beginning to ease. However, as we venture into the outlook for the coming year, it's worth noting a dose of humility. The news of the omicron variant illustrates just one of the uncertainties the global economy could face in 2022.

In the U.S., we expect growth to cool from the near-record acceleration in economic activity experienced during 2021. However, despite moderating, economic growth should remain well above its 20-year average. This outlook is supported by a strong consumer and the need for businesses to rebuild inventories and continue to invest in their business. While business investment has already returned to pre-Covid levels, with CAPEX in the U.S. the strongest since the 1940s, surveys suggest that investment plans for 2022 remain very robust.

The most widely discussed economic trend of 2021 – inflation – looks set to continue into the first half of 2022. However, we expect inflation to "peak then retreat" over the course of the year. The inflationary boost in 2021 has been driven in large part by the confluence of a low base effect (inflation is compared year-over-year), higher energy prices, supply chain issues, and stimulus-fueled demand. The sharp rise in housing prices is expected to keep inflation elevated through the first half of next year with shelter the largest component within core inflation measures. However, by the summer, the base effect will be turning into a headwind (i.e., the bar to exceed 2021 readings will be high), logistics should be operating *more* smoothly, and the boost from fiscal stimulus will be fading.



The labor market will also be a key factor impacting inflation. While the unemployment rate has declined sharply, the labor force participation rate has barely budged. Businesses continue to report challenges in finding workers—particularly skilled workers. There are currently over 10.5 million job openings across different sectors of the U.S. economy. The labor shortage has resulted in wage pressures, particularly in lower-wage jobs.

While staffing shortages may ease as we continue to move on from the initial pandemic shock, part of the challenge is demographics and the size of the working age population for which there is no quick fix. In the near term, the imbalance in the labor market between the supply of and the demand for workers will be a headwind to the speed at which the economy can expand. Longer term, businesses will look to harness automation, allowing a smaller staff to maintain higher levels of production.
From a government perspective, fiscal policy is shifting from the massive income replacement measures during the first 18 months of the pandemic, to infrastructure and social spending and will be an incremental drag on growth. The recently passed $1.2 trillion infrastructure bill will have less of an impact on economic growth in the near term, since the spending will take place over a 10-year period. The social spending package, aka Build Back Better plan, is much larger but appears unlikely to pass in its current form.

Another key event in Washington is the November midterm elections. President Biden’s approval ratings have declined over 2021, and early polling suggests the Democrats will lose at least one of the two Congressional majorities they now hold. If that is the case, the hurdle for additional fiscal policy is going to be high, which could have some economic impacts for 2023.

Another headwind to the economy will be the reduction in monetary stimulus with the Federal Reserve on track to stop asset purchases by March and forecasted to raise its policy rate three times over the course of the year. This timeline – which is much faster than initially anticipated – has been forced upon the Fed due to the persistence of higher levels of inflation.

Even before the emergence of the Omicron variant, the speed of the economic recovery in the U.K. was the slowest among G7 economies. In addition to the fallout from the pandemic, the region continues to deal with the impacts of Brexit, which continues to cause policy uncertainty as well as accentuating acute labor constraints.
Supply chain pressures and energy prices are fueling inflation, which combined with the tight labor market, means that the Bank of England is expected to hike interest rates several times over the course of the year.

Europe starts the year with healthy growth momentum. Business surveys show broad-based gains across countries and different economic sectors. In addition, fiscal policy looks set to provide support as the disbursements from the EU recovery fund increase, and the newly elected government in Germany appear willing to pursue a more accommodative fiscal stance. The labor market recovery in Europe is occurring faster relative to many other countries. Economists suggest this smoother revival is due, at least in part, to the greater use of furlough programs, which kept employees more engaged.

Presidential elections are planned for Italy and France during the course of 2022. If these elections follow script, Europe could have an extended period of electoral stability ahead, which may allow leaders to undertake another push at further deepening economic integration.

With a comfortable election victory, easing social restrictions and strong progress on the vaccine rollout, some of the political and policy uncertainty has been alleviated in Japan. A promised fiscal stimulus package could boost economic growth directly by 0.1% and have the potential for even more through indirect effects on consumer and business confidence. Japan is one of the few economies where economic growth is forecasted to accelerate in 2022.

The main risks to economic growth appear to be tied to supply-chain disruptions which would curtail output and a decline in exports due to a slowdown in Chinese growth.
In the third quarter, Chinese economic growth stalled due to the combination of a slump in property development, power shortages hitting industrial production, and sporadic Covid lockdowns.

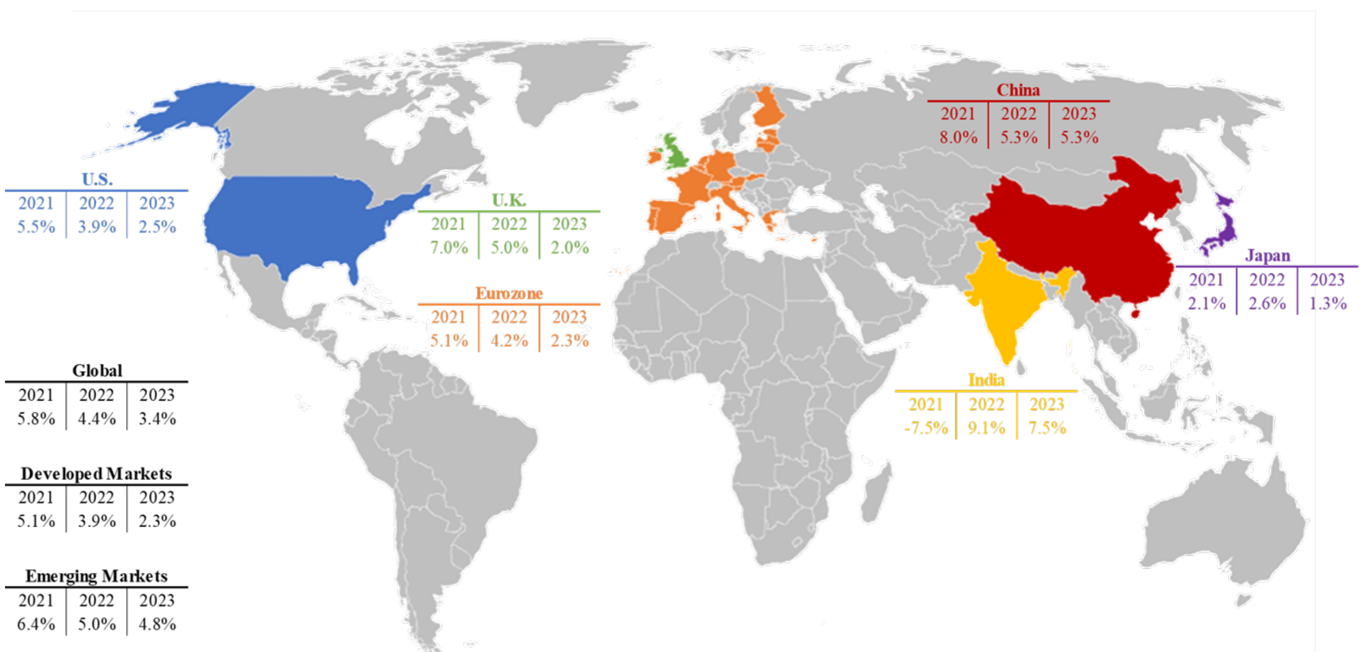
Chinese authorities appear dedicated to reshaping the economy by taming debt levels (deleveraging), increasing competition, and smoothing wealth imbalances. Economic activity will also be impacted by China’s “zero tolerance” policy on Covid outbreaks, which in essence puts areas with outbreaks into lockdowns. While this limits the spread of the virus, it can have major impacts on domestic growth and the global supply chain. Together, these factors suggest that economic growth in China will be slower than the 6.6% annualized economic growth rate in the years 2015-2019 and will not be the ‘engine of global growth’ as it was post financial crisis. The consensus forecast expects the Chinese economy to grow at 5.2% and 5.3% in 2022 and 2023**,** respectfully.

The growth outlook for other individual emerging market countries will depend on a variety of factors, including the path of the pandemic and its variants, government policy responses, whether inflation is transitory or not, and the state of global geopolitics.

In general, inflation rates have been rising, often beyond central banks targets, triggering front-loaded interest rate hikes in Latin America and Central Europe. Emerging market economies, on aggregate, are forecasted to expand by 5.0% in 2022. The experience of the last two years has clearly demonstrated the high degree of uncertainty that exists around any forecaster's base case.

The most obvious risk to our forecast relates to the evolution of the pandemic. More virus outbreaks and the potential for the emergence of new harmful variants could slow the recovery. Other risk factors include the potential for a policy mistake, particularly from the Federal Reserve, as it seek to remove stimulus from the system without creating a sudden tightening in financial conditions, a sudden slowdown in Chinese economic growth, geopolitical tensions, and cyber risks.

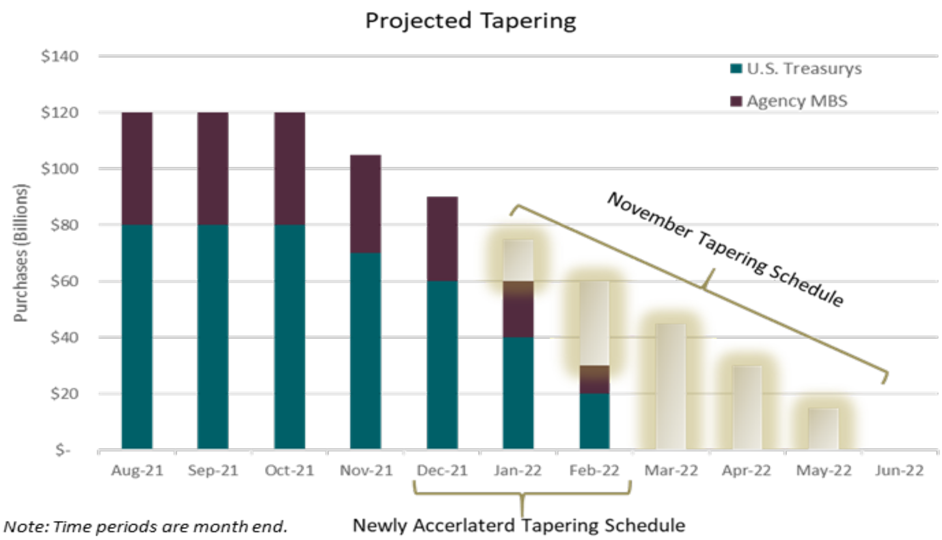
The global economy heads into this year with hopes for a return to normality and fears that it will be – once again – delayed. Our base case is for economic activity to remain above trend, supported by strong household and corporate balance sheets, CAPEX spending and favorable trends in productivity. Inflation will remain elevated but moderate over the course of the year as supply chain disruptions slowly ease and central banks remove monetary accommodation.



Source: Bloomberg 12.13.2021

Fixed Income:

In November, the Federal Reserve announced the first step in the process of normalizing monetary policy by 'tapering' the monthly amount of assets it would purchase through its quantitative easing (QE) program. This initial plan was updated at the December meeting when the committee announced its intention to wind down asset purchases quicker, finishing the process in March instead of June.



Source: Federal Reserve 12.15.2021

The acceleration in pace of winding down asset purchases was driven by inflation with central bankers being forced to concede that inflationary pressure had been far more persistent than they had expected.

The real question for fixed income investors is the longer-term outlook for inflation. Prior to the pandemic, there were five primary factors which created the low inflation environment that follow the financial crisis:

1) Demographic trends, including an aging population and declining birth rates, particularly in much of the developed world
2) The impact of technological advancements
3) Global savings glut
4) Large amounts of private and public market debt
5) Globalization

With the exception of globalization, these trends remain in place, and in fact have been accentuated by the pandemic.

The range of outcomes for inflation in 2022 remains wide and will be heavily influenced by the timing of the supply chain normalization. However, longer-term, we expect the forces above to once again exert downward pressure on the overall rate of inflation.

The uncertainty around the durability of elevated inflation will drive the markets expectations around Fed policy, creating an environment where inflation data will be a source of volatility for both interest rates and credit spreads. Given our expectation that returns for fixed income indices will be driven in large part by coupon income this year, it will be critical for investors to be nimble and opportunistic during periods of volatility.

While rates are low compared to the long-term average, we continue to view high quality duration, such as U.S. Treasuries, as the best source of diversification against risk-off events or negative growth shocks. These securities also provide a source of liquidity to take advantage of market dislocations.

Investment grade companies have utilized the past two years to solidify their balance sheets. A combination of capitalizing on cheap financing, due to record low interest rates, as well as significant cost cutting and improved operating efficiencies, has resulted in an attractive fundamental backdrop.

Companies have thus far remained defensive with capital allocation. However, as we progress through the economic cycle, this trend will transition as companies look to use their balance sheets to finance more shareholder friendly activities, such as dividend increases and/or share buybacks, resulting in a deterioration in credit metrics. Ongoing disruptions in the supply chain and the need to rebuild inventories may push companies to raise CAPEX spending, which may require debt-financing.

The quality of corporate balance sheets may also face additional pressure due to rising labor and input costs. So far, many companies have been able to pass through higher costs, the question is how long they will be able to do so. We expect this topic to be a key focal point for investors over the coming quarters. Importantly, pricing power will vary between industries and individual companies.

The supply / demand technicals remain supportive. The global search for yield continues and the U.S. corporate bond market continues to provide incremental yield, even after currency hedging.

Starting valuation levels suggest minimal room for price appreciation, suggesting that returns will be driven, in large part, by coupon yields. Since broad based spread compression is unlikely, investors will need to focus on sector allocation and individual issuers to generate alpha.

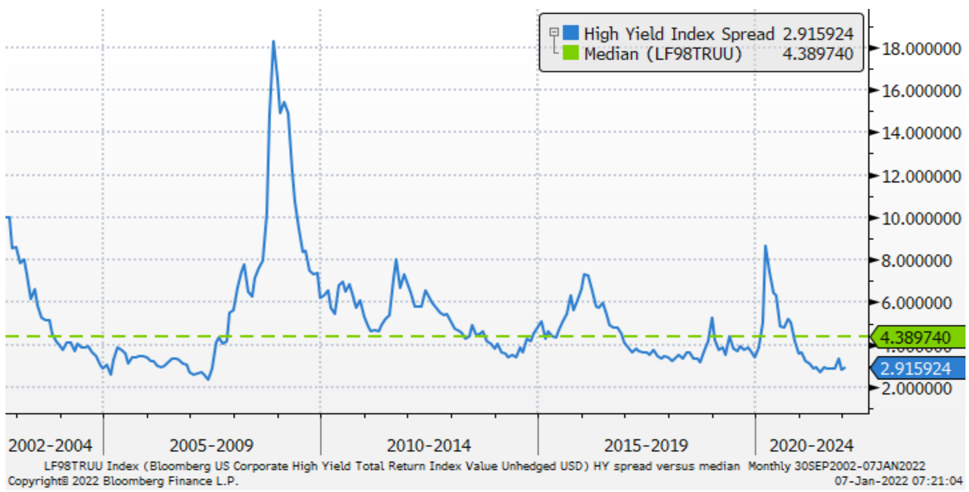
In terms of sector allocation, we are focused on areas of the market where management teams are more likely to follow a conservative approach to capital allocation and have pricing power to offset the impacts of an inflationary environment. Conversely, we remain cautious on sectors where valuations are more stretched, pricing power is weak or the risk of shareholder friendly type activities is high (i.e. where companies have ample debt capacity and appetite for stock buybacks or dividend increases).

More specifically, we are finding opportunities in the banking, capital goods, communications, home builders, pipelines (MLPs) and REITs.

Frequently, the individual companies which offer the most attractive value within these sectors are BBB rated. These companies provide higher yields than comparable maturity, higher-rated, companies but have management teams who are focused on preserving or improving credit metrics, liquidity and credit ratings. It is important that investors rely less on *current* credit ratings and more on identifying issuers with improving fundamental trajectories.

Lastly, credit 'mini-cycles' are becoming more frequent and we expect bouts of volatility during the year. The ability to use the opportunities created by these air pockets could be an important source of enhancing returns.

At an index level, valuations in the high-yield market are fair. While spreads are historically tight, the default rate remains very low, at 0.83% (J.P. Morgan as of 11/30/21) and is forecasted to remain low in 2022. Additional spread compression will be limited, meaning returns for the overall index will be capped around coupon income.



Unlike high-yield bonds and bank loans where the price of a bond can be capped by issuer-owed call options, convertible bonds still offer the potential for price appreciation since the value of a convertible bond can rise if the issuer's common stock price increases. The sector also offers the opportunity to allocate to issuers, particularly technology and biotech companies that often don't issue bonds in the more traditional areas of the corporate bond market.

For qualified investors, we find private credit markets attractive. This sector offers higher yields and diversification from public credit markets in exchange for illiquidity and complexity. Within the space, our preference is for senior secured loans with floating rate coupons, which provide some protection against higher interest rates.

Manager selection in private markets is critical. Compared with managers in traditional public market asset classes, there is a much wider dispersion in performance between managers in private markets.

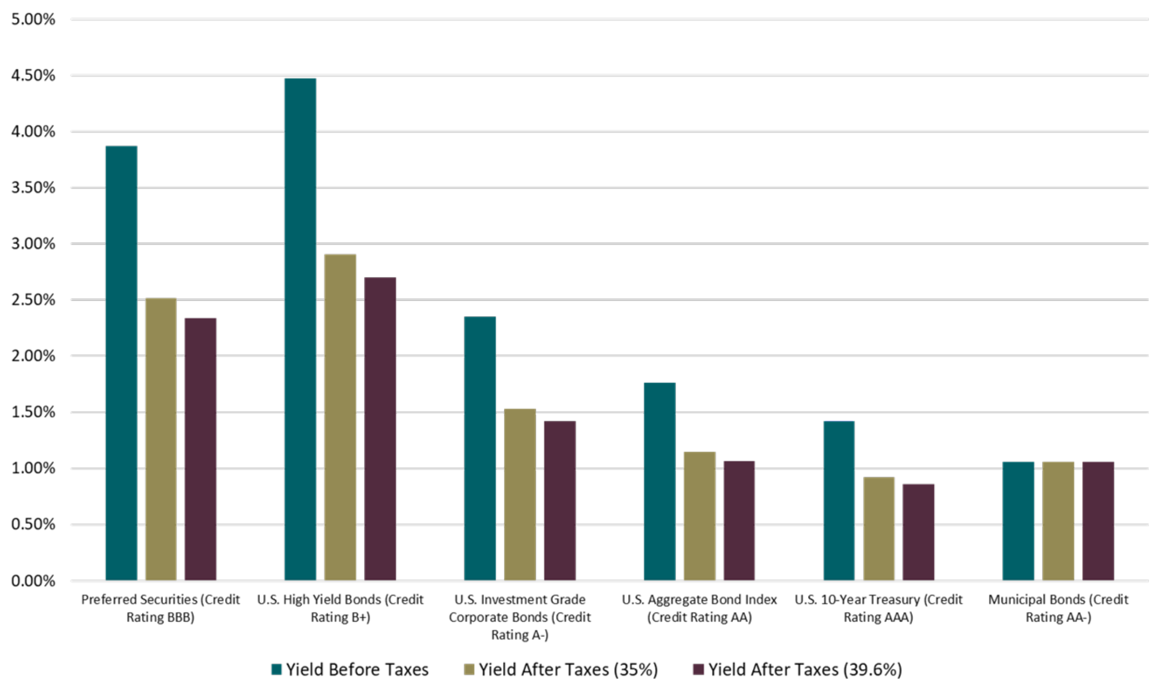
Fundamentals remain solid in the preferred market, with banks – the largest issuer of preferreds – continuing to post strong earnings and capital market activity while maintaining pristine credit quality as highlighted by the results of the Federal Reserve's 'stress test'.

In addition to strong fundamentals, the technical backdrop is also supportive. Robust new issuance has been more than offset by redemptions, while the search for yield continues to bring investors to the sector.

From a valuation perspective, there is a large divergence between the $25 par and $1000 par preferred markets. Most preferred securities contain call provisions, meaning that the issuer will call a security when they can be refinanced at cheaper levels. Today, many preferred securities are trading above their call price (par), meaning investors *may* experience a loss if they are not actively managing yields to call or are accessing the market through a passive vehicle such as an exchange traded fund (ETF). Recently, valuations in the $25 par preferred market have become so rich that a significant portion of these securities are trading with a negative yield-to-call / yield-to-worst.

Conversely, valuations in the $1000 par market remain relatively attractive. While the yield on many of these securities is lower than pre-pandemic, the decline has been driven by lower U.S. Treasury yields rather than a compression in risk premium. The favorable fundamental and technical backdrop suggest credit spreads could compress from current levels, which are at similar levels to the beginning of 2020.

Overall, we continue to find better value in $1000 par fixed-to-floating rate preferreds compared to the $25 par market fixed-rate securities due to more attractive valuations and lower sensitivity to interest rates. In addition to U.S. preferreds, we find selective opportunities in preferreds issued by European banks, particularly securities issued by Swiss and U.K. banks.



Source: Bloomberg 12.13.2021

The supply / demand technicals in Agency residential mortgage backed securities will remain challenging, with net issuance continuing to be strong while the Federal Reserve reduces its purchases of Agency MBS. Against this unfavorable technical backdrop, valuations are lofty.

Structured credit continues to offer an attractive relative value proposition, despite the significant recovery that has already occurred since the depths of the pandemic. Non-agency mortgage backed securities (MBS) are particularly attractive, which are well supported by the increase in home prices and healthy consumer balance sheets. Furthermore, the supply/demand imbalances which helped drive the record pace of home price appreciation in 2021 remain in place and will continue to be a tailwind for the housing market.

Collateralized loan obligations (CLO) offer an attractive spread pick-up relative to similar rated corporate bonds and have floating-rate coupon structures.

Structured credit markets also provide diversification from some of the potential risks facing the corporate bond market, such as inflation pressures, supply chain disruptions and changes to tax policy. For example, while supply chain disruptions could negatively impact corporate profits, they have resulted in higher home and used car prices, benefitting non-agency MBS and asset-backed securities (ABS) tied to auto loans. Similarly, while wage inflation pressures threaten to weigh on corporate profits, they are a tailwind for some sectors, such as housing, levered to the consumer (in the case of housing the individual’s income is increasing while the mortgage payment is fixed).

While select opportuntities exist in emerging markets, we generally view the sector as unattractive. A rising rate environment in the U.S. and additional U.S. dollar strength could create additional headwinds.

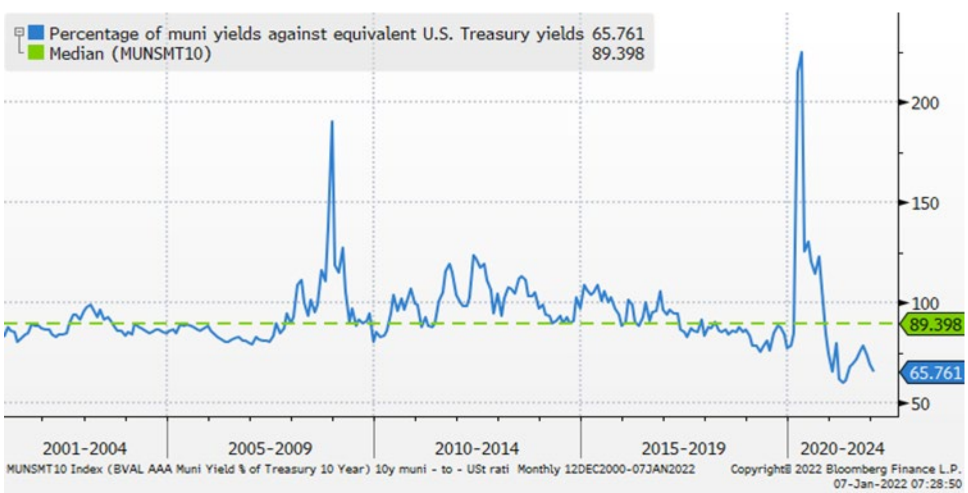
The strong performance of the municipal bonds in 2021 was driven by limited supply, strong demand and improving credit fundamentals.

The last three years have seen a new era in the financing of municipalities with many issuers deciding to issue taxable munis, resulting in a decline in tax-exempt issuance. Demand has been historically strong, driven in part by concerns over the potential for higher tax rates.

Credit fundamentals within the sector have strengthened as many municipalities have experienced a significant revenue rebound as a result of the economic recovery and substantial fiscal support. In addition, the sharp appreciation in home prices has benefitted property tax for local governments.

From a valuation perspective, the ratio of yields on muni bonds relative to yields on Treasury bonds of the same maturity – a common metric used to evaluate the relative attractiveness of muni bonds – is low. In other words, even after considering the effect of taxes, Treasuries and other highly rated bonds often yield more than munis, even for investors in the highest tax bracket.

In terms of security selection, our focus remains on high-quality, general obligation bonds, which benefit from the taxing power of the municipality and essential service revenue bond sectors – those backed by utilities, such as water and sewer.



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