Fixed Income Round Table:
What to expect from the bond market in 2022
Outlook 2022

Key messages:

1. Inflation has been a key driver in markets lately, with central banks recalibrating their views on inflation and telegraphing to market expectations.
2. Although recent sharp moves upwards in yields have been swift, we believe much has been priced into the curve.
3. Despite the current challenges of the market, many opportunities still exist within fixed income.

Summary

Inflation: How it has played out recently and what to expect going forward

- Inflation has been a driver of markets over the last few quarters, and we have seen a broad-based increase in inflation in both goods and services.
- A large number of components of inflation have been registering above 3%, suggesting the breadth and depth of inflation is significant.
- Fiscal and monetary policy brought on by the COVID-19 response created "demand pull" inflation, while supply-chain constraints added upward price pressure in the face of the extra demand.
- Labour and wages have affected inflation, with broad-based gains in wages being felt across all cohorts over the last few quarters.
- With a record high number of job vacancies seen in 2021 and with the US only now seeing employment at pre-pandemic levels, wages have been positively impacted.
- With these factors, we see inflation as remaining "sticky" and sustained at these higher levels (above central bank targets) for the time being, but do not necessarily see them moving much higher.
- However, consumers will eventually feel more pressure and will become more sensitive to the higher costs brought on by elevated input costs and wages – costs that businesses have been able to pass through with relative ease.

Rates and monetary policy

- Policy support has been unprecedented during the COVID-19 pandemic.
- The yield curve did not react initially with the expectations of higher inflation in 2021, as illustrated through a steepening of the yield curve and short-term rates held low.
- However, over the last couple of months, we have seen a recalibration of central bank's views of inflation and a policy level-set, and a corresponding change in the shape of the yield curve. The yield curve has flattened with front-end rates increasing sharply with the expectation that tightening will occur with higher inflation.
- Current market pricing for central bank policy changes in 2022 shows approximately 140 bps priced in for Canada and about 85 bps from the Federal Reserve. The expectation is for approximately four hikes from the Fed in 2022, with some opining that five or six hikes are warranted.

- However, monetary policy expectations are not uniform across many central banks, as illustrated with the European Central Bank (ECB) seen lagging in response, and China looking to ease monetary policy to support growth.

Our views on credit

- Investment grade credit had a difficult year in 2021, driven mainly by the increase in overall rates. The rising yield effect was more than enough to overwhelm the coupons being paid in these products. High yield was a brighter spot as there was enough coupons to overcome the interest rate risk.
- Even year-to-date (January 2022), we have seen a quick downturn in credit on the back of a sharp rise in yields.
- However, with these sharp moves higher in rates, we believe much has been priced into the rates market. We view continued sharp rises in rates as unlikely to be sustained in 2022, with only gradual interest rate increases being felt.
- **We remain constructive on credit overall**. There was a big spike in spreads in March 2020, however high yield spreads recovered very quickly. Many companies took the opportunity to term out their debt by refinancing, to the point where refinancing risk has gone down in the market which should support spreads.
- Fundamentals remain strong, with increases in quality seen in overall high yield. Default rates are historically low and are expected to remain low.
- Our view of high yield remains positive however, we prefer loans over high yield. The floating rate nature of loans significantly reduces the interest rate sensitivity that is currently felt by high yield bonds.

Current positioning in our mandates

- **Duration:** Our overall view is to be underweight duration, which we recently moved from significant underweight. We realize that a lot of the move in yields has already occurred and a heavily indebted world prohibits a massive rise in yields as interest rate sensitivity would hit growth. We are neutral in Canada duration, as a lot has been priced into the curve. We are still short duration in the US, with some upward movement expected. We like China duration as they are currently in a different central bank cycle (rate cuts/easing monetary policy).
- **Credit:** We remain overweight credit overall. We prefer private credit and leveraged loans for their relative value and yield potential. We still like investment grade corporates over government, but there is little buffer in terms of spread.
- **Emerging markets local debt:** We see the sector as relatively attractive and we are moderately overweight.

How we are navigating the recent volatility

- Rates volatility has spiked higher recently, so we need to always look at our position sizing in the face of increasing volatility. We also look at different types of volatility in addition to rates, including foreign exchange and credit spread volatility. It's important to look at all markets and decide how to express individual views but be pre-emptive in our views in quick markets.

Inflation-protected securities: Where do we go from here?

- We saw very strong performance from inflation-protected securities in 2021, especially TIPS.

- Break-evens have shown strong signs of recovery since the March 2020 lows. However, the biggest driver of performance in 2021 was not expected future inflation, it was realized inflation. This was reflected in the large carry provided by the inflation compensation.
- Going forward, inflation will likely remain high, which suggests that it is still a good time for TIPS due to their real inflation compensation potential.

A little more on China and other emerging markets, and why we like it

- A key question is whether China really behaves like other emerging markets.
- Overall yields are much higher in China than other developed markets, which is a standout if you believe that China is more like a developed market. The central bank in China is currently cutting rates to spur growth, much like a developed market, where most emerging markets need to increase rates in a crisis to support their currency.
- We like China Government Bonds (CGB) and express this view in a lot of our global mandates, and in some domestic mandates whenever possible.
- We like China high yield, as a lot of the bad news has been priced. We see relative attractiveness but will add slightly to positions and do so selectively.
- We also like other areas of emerging markets and prefer jurisdictions that have higher commodity exposure. We also focus on countries whose central banks have been pre-emptive in policy response and hiking rates in light of inflation. Brazil, Mexico, Chile and Russia are examples.

Thoughts on the preferred share market

- It was undoubtedly a great year for preferred shares in 2021. We do own some preferred shares and have held during their recovery. However, with this performance, we feel the preferred market is close to full valuation. The preferred market has changed over the years with less new issuance (replaced by hybrid bond/LRCN issuance). With valuations where they currently are, we feel that risk-off moves in the market could challenge valuations and strain an already illiquid market. As such, we have been sellers of preferred shares.

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