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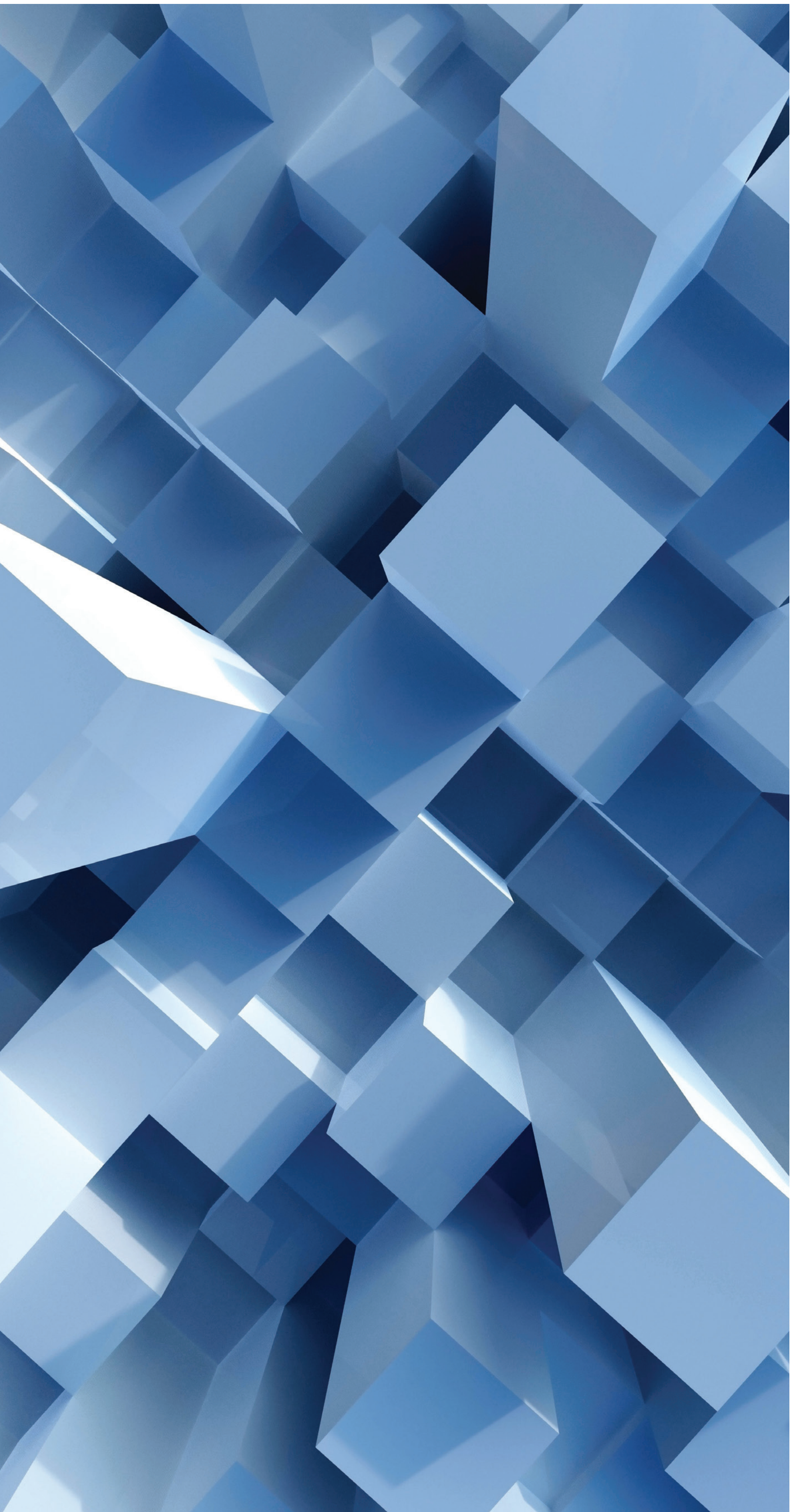

2022 Fixed Income Outlook

No Market Consensus Widens the Opportunity Set

We See Great Potential for Active—and Selective—Investors Building Fixed Income Portfolios in the Upcoming Year

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Executive Summary

- 2022 seems to be shaping up as a year without a market consensus, but instead a wide range of expectations—and opportunities—for active investors.
- The key variable is inflation, and whether transitory or persistent the Fed's response will have a profound impact on asset valuations in the upcoming year.
- Building our own portfolios we like specific areas in securitized credit, short-duration high yield and emerging markets, amongst others.

Full Outlook

2022 seems to be shaping up as a year without a market consensus, but instead a wide range of expectations. The bad news is that the many "unknowns" in the markets are creating deep disagreement amongst professional forecasters in terms of growth, inflation and policy actions. But the good news is that as the "unknowns" morph into "knowns" we believe active and selective investors will find ample opportunities to identify assets with great potential for absolute or relative gains.

Central bank policy was a major factor driving asset prices in 2020 and 2021 and will likely to continue to be one into 2022, but with a very important distinction: policy will serve to reduce, not increase, accommodation. Easy policy meant that significant liquidity had been poured into the markets and made "buying-the-dip" a tried-and-true tactic. Things will be different in 2022 as the U.S. Federal Reserve (Fed) debates and contemplates raising interest rates and tapering the pace of asset purchases from its quantitative easing (QE) program.

However, even though the Fed is expected to raise rates as a means of addressing inflation risks, it does not want to slam on the brakes and tighten financial conditions too much or too quickly. A measured response is required, and anticipation of what exactly that response will be has currently created a wide chasm between forecasters and investors in assessing the corresponding and appropriate valuation of asset prices.

The key variable is inflation. If inflation is in fact transitory and falls sufficiently in 2022, the Fed will likely be able to tap the brakes and slow the economy down. If inflation persists and becomes a bigger roadblock, a more draconian solution might be required. Either case, and iterations in between, will have a profound impact on asset valuations in the upcoming year.

Navigating Through Uncertainty

Macro variables, specifically the shape of the U.S. Treasury yield curve and the absolute level of 10-year yields, are early indicators of asset performance and tend to be leading indicators when policy is changing. In the case of credit spreads the Bloomberg U.S. Corporate Index is used as a generic and proxy view on the broader credit spread market.

We represent our investment view via a four-quadrant risk scenario model based on outcomes we believe fall into a probable category, and that will be adjusted throughout the year as the "unknowns" become more "known" *(Display 1)*.

This four-quadrant risk assessment is a general guideline but more importantly a starting point in our investment decision-making process. We are not providing a forecast per se, instead a general view on direction and magnitude.

- **QUADRANTS I & II** represent a constructive risk environment. The key linkage is a Fed that allows the economy to run hot and keep default risks low. A steeper curve informs this most, and an unchanged curve denotes a benign environment and a need for yield or spread products.
- **QUADRANTS III & IV** represent a risk-off investing environment. The Fed tightens financial conditions, messages faster tightening and contracts future growth, increases default risk. Curve flattening informs most.

A Few Observations

Rising interest rates, accompanied by a flattening yield curve spurred by an aggressive Fed, tightens financial conditions most as reflected in **Quadrant III**. The general state of financial conditions is a metric used in the Fed's policy reaction function to measure the availability and cost of credit. Thus, a sharp tightening of financial conditions contracts growth and cashflows most, thereby increasing default risks. While

DISPLAY 1

Policy Has Driven Asset Performance, and Will Likely Continue to do so in 2022

Our Four Quadrants of Risk: Policy, Yield Level, Yield Curve and Spreads

II 3x Fed hikes in 2022 Yields rise, T10y: 1.80-2.20% Curve steepens IG: 85-110bps OAS (buy the dip)	**I** No Fed in 2022 T10y: 1.45-1.75% Curve unchanged IG: 75-100bps OAS (grind tighter)
4x Fed hikes, faster taper Yields: T10y > 2.25% Curve flattens IG: 100-130bps OAS (default risk rising) **III**	2x Fed hikes in 2022 Yields fall, T10y < 1.25% Curve flattens IG: 95-120+bps OAS (be patient, wait to buy) **IV**

Source: MSIM as of January 10, 2022. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

this is not the Fed's goal, it hinges on whether inflation stabilizes.

Quadrant I is the most benign outcome that may result in low volatility and demand from investors to own yield and spread.

In our view, some combination of **Quadrant II and IV** most tightly align with the goals of policy makers. Excess accommodation is removed and there is a modest tightening of financial conditions. Asset prices readjust for this transition in policy and the yield curve will inform us most as to the depth of the adjustment. A steeper curve is more supportive for assets, a flatter curve less so.

The Opportunity Set: Active Management and Asset Selection Could Be Big Winners in 2022

Market forecasts are an important element going into 2022. But, the assumptions currently factored into assets prices are just as important, if not more so, as these prices set the initial conditions for expected returns for the upcoming year. Market pricing indicates a short, but sharp, tightening cycle from the Fed and the flattening of the yield curve in the fourth quarter of 2021 indicates that growth will likely moderate in the future. Many indices are already repricing for this outcome. But, this market-driven beta is not where the opportunities are in 2022.

As we see it, the opportunity set can be thought of more opportunistically when trying to source alpha. Investment grade corporate fundamentals provide a strong backdrop, but we see more return potential in financials and BBB-rated non-financials. We are cautious on A and above non-financials, companies with M&A risk and seeking a more optimal capital structure that can dilute valuations for bond holders.

In the high yield (HY) space absolute spread levels are close to what we consider to be fully valued, but relative valuations across sectors are reasonable. Loans are expected to have comparable returns to HY bonds, but we prefer short-duration HY versus the broad index. By rating cohort, we see value in single-B rated securities over BB or CCC-rated securities. The sectors we prefer are Energy, Cable/Media/Broadcasting, Retail and Building Materials.

Securitized credit, especially related to the consumer and housing, will remain compelling as a short-duration asset class with respectable yields and solid credit fundamentals. Housing in both the U.S. and Europe remain well-supported by price appreciation of the underlying assets and the credit quality of borrowers. We are wary, however, of commercial real estate but this varies greatly by sector. Agency mortgage-backed securities may also lose a tailwind from Fed purchases and may cheapen in 2022.

Local emerging markets (EM) stands out as a laggard in 2021 with a lot of room for improvement in 2022. This is because EM central banks have been well ahead of developed markets in terms of policy rate hikes designed to stem inflation risks. If inflation stabilizes as we expect in 2022, then both local EM debt and currencies stand to appreciate as global investors will be attracted to the yield, carry and potential returns from this asset class.

INDEX DEFINITIONS

The **Bloomberg U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market.

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