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Can the Fed Thread the Needle?

To say the Federal Reserve has their work cut out for them would be an understatement. As we enter 2022, inflation tops the list of risks on investors' minds. It seems most people have grown accustomed to living with the coronavirus and its variant surges. Here in the state of Indiana, the College Football Playoff National Championship game was played with thousands of fans in town and few restrictions attempting to limit the spread of the Omicron variant. The economy keeps chugging along right through the waves of infection thanks to the heroic efforts of our healthcare workers.

After many years of low growth, low inflation, and low interest rates, suddenly we are talking about the prospect of an inflationary spiral. How did we get here? And can the inflationary situation be resolved? Our team has debated this topic over the last several weeks. As our research analyst Mitch DePoy explains in further detail in this letter, we believe aggressive fiscal policy coupled with economic dislocations related to the pandemic are mostly to blame for rising prices. The Fed bears some responsibility, as they largely supported fiscal stimulus measures and admittedly failed to anticipate the persistence of supply chain bottlenecks and labor market tightness. The Fed pivoted quickly, however, and is now focused on removing monetary policy accommodation and navigating a soft landing for the economy that reigns in inflation without causing a recession. In short, the Fed must thread the needle.

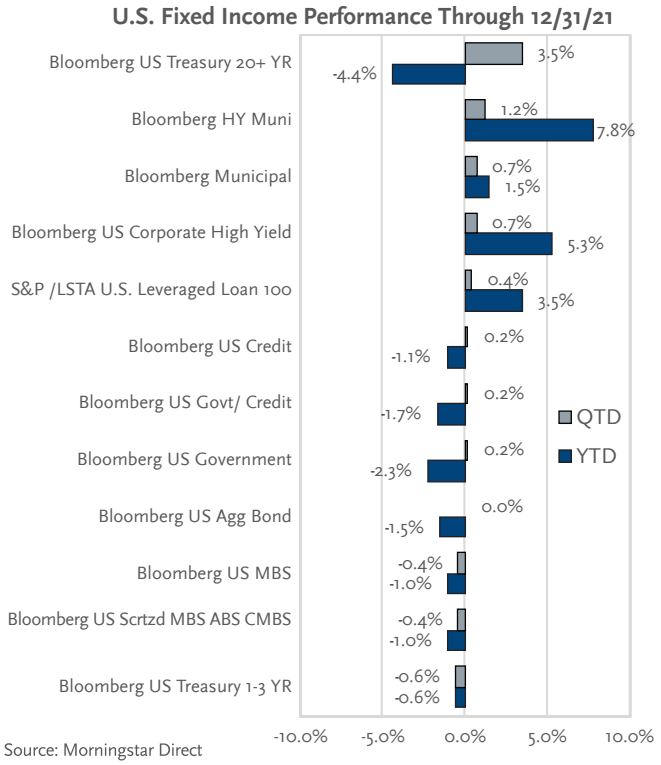
U.S. Fixed Income Market Performance:

Yields remained low on a historical basis and the yield curve flattened during the quarter. The 2-year and 10-year Treasuries entered the quarter yielding 0.28% and 1.52%, respectively. While the 2-year Treasury yield increased to 0.73% as investors priced in expected Fed rate increases, the 10-year Treasury yield finished basically where it started the quarter. The 30-year Treasury yield declined by 14bps to 1.90%. Below are highlights on fixed income performance during the fourth quarter.

- Credit was positive as the yield-carry offset rate increases on the short end. The Bloomberg U.S. Credit Index returned 0.2% while the U.S. Corporate High Yield Credit index returned 0.7%. Investment grade spreads widened modestly from 84 basis points to 92 basis points but remained near record tights. High yield spreads tightened from 315 basis points to 310 basis points during the quarter.
- The best performing segment of the fixed income market was long-duration government bonds due to the yield curve flattening.
- Floating rate leveraged loans appreciated as the S&P/LSTA U.S. Leveraged Loan 100 Index returned 0.4% as credit spreads tightened.
- Municipal bonds were positive as tax exempt income remains attractive and investors anticipate changing tax rates. The Bloomberg Barclays Municipal Bond index rose 0.7% for the quarter. High yield municipal bonds generated a return of 1.2%.
- Emerging market sovereign debt, both local and U.S. dollar-denominated, declined. Major developed and emerging market currencies experienced mixed results relative to the U.S. Dollar.

2022 Economic and Fixed Income Outlook:

Economic growth reaccelerated in Q4 after a slowdown in Q3 related to the Delta variant and supply chain bottlenecks. The current consensus estimate for GDP growth in Q4 is 6.0%, increasing from 2.3% in Q3. Growth has been supported by strong consumer spending



Source: Morningstar Direct

resulting from healthy balance sheets, a normalization in the savings rate, economic reopening, and wage growth. Exports have also rebounded as supply chain bottlenecks eased a bit allowing production levels to improve. Demand for U.S. equipment and supplies was buoyed by reopening of economies abroad, particularly in Asia.

Job growth slowed some in Q4 from earlier in the year as economic conditions continued to normalize, nevertheless unemployment at 3.9% is rapidly approaching pre-pandemic levels in the mid-3% area. Inflation continues to be a concern with Core PCE YoY increasing to 4.7% in November, significantly ahead of the Fed's 2.0% target. We include more detail on our outlook for inflation below. With inflation running hot and wages growing at the strongest levels in years, the Fed recently announced an acceleration of tapering, doubling the monthly reduction in its bond purchases to $35 billion and putting balance sheet expansion on track to end in March 2022. Slowing accommodation by reducing asset purchases is not the same as tightening monetary policy, but the Fed's projections for rate tightening liftoff have moved dramatically forward and they are beginning to discuss the timing and pace of balance sheet runoff.

While the recent surge in Covid cases related to the Omicron variant has clouded forecasts for 2022 somewhat, we continue to expect strong growth in the 3.5% to 4.0% area. This is lower than 2021 as the effects of stimulus continue to wane, but still above pre-pandemic levels as pandemic-impacted sectors rebound and inventory levels are rebuilt. We expect unemployment to reach pre-pandemic levels of 3.5% in 2022 and labor force participation for prime age workers to continue to recover. We expect the Fed to begin raising the Fed Funds rate in the first half of 2022 from the current target range of 0% to 0.25%, reaching 0.75% to 1.00% by year end. We do expect interest rates to float up modestly with the yield curve flattening as Fed increases push up the short end. We expect the demand for credit to remain strong in this environment and spreads to remain at low levels. Rising rates could weigh on total returns, especially in investment grade portfolios, but also present opportunities for increased income in the future. High-yield portfolios are likely to return low-single digits in 2022.

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Our Thoughts on Inflation:

Over the last two years, we have written in detail about the large amounts of fiscal stimulus and monetary support provided to the economy by Congress and the Fed, respectively. These aggressive measures prevented a deep recession and allowed a robust and speedy recovery. While the efficacy of some of the measures at addressing true needs can be debated (think PPP program or expanded child tax credits for wealthy households), we largely got what we paid for. When the decisions were made, the risk of doing too little seemed greater than doing too much. But with the advantage of hindsight, we may have done too much.

The most recent reading of the Fed's preferred inflation metric, Core PCE YoY, is trending much higher than preferred. On a MoM basis, inflation has averaged 0.38% in 2021, more than double pre-pandemic levels in the 0.14% range. The most recent reading of 0.46% in November would equate to 5.7% on an annualized basis, far exceeding the Fed's target of 2.0%. The Consumer Price Index, another inflation gauge, increased 7.0% YoY in December, the highest reading since 1982 and the third straight month over 6.0%. Excluding historically volatile food and energy prices, CPI increased 5.5% YoY, ahead of November's increase (4.9%). While inflation appeared to be accelerating as we exited 2021, it also expanded to a wider range of sectors beyond those most impacted by the pandemic. These factors caused the Fed to shift rather abruptly to a more hawkish stance as we enter 2022.

Similar to the Fed, we have been somewhat surprised at the persistence and broadening out of recent inflation. Looking back, we underappreciated a few important factors. First, in retrospect, the $1.9 trillion stimulus bill passed by the new administration in March 2021 just as vaccines became more widely available was probably excessive. Second, a lot of this money was channeled into consumption of goods instead of services due to continuing restrictions and caution related to virus transmission. At the same time, producers struggled to rebuild inventories drawn down at the onset of the pandemic while also building a safety stock that has become necessary in the pandemic regime of supply tightness. Variant surges causing the sidelining of workers in factories and distribution facilities have further exacerbated supply chain bottlenecks. Finally, the labor market has demonstrated more tightness than we anticipated. While the labor force participation rate has recovered 0.4% in 2021 to 61.9%, it remains stubbornly below pre-pandemic levels (63.4%). In a normal environment, this would suggest slack in the labor market. This is not a normal environment, however. We believe the presence of Covid and performance of securities markets has accelerated retirements. Additionally, younger people who could otherwise work are held back by lingering Covid concerns and the need to care for children who may or may not be in school depending on local case rates and restrictions. The number of employers reporting difficulty finding staff and accelerating wage growth are evidence of labor market tightness.

Despite inflation that has been stickier and higher than expected, a few factors give us confidence that inflation will recede. First, interest rates have increased some but remain below pre-pandemic levels suggesting market participants are not pricing in a long-term inflationary spiral. The 5 year forward TIPS breakeven rate of 2.2% remains similarly well-anchored. Second, survey based measures of inflation expectations have moved up modestly but not enough to become determinative of long-term inflation. Third, as Covid becomes more endemic, stimulus wears off, and consumer spending normalizes, we expect supply chain disruption to alleviate and growth to cool. Finally, the Fed has quickly pivoted to reduce monetary policy accommodation and appears on course to raise rates perhaps as soon as March and begin allowing the balance sheet to run-off.

In summary, inflation has surprised to the upside and remains a present concern, but as rates have already moved higher in early January to reflect the Fed's hawkish pivot, we do not anticipate significantly higher interest rates from current levels. We would also not be surprised to see longer-term trends such as increasing productivity, population aging, low population growth, and high government debt levels to reassert themselves beyond 2022.

How we are positioning portfolios at this time?

We believe markets are in many ways looking through the various Covid surges similar to the way that our society in general is learning to live with it. We are very focused on the inflation picture and credit quality of the corporate debt positions we hold. We believe balance sheets will continue to improve throughout 2022 and that credit defaults rates will reach all-time lows. This is however no time to become complacent. On the contrary, we will sharpen our focus on relative value and be sure we are positioned appropriately for what will be a challenging 2022. We frequently mention in discussions with clients that managing a fixed income portfolio is like being a captain of an ocean liner; we maintain a sharp eye on the horizon and steer clear of storms well in advance. The visibility allows our team to post top quartile results on a very consistent basis for our clients. As long-term, value fixed income investors, we remain focused on capital preservation through portfolio duration and credit analysis. We maintain our bias toward rising interest rates in the near-term and continue to favor corporate credit. Remember, our bottom-up investment process and extensive research focus helps us identify relative value opportunities in the marketplace, giving us confidence in the risk-reward trade-offs in our portfolios. While market fluctuations can cause short-term underperformance, our long-only style of investing has delivered positive results with reduced volatility over the long term. If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

Thank You

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