OPPENHEIMER
INVESTMENT MANAGEMENT

Nowhere to Hide

Financial markets are off to a very challenging first quarter with most asset classes, from fixed income to equities, posting material total return losses amid rising inflation, slowing growth, and heightened geopolitical risk. After finding itself behind the inflation curve, the Fed has pivoted to a decidedly hawkish tone. Russia's invasion of Ukraine, while adding some uncertainty to the growth outlook, has exacerbated inflation concerns through higher food and energy prices along with additional supply chain disruption. Meanwhile, the Omicron Covid variant dented growth temporarily, but not enough to cool the economy meaningfully. Amidst an accelerating timeline for the removal of monetary policy accommodation, interest rates have risen across the board, but especially on the short end as the market priced in Fed rate hikes. Federal funds futures now indicate eight full hikes by the end of 2022, up from the four hikes expected just three months ago. Equities sold off in the quarter while credit spreads widened. So far this year, there has been nowhere to hide.

In this addition of OIM's quarterly market and economic commentary, we will review performance in fixed income markets, offer some additional insight into labor market tightness, and conclude with some perspective on how we are positioning portfolios at this time.

Fixed Income First Quarter Market Performance

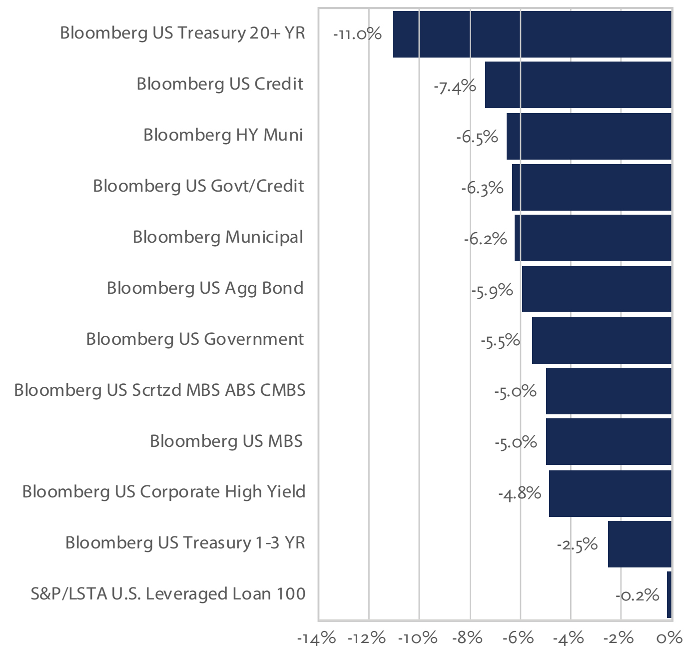
Yields increased significantly yet remain low on a historical basis as the yield curve flattened during the quarter. The 2-year and 10-year Treasuries entered the quarter yielding 0.73% and 1.51%, respectively. While 2-year Treasury rates increased by 1.60%, the 10-year Treasury yield finished the quarter only 0.83% higher. Corporate credit returns were negative during the quarter. Below are some performance highlights for different sectors of the fixed income market during the quarter:

- Credit was negative as investors drove spreads wider. The Bloomberg U.S. Credit Index returned -7.4% while the U.S. Corporate High Yield Credit index returned -4.8%. High yield spreads widened from 283 basis points to 325 basis points during the quarter. Investment grade spreads widened from 92bps to 116bps.
- The best performing segment of the fixed income market was U.S. Treasury Bills due to their perceived credit quality and short duration.
- Floating rate leveraged loans held up relatively well as the S&P/LSTA U.S. Leveraged Loan 100 Index returned -0.2%.
- Municipal bonds declined as higher rates impacted bond prices. The Bloomberg Barclays Municipal Bond index fell -6.2% for the quarter. High yield municipal bonds generated a return of -6.5%.

Threading the Needle

At this point the Fed readily acknowledges inflation is running at unsustainable levels and is the more pressing concern between the Fed's dual priorities of price stability and full employment. In his March 2022 press conference, Chair Powell referred to price stability as a "precondition" for achieving the kind of labor market that prevailed before the pandemic, which was one that pulled discouraged workers back into the labor market and spread the gains of wage growth broadly to underprivileged groups. The challenge for the Fed this time around is primarily twofold. First, inflation is running at unprecedented levels.

U.S. Fixed Income Performance Through 3/31/22



Headline CPI YoY rose to 8.5% in March 2022, the fastest pace since 1981. The Fed abruptly shifted its policy stance in 2021, leading many to argue the Fed was already "behind the curve" when it came to controlling inflation. With the outbreak of war in Eastern Europe this quarter, those fears were only reinforced further, increasing the probability that the Fed will be forced to move "too far too fast" in removing policy accommodation, eventually leading to recession. This scenario appeared to be reflected in the inversion of the yield curve (as measured by the 2Y to 10Y treasury spread) that occurred briefly during the quarter. At the writing of this letter, the 2's to 10's spread has steepened back to 36bps, but the balance between cooling demand while maintaining growth bears watching.

Another challenge the Fed faces this time around is an exceptionally tight labor market. As the chart below demonstrates, the current level of job openings relative to the number of unemployed workers in the U.S. is approximately 1.7. This level is well above the peaks seen in the last two economic cycles. Many companies are reporting challenges with staffing levels and filling open positions. A popular argument earlier in 2021 was that the pandemic caused many workers to remain out of the labor force due to health concerns, caring for dependents, or other reasons, explaining the tightness in the labor market. This theory would lend one to believe that the labor supply tightness would alleviate as workers returned to the labor force. This argument, however, was recently debunked by Paul Krugman in an article we recommend for your consideration. Krugman demonstrates that labor force participation among prime age workers and older workers has recovered quite rapidly and is already near pre-pandemic levels. Krugman's alternative explanation for the labor market tightness is a dual effect of a shift in employment to gig work and a decline in immigration under the Trump administration and Covid restrictions. If Krugman's arguments are correct, the Fed will not receive much help on inflation from additional labor supply coming back into the market, and will instead be more reliant on monetary policy to cool demand without tipping the economy into recession. As is always the case with monetary policy, the Fed must thread the needle.

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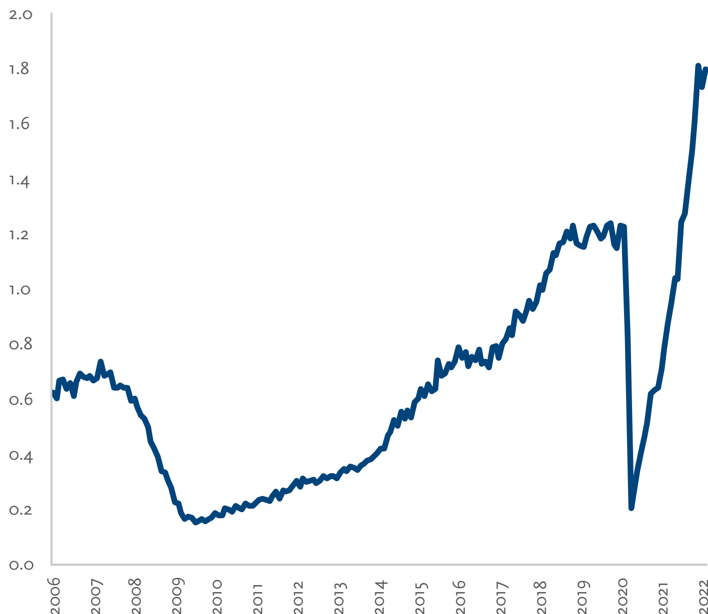

Source: OIM Research; Bloomberg Data

Consolation for Fixed Income Investors

Below are some factors we believe should offer consolation to fixed income investors who are disillusioned following the sell-off in Q1:

- The 5yr UST at 2.7% is nearly on top of the median of FOMC participants' projections of the Federal funds rate at the end of 2023 (2.8%) and 2024 (2.8%) and higher than the longer run median estimate (2.4%). While rates moved higher quickly, we believe inflation fears and Fed hawkishness are now mostly priced in.
- FOMC participants' median estimate of Core PCE Inflation is currently 2.6% in 2023 and 2.3% in 2024. The Fed's longer term estimated PCE inflation is 2.0%. Yields on intermediate treasuries exceed these levels, signaling positive real yields. Financial conditions have tightened meaningfully in the form of higher mortgage and other loan rates, lower equities, a flatter yield curve, and dollar strength. While the Fed may be behind the curve, the market is not.
- Reduced UST liquidity and high rate volatility no longer stem from headline turmoil, reflecting persistent lack of sponsorship from macro investors and market makers. Cash is still coming into the markets, but on a delayed basis to see if yields can find stability. Investors are structurally short the bond market. We believe a lot of cash is sitting on the sidelines and could support bond prices going forward.
- Global markets continue to search for bad news for bonds and good news for stocks. Credit spreads have stabilized after selling-off with Russia's invasion of Ukraine.

How we are positioning portfolios at this time?

Investment Grade and High Yield Corporate credit managed to improve slightly at quarter end as spreads tightened from their wides in mid-March. Per the Bloomberg Barclays Credit Index, corporate credit tightened to 27 basis points versus comparable Treasury yields between March 15 and March 31. High yield spreads tightened 86 basis points during the same time period. We expect the demand for corporate credit to remain strong and spreads versus Treasury bonds to remain at historically low levels. Geopolitics and monetary policy have overshadowed several healthy developments in credit fundamentals and rating trends. We remain constructive on economic and credit fundamentals. It is still our view that interest rates could drift higher as the Fed remains hawkish and as inflation remains elevated. However, our baseline case remains that growth and inflation will likely slow down as we move through 2022. Year ago measures of inflation begin to get tougher as we move through the spring, so current year inflation readings will have stiffer comparisons. We expect supply chain challenges to continue to alleviate, albeit with the potential for intervening hiccups like the events in Eastern Europe and the Covid surge in China. Consumption should continue to shift back to services from goods. Labor force participation still has some room to improve. And finally, monetary policy will begin to bite.

Rising interest rates have weighed on total returns, especially in investment grade, but also present opportunities for increased income and yields in the future. There are no positions in the portfolios with any viability/sustainability concerns through the market cycle. As a result, while there has been price decline, the income potential has improved and we do not have to realize any losses. Our focus on portfolios is capital preservation in the short term as we continue to overweight shorter maturities and 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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