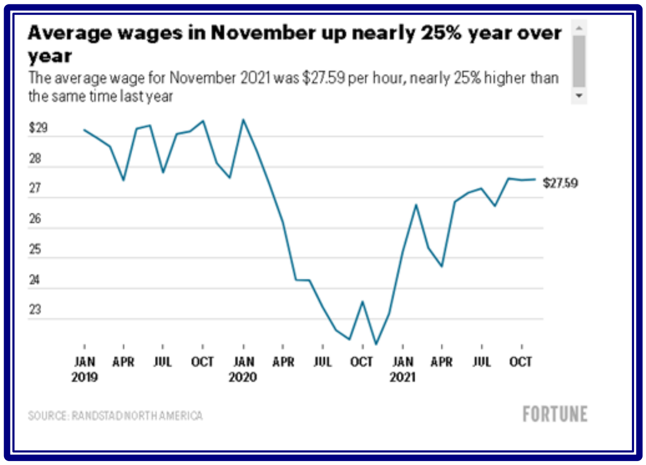
ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

JANUARY, 2022

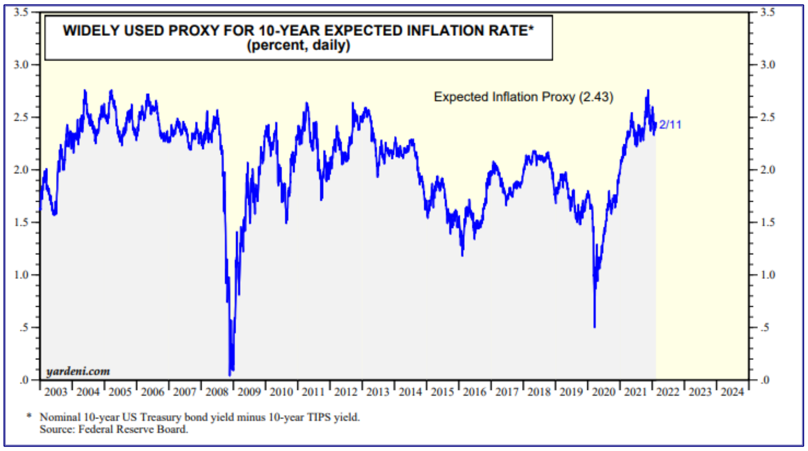
IN BRIEF: The U.S. Fixed Income Markets, Performance, and Strategy

A resurgence in economic activity fueled by the reopening of businesses and lifting of pandemic restrictions across America has bolstered consumption growth. The resulting inflation was widely anticipated but its longevity has more recently been called into question as the Fed shifts away from its "transitory" language. Pent up demand and supply disruptions as the economy reopens should subside, however it's the degree of labor market shifts exerting upward pressure on wages that has investors and economists raising and extending their inflation forecasts beyond 2022.



Wage increases tend to be "sticky" in nature. Once employers raise compensation to attract labor, tight conditions require them to maintain these levels. Passing through some of the pressure in the form of higher prices helps to alleviate bottom line compression.

The 10-year breakeven has moderated somewhat since last quarter but remains elevated at 2.5%. Investors appear to have adjusted their expectations for inflation, in a sign of confidence in the Fed's ability to manage inflation levels as it shifts towards more hawkish policies. This suggests that the economic headwinds from supply shortages and wage pressures could subside and alleviate pricing pressures. However, it would be premature to label this modest reversal as a trend, particularly with the number of moving parts. Developing supply/demand balances, labor market conditions, and pricing pressures among other indicators (particularly Covid-19 status) and coinciding Fed Policy will determine the path forward.



Source: Yardeni Research

Fixed Income Sector Performance – Q4 2021

	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing 12m TR
Treasury (Intermediate)	Aaa/AAA	4.03	3.84	1.02%	N/A	$101.10	-1.65%
Agency	Aaa/AA+	3.81	3.48	1.03%	0.01%	$103.90	-1.09%
MBS	Aaa/AAA	5.84	5.23	1.85%	0.83%	$103.30	-1.21%
Municipal	AA2	3.74	3.39	0.63%	-0.39%	$113.14	0.22%
Corporate (Intermediate)	AA2	5.68	5.24	1.73%	0.71%	$104.66	-1.71%
High Yield	B1	6.43	3.77	4.28%	3.26%	$103.38	5.36%

Source: Altman Investment Management Research and Bloomberg

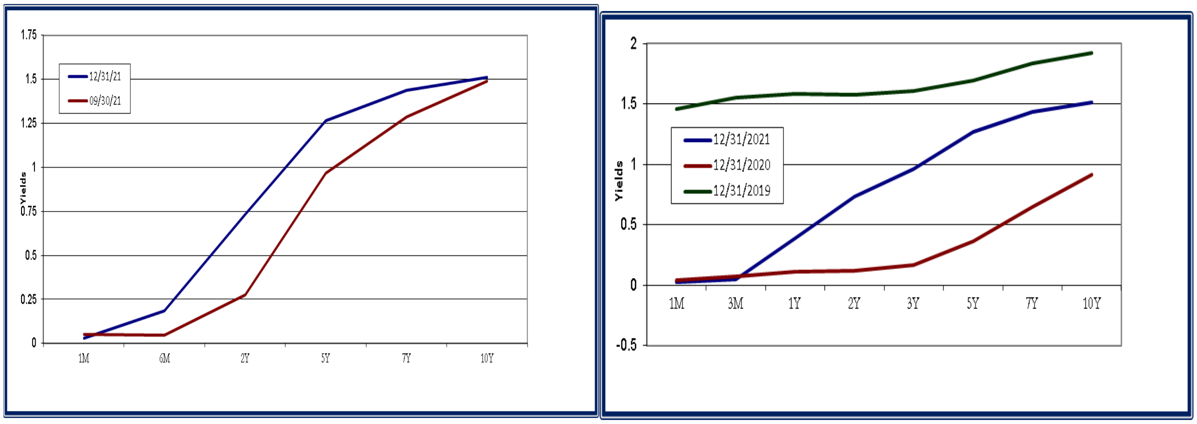
Sector Close-Up:

➢ Government Bonds

The yield on the 10-year rebounded off its lows to finish 2021 at 1.51%. The curve steepened with rates in the 2–3-year space registering the largest gains. This was driven by the shift in Fed Policy towards a more hawkish view. Consensus is calling for year-end 2-year Treasury yields of around 2.2% which implies yields could be range bound.

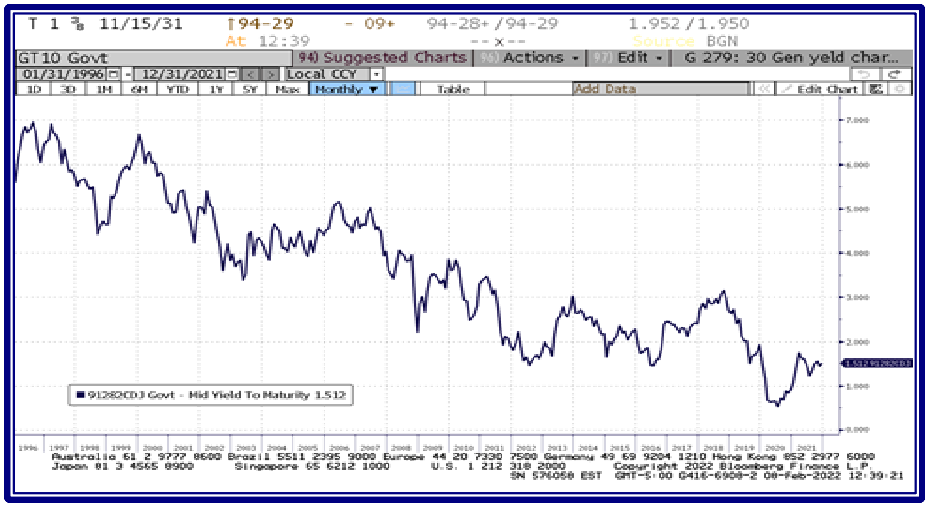
The recent price pressure on the treasury market, which led to the 10-year reaching as high as 2% as we enter 2022, was aggravated by a heavier corporate debt issuance calendar in efforts to lock in lower borrowing costs before rates rise. Demand is anticipated to dwindle, as the Fed reduces its asset purchases. Supply should increase as the Fed reduces purchases - and could be further impacted depending upon the packaging and timing of Build Back Better legislation. This would be on top of the Q4 normalization that occurred after months of flights to safety.

Intermediate Bond Yields Climbed at Faster Pace than Long Term Yields



Source: Bloomberg and Altman Investment Management Research

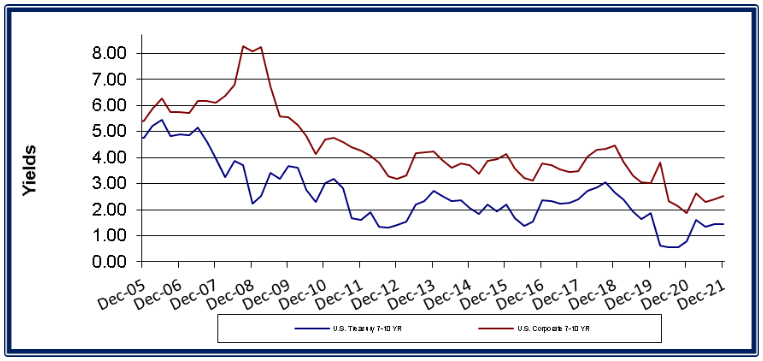
Ten-Year Generic Treasury Yield



➢ Investment-Grade Corporate Bonds

Strong earnings growth drove up credit quality in corporate issuance during the year. Higher cash levels coupled with relatively low borrowing costs and deleveraging efforts have improved financials. Additionally, investors flocked to corporate bonds throughout most of 2021 during a period of waning supply. According to Bloomberg, forecasts for tighter supplies could help offset the negative impact from rising rates. We therefore could see spreads hold somewhat steady in 2022 around the 1% level, which is low by historical standards.

Long Term Corporate to Treasury Spreads



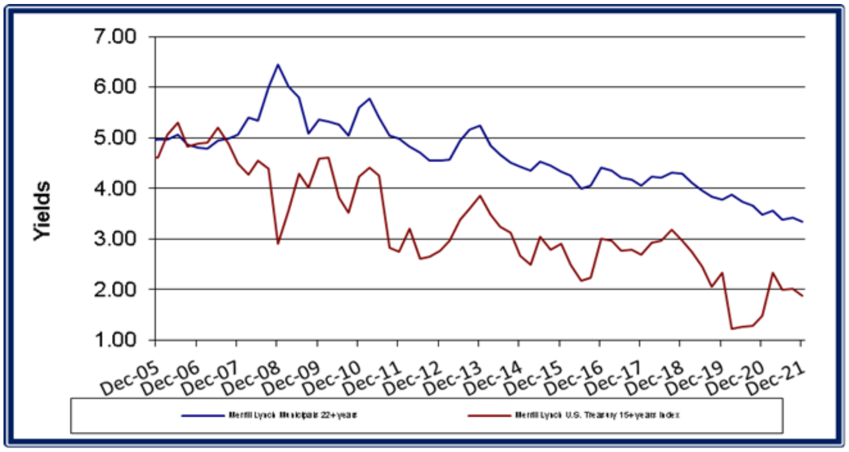
Source: Bloomberg and Altman Investment Management Research

The near-term risk to corporate credit is the direction and pace of Fed policy. According to a recent Reuters poll, the Fed is anticipated to begin its first of many rate hikes in March, with the level reaching as high as 1.0-1.35% by yearend. Should its pace accelerate above expectations, it could increase volatility and elevate spreads from current levels. We favor higher quality issues with improving fundamentals in the mid to lower duration range.

➢ Municipal Bonds

Municipals led the investment grade universe this past year, with returns flat against declines in treasuries, agencies and mortgages. The spread over treasuries narrowed since 2020 but still offers relative yield pick-up supporting investment. Credit quality is on the rise, with state government revenue growth having recovered to pre-pandemic levels alongside declining default trends and favorable federal policies.

Long Term Municipal to Treasury Spreads



Source: Bloomberg and Altman Investment Management Research

Although specific municipal provisions were eliminated from the Infrastructure Investment and Jobs Act, the $1.2 trillion investment plan aims a large portion of its spending towards transportation. This commitment along with aid given earlier this year from the American Rescue Plan, which provided $350 billion to state and local governments, are both supportive of the municipal bond landscape. Uncertainty remains around The Build Back Better plan since it received opposition in the Senate. It will likely need to be broken into parts before it can gain wider support.

➢ Gauging the U.S. Economy: *Interest Rate Tipping Point*

The great monetary accommodation unwind is finally underway - and we expect will gather pace in the months ahead. Uncomfortably high inflation is the catalyst for central banks' recent policy pivot and the latter is ultimately intended to sustain the economic expansion. Yet many investors are already fearing that even modest interest rate hikes could significantly impact economic growth. We continue to focus on the question of how high interest rates will have to rise to threaten the U.S. economic expansion within the framework of both the pace and magnitude of rate hikes. In setting asset allocation and portfolio construction during these challenging times, we recognize that different economic sectors will react differently to increases in interest rates, depending on varying leverage levels, other structural factors, as well as overall global market exposure. Our assessment of how the economic cycle progresses could have broad implications for capital markets and our investment strategy.

The areas of focus can be summarized in three categories: the rate gap, potential GDP and inflation. In summary, the rate gap is the difference between nominal GDP growth and interest rates as a measure that is either positive or negative. A positive gap is accommodative monetary policy or negative is restrictive monetary policy. Potential GDP is a measure that determines whether the economy is operating above or below its potential. If the gap is positive the policy is accommodative and if negative its restrictive. The third issue is whether inflation is above the target growth or above potential and the gap between growth and interest rates is positive and one could conclude that Fed policy is "behind the curve".

The tipping point for interest rates is usually only clear in hindsight since it hinges on a variety of factors such as overall leverage in the economy, and structural and regulatory factors, as well as other external factors. What we do know is that the tipping point is lower for the weakest sectors or most highly leveraged sectors of the market, and is higher for the strongest sectors. In that effort, we monitor our investment holdings that stay consistent with this approach.

We highlight the following observations concerning past economic cycles:

- The fed funds policy rate has been generally below the nominal GDP growth rate for two decades, in contrast to policy rates generally above the potential growth rate and reflecting chronic fears of inflation from the 70's and 80's.
- The last three rate cycles have ended with the fed funds rate either comparable to nominal GDP growth or well below, as was the case in 2019.
- The last Fed hiking cycle of 2018 was the first in four decades that ended with the 10-year Treasury yield below nominal potential GDP growth. While the Fed's policy hiking cycle at that time ultimately coincided with heightened recession fears, it reflected the U.S. trade policy and a global manufacturing slowdown rather than monetary drag. This indicates that the U.S. economy would have accelerated in 2020 in the absence of the pandemic. As a result, we conclude that the earlier rise in interest rates played no role in the brief recession in 2020.
- We expect the U.S. output gap will turn positive this year, consistent with ongoing inflationary pressures and higher real interest rates.
- The implication is that the fed funds rate could rise above the Fed's projected 2.5% longer-run level without jeopardizing the U.S. economic expansion, absent any other negative shocks, and assuming the rise is orderly. Similarly, the economy could likely withstand a further 150-200 bps increase in the 10-year Treasury yield over a 1–3-year horizon.

CONCLUSION:

Fed policy remains accommodative and has room to unwind before reaching a level that could stifle future growth. Any progress on the pandemic side would of course be beneficial, but the uncertainty surrounding treatments, future variants and longevity of restrictions remains.

The monetary unwinding should not be viewed, at least at this juncture, as "tightening" since policy should remain highly accommodative for some time. But with many of the drags dampening growth in the last expansion no longer present, and inflation potentially deepening its hold on the economy, the required normalization of interest rates may turn out greater than markets are currently anticipating. It is inevitable that interest rates will rise relative to underlying GDP growth, such that we expect the interest and debt-servicing burden on the economy will gradually increase. However, the starting point is still favorable and we still conclude that the U.S. economy can withstand a significant rise in interest rates (real and nominal) if the rise is orderly.

It is reasonable to expect that the fed funds rate will eventually exceed current estimates of nominal potential GDP, as the economic expansion matures further down the road. We expect that the capital markets will continue to be under a cloud of uncertainty, despite the resilience of the overall economy, associated with rising interest rates and coincident elevated valuations in a concentrated few stock that dominate the market capitalization. The outlook for bonds in the shorter term, in our view, appears to be more vulnerable than stocks in general.

Rates lifting with the 10-year exceeding the 2% threshold creates opportunities for fresh money. We anticipate these higher levels will emerge as the year progresses creating opportunity to begin repositioning our above average cash holdings in balance accounts into shorter duration bonds. The final purchase has to consider both the opportunity cost of sitting in cash and the expected plateau of short-term yields. The path of rates in the shorter term is still unclear at this juncture. Our preference given the uncertainty that Fed policy missteps suggests that we emphasize only high-quality corporates for incremental yield pick-up as the pace of rising rates slows. Healthy cash flows should buffer the impact of rising government bond yields on credit performance on a 1–2-year horizon, but current tight spreads imply historically disappointing absolute returns.

Our forecast of rising interest rates still warrants maintaining an underweight stance on fixed income and government bonds exposure in balanced portfolios, complemented with an overweight on cash and a bias towards equities.

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