Building Better Outcomes

Flexibility Will Be Key for U.S. Multisector Income

Vishal Khanduja
Director of Investment Grade Fixed-Income Portfolio Management and Trading, Portfolio Manager

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Boston – We believe 2022 will be a year of policy transition for U.S. bond markets, and that investors should prepare for higher volatility and higher interest rates. Below, we discuss several themes that support this outlook and the implications for U.S. fixed-income strategy.

Investment Themes

Lower, But Still Elevated, Inflation

The debate over whether high inflation will prove temporary or persistent has dominated the macro conversation for some time. We expect inflation to moderate from the late-2021 spike, as we believe global supply disruptions and durable goods demand — the two dominant factors leading the spike — may continue to ease. A new COVID-19 variant has clouded the picture, but nonetheless, we believe inflation will remain above long-term averages in 2022. Wages have been growing at their fastest pace in decades, and rents have increased over 10% nationally since October 2020. Both wage and rent inflation tend to be persistent components.

Policy Normalization, With Risks Tilted Toward a More Hawkish Fed

Global liquidity peaked in 2021 as central banks started unwinding emergency measures put into place during the early stages of the pandemic. We expect the global tightening trend to continue, with the speed, magnitude and timing dependent on the performance of policymakers' respective economies and the path of COVID-19.

In the U.S., the Fed is tapering its monthly bond purchases by an amount that, if maintained, will end quantitative easing (QE) by mid-2022. Chair Powell had earlier downplayed the notion that interest-rate hikes will follow closely behind. However, given our outlook for inflation, we see the potential for the Fed to taper faster and raise rates sooner than markets are anticipating. Fiscal policy will also be less expansive in 2022. Even the most aggressive government spending proposals pale in comparison to the roughly $6 trillion in COVID relief bills passed in 2020 and 2021.

Continued Strength in Credit Fundamentals

Consumer finances have never been stronger, thanks to government stimulus payments, high savings rates and surging home prices, among other factors. Household net worth is at an all-time high, while consumer credit delinquencies and the household debt service ratio are at record lows. With U.S. employers currently looking to fill more than 10 million job openings, wage inflation should remain supportive of the consumer.

Corporate balance sheets are also in very good shape, as are corporate earnings. S&P 500 companies reported third-quarter earnings growth of approximately 40%, and profit growth is expected to remain healthy over the coming quarters. Inflation is generally good for corporate earnings, especially when combined with above-trend GDP growth, which is the consensus forecast for 2022. So far, most companies have been able to pass through higher costs.

A Challenging Starting Point for Markets

A substantial portion of the investment-grade U.S. bond market appears priced for perfection. Credit spreads on the Bloomberg U.S. Corporate Investment-Grade Index tightened to their lowest levels of the past 15 years in June 2021. Spreads on securitized indexes are also compressed. And while nominal yields have risen in 2021, they remain very low.

Strategy Implications

Based on the themes outlined above, we believe 2022 will be another difficult year for traditional bond strategies, which are overly reliant on exposure to longer-duration and high-quality assets to generate returns and income. Valuations are extremely tight across the high-quality spectrum of the U.S. bond market. As a result, we believe that an active, multisector approach to fixed-income investing will be critical to producing income and returns in 2022. In our view, the most successful strategies maybe those with the flexibility to pursue value in lower-quality, nontraditional sectors of the market that are either not well represented in the broad U.S. benchmarks or outside of them entirely.

A Focus on Credit

We are more constructive on credit as a return driver in 2022, given strong fundamentals. Healthy consumer balance sheets, low unemployment and wage inflation should be supportive of assets across the consumer space. Corporates will generally benefit from an inflationary environment. Banks, for example, should see stable-to-declining loan losses, combined with the potential for yield curve steepening, resulting in higher profitability.

Within corporate credit, we remain cautious on single-A-rated nonfinancial issuers due to their limited potential for spread tightening and possibly higher downgrade risks. In recent quarters, management teams in this cohort have demonstrated a preference for shareholder rewards over credit ratings stability. We continue to find value in select BBB-rated and crossover credits, which should benefit from the benign credit environment and upgraded outlooks from ratings agencies.

In securitized markets, we see continued potential in sectors that have contributed to strong performance in 2021. In commercial mortgage-backed securities (CMBS), we continue to view properties with e-commerce exposure as beneficiaries, even if the economic expansion is bumpy. Hospitality should benefit from a sustained reopening, but security selection will be critical in capturing the best opportunities — recent notable hotel sales have highlighted interest in the space. Within other sectors, we expect seasoned residential credit to benefit from the strong home price appreciation witnessed post-COVID. Additionally, consumer-related debt looks selectively interesting, given ongoing strength in consumer balance sheets.

Out-of-Index Opportunities Offer Risk-Adjusted Returns

High-yield exposure can provide additional income and stability for multisector portfolios in periods of volatility and rising rates. Although spreads on major high-yield bond indexes are fully valued, select BB-rated and B-rated credits look attractive in the low-default environment. Firms that are "rising star" candidates will also benefit from the strength of the corporate sector. Credit rating agency, Fitch, expects the U.S. high-yield bond default rate to finish 2021 below 1% and to be around 1% in 2022.

Bank loans are another interesting area, offering attractive price stability with low duration sensitivity. We see them as a potentially good area of risk-adjusted returns as the market copes with volatility from tightening Fed policy. And for portfolios that permit them, emerging-market corporates have traditionally offered higher yield versus their developed-market counterparts, and we expect fundamentals to broadly remain solid.

Risk Considerations

Investing entails risks and there can be no assurance that any strategy will achieve profits or avoid incurring losses.

Multi-Sector Credit – The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. As interest rates rise, the value of certain income investments is likely to decline. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. Investments rated below investment grade (sometimes referred to as "junk") are typically subject to greater price volatility and illiquidity than higher rated investments.

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