FIXED INCOME OUTLOOK

REGIONS
INVESTMENT MANAGEMENT

Is Inflation Here To Stay?

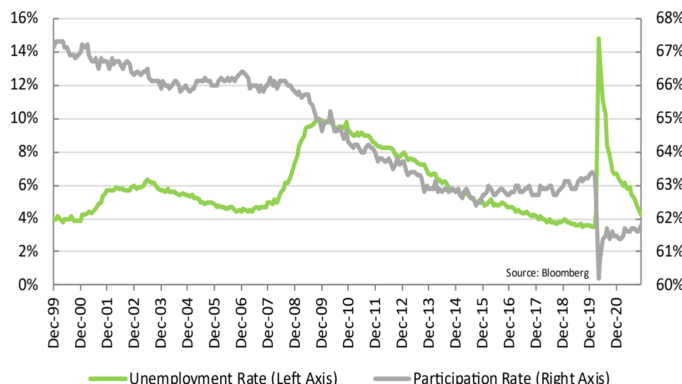
January 2022

Nearly two years following a massive, pandemic-led economic downturn, inflation is now popping up everywhere, from housing to the tab at restaurants and the cost of getting there. This should not be a surprise to anyone. By design, the Federal Open Market Committee (FOMC), led by Jay Powell, intentionally sought to fight the downturn and restore jobs with a flood of liquidity in the form of bond purchases and near-zero interest rates. The legislative and executive branches did their part too with trillions of dollars in arguably excessive fiscal spending.

Personal Consumption Expenditure Core Price Index (Year over Year Percentage Change)

And it worked… sort of. The unemployment rate certainly dropped, and it now approaches pre-pandemic levels; however, the labor force participation rate seems somewhat stuck at a lower level. No doubt, the return to work has been slowed for a host of reasons including ongoing COVID-related health concerns, limited options for child and eldercare, desires for higher pay and more workplace flexibility, and sheer mental exhaustion. Resignations and retirements are up, while rising wages are contributing to inflationary pressure.

United States Employment and Labor Force



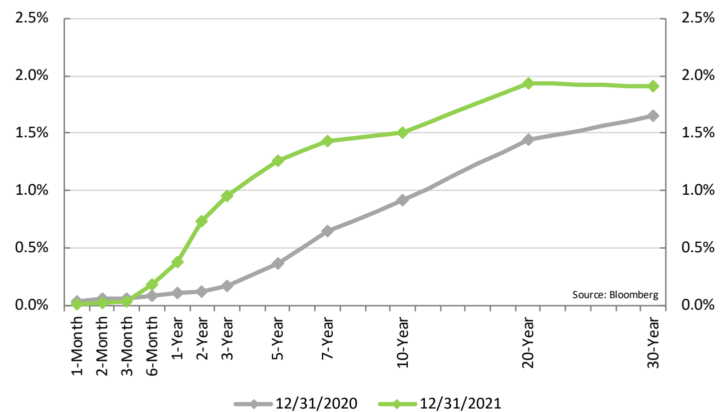
Supply chain problems are adding to inflationary pressure too. While bottlenecks are likely to begin easing later this year or in 2023, it will come with a price, i.e. higher prices as companies up and down the manufacturing, distribution, and sales chain work to supply the rebound in aggregate demand. Globalization and trade have put downward pressure on prices for years, but with geopolitical tensions starting to rise, further gains in efficiency will be harder to come by and decisions around sourcing alternatives may take years to implement.

Finally, central bank intervention in the markets has led to a massive runup in asset prices from homes to farmland, from stocks to bonds, and from nonfungible tokens to used cars. Owners of assets have benefitted tremendously (or at least maintained purchasing power) while everyone else faces the consequences of higher prices. This is a fairness quandary which our government has created and may be forced to address in the future.

With inflation fears top of mind, Team Powell announced plans in December to double the pace of tapering (or reducing) its bond purchases starting in January. Based on that decision, the aggressive $120 billion of new monthly purchases ($80 billion in Treasuries and $40 billion in agency mortgage-backed securities) that the Fed has added to its balance sheet during most of the pandemic will be nearly shut down by the end of March. Still, we expect the Fed to reinvest its existing holdings for some time, and its massive balance sheet, totaling nearly $9 trillion, will in our opinion remain elevated for years to come.

Once the taper has ended, the FOMC has indicated it will raise the fed funds rate from the zero bound, increasing it three times in 2022 at 25 basis points each, followed by three more in 2023, and two more in 2024. We'd point out that a lot can happen over the next few years that may change how the Fed's plan plays out. Moreover, we doubt the actual rate increases will end up being this aggressive.

Treasury Yield Curves



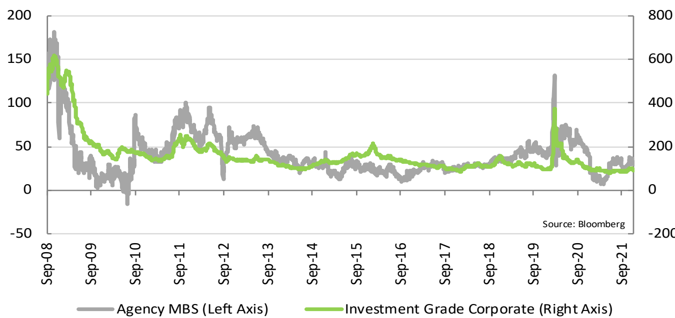
How we are Positioned

We are staying the course and are positioned for rates to gradually rise over the next few years. Because of our sticky interest rate expectations, we remain slightly underweight duration relative to the benchmark in our aggregate strategy. Specifically, we look for a much slower path for the FOMC to raise the fed funds rate. We look for one 25 basis point move in 2022, a second in 2023, and a third in 2024 as Team Powell

seeks to manage inflation down, while at the same time not pitching the economy into a recession. Notably, the current mix of voting members on the FOMC will change as some committee members' voting status rotates, and as currently unfilled and soon-to-be-vacant voting positions are nominated and confirmed. Over the next three years, we expect the yield on the ten-year Treasury to rise to the 2% area from its current levels near 1.5%, and unless inflation drops significantly, we expect real yields (nominal yields minus inflation) on Treasuries to remain negative.

As for corporate bonds, we are overweight the benchmark on a duration-adjusted basis even though valuations (yield spreads) are at historically tight levels. Simply, corporates are one of the few areas with good opportunities to pick up spread. We are managing our credit risk by concentrating most of our credit exposure on short-term bonds, while underweighting our corporate exposure on the long end of the yield curve. Notably, corporate earnings, cash flows and balance sheets are very strong, and it appears that corporate tax hikes from Washington will be minimal, if any at all, in the near term.

Average Option-Adjusted Spreads (Basis Points)



We are underweight agency mortgage-backed securities (MBS) given tight spreads and limited compensation for convexity risk. As the Fed completes its taper of bond purchases, it is possible MBS spreads will widen even though the Fed will remain an important MBS buyer as it reinvests its portfolio. In the last cycle, these reinvestments continued until after the Fed began raising short-term rates which we expect to start in 2022. In any event, we remain focused on careful security selection as the best way to manage risk in this sector. Finally, given the stinginess of Treasury yields relative to opportunities in spread product, we are underweight Treasuries on a duration-adjusted basis but with a tilt to the long end of the yield curve.

Inflation is a tough problem with several drivers at work, some of which policy makers can manage more easily than others. Unfortunately, once inflation takes root, it's as tough as kudzu to get under control. Nonetheless, in the long run we believe globalization (however it realigns), technological advances, and demographics will bring us back to a low inflation environment. In the meantime, persistently low nominal bond yields will remain a challenge for fixed income investors looking for real returns.

Sector Performance as of 12/31/2021

	QTD	YTD
Bloomberg Barclays US Aggregate Index	0.01%	-1.54%
Bloomberg Barclays US Treasury Index	0.18%	-2.32%
Bloomberg Barclays US MBS Index	-0.37%	-1.04%
Bloomberg Barclays US Corporate Index	0.23%	-1.04%
Bloomberg Barclays US High Yield Index	0.71%	5.28%

Source: Bloomberg

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