ECONOMIC AND FIXED INCOME COMMENTARY

OPPENHEIMER
INVESTMENT MANAGEMENT

"Nobody rings a bell at the bottom"

Here in the Midwest, and particularly in central Indiana, we tend to be conservative in nature. We aren't too flashy with our market rhetoric, pontifications, or table-pounding convictions, but we know an opportunity when we see one. Over the years, we have had the privilege of gleaning wisdom from many insightful investment professionals. Our own Chairman, Bud Lowenthal, offered us a bit of wisdom at the height of the financial crisis in 2008 that has stuck with us through the years. He said, "Guys, nobody rings a bell at the bottom, there are opportunities being presented, we need to take advantage of those for clients." We believe such an opportunity exists today in fixed income.

In this edition of OIM's quarterly market and economic commentary, we will review performance in fixed income markets, discuss the differences between the inflation measures of CPI and PCE, and conclude by explaining why the current environment offers attractive total return and income opportunities for long-term investors.

Fixed Income Third Quarter Market Performance

Yields increased during the quarter, particularly for shorter maturities. The 3-month Treasury yield increased by 1.61% to 3.33%, while the 2-year and 10-year Treasury yields rose by 1.30% and 0.85%, respectively. At quarter end, the 2-year Treasury yield was 4.28%, the 10-year Treasury yield stood at 3.83% and thus, the closely followed yield difference between the 2-year and 10-year Treasuries remains inverted at -0.45%. Corporate credit returns were also negative during the quarter. Additional quarterly fixed income performance highlights include:

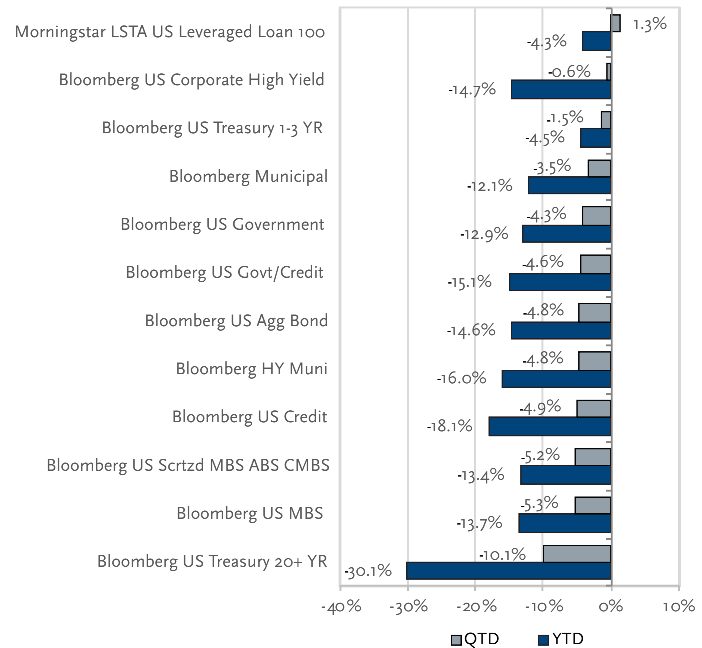
- Negative quarterly returns for credit despite relatively unchanged investment grade credit spreads and tighter high yield credit spreads. The Bloomberg U.S. Credit Index returned -4.9% while the U.S. Corporate High Yield Credit index returned -0.6%. High yield spreads narrowed from 587 basis points to 543 basis points during the quarter.
- US Leveraged Loans was the best performing fixed income segment as the S&P/LTSA U.S. Leveraged Loan 100 Index returned 1.3%.
- Municipal bonds declined as higher rates impacted bond prices. The Bloomberg Barclays Municipal Bond index fell -3.5% for the quarter while high yield municipal bonds generated a return of -4.8%.
- Emerging market sovereign debt, both local and U.S. dollar-denominated, declined as almost all major developed and emerging market currencies depreciated relative to the U.S. Dollar.

What are the CPI and the PCE and how do they differ?

The Consumer Price Index (CPI) and the Personal Consumption Expenditures Price Index (PCE) are two distinct attempts to measure inflation. In design, they attempt to answer two slightly different questions. In construction, they differ primarily in formula, weighting and scope. In use, they differ in applications from setting monetary policy to adjusting social security benefits.

The CPI is produced by the Bureau of Labor Statistics (BLS) and was designed to measure out-of-pocket expenditures by non-institutional urban consumer households only, whereas the PCE is produced by the Bureau of Economic Statistics (BEA) and was designed to measure changes in prices for all consumption items – not just those paid for out-of-pocket by consumers. For example, in the health care category, CPI only measures the out-of-pocket costs such as insurance premiums, deductibles, etc. while excluding the costs borne by insurance companies, employers, Medicare, etc. The PCE includes these costs. As such, the weighting of health care in the CPI (8%) is much less than in the PCE (18%). The same is true for educational services where most of the cost is borne by local government and not consumers' pockets. Another consequence is that housing or shelter costs are weighted much higher in the CPI (32%) than in the PCE (15%).

U.S. Fixed Income Performance Through 9/30/22



Source: Morningstar Direct
Indices are provided for comparison only and are not available for direct investment.

Historically, the CPI adjusted the weighting of its market basket of goods and services every two years. Beginning January 2023, the CPI will adjust the weighting annually while the PCE adjusts the weighting quarterly. The difference in the frequency of adjustments has a couple important consequences. First, more frequent adjustments reduce the influence of substitution bias. As a good or service becomes more expensive, consumers will tend to switch to a similar but lower cost alternative. More frequent weighting adjustments better reflect this phenomenon, resulting in a lower rate of inflation over time. Over the long term, PCE averages about 0.3% below the CPI on an annualized basis. Secondly, collecting the expenditure data used to determine the index weighting takes additional time. As a result, the CPI is reported mid-month while the PCE is reported on the last Friday of each month.

The FOMC targets annual *headline* PCE inflation of 2.0% over time – not at each report. The FOMC prefers the PCE as it is a broader measure of inflation and has less substitution bias. Social Security and other government benefit programs prefer CPI in an attempt to better match transfer payments to the costs actually experienced by consumers.

The "core" measures of the CPI and PCE are sub-indexes which strip out volatile food and energy costs. Food and energy costs are large expenditure categories for consumers and cannot be ignored; however, the short-term price volatility can obscure the information about inflation from less volatile categories. The FOMC and market participants tend to focus on the core numbers as indicators of the long-term trajectory of prices, but certainly the cost of food and energy are important to consumers and setting inflation expectations.

Japan has inflation?

Why are we bringing up this topic now? Because it's always good to be thinking about where our economy and inflation may be headed in the long-run. It was not long ago when the FOMC was trying to get Core PCE inflation up to 2% rather than back down to that level. In Japan, Core inflation accelerated to 2.8%, up from 2.3% last month. The rise marks two consecutive months above the BOJ's 2% target, a phenomenon that has only happened twice since 1992 (briefly in 1997 and 2014). Since 1992, core inflation has been negative more often than positive in Japan, and as a result, the Bank of Japan is likely to tolerate a further increase before taking steps to contain it.

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Source: S&P Global

The Case for Fixed Income Investment at this Time

We think the relative value between stocks and bonds currently favors bonds due to the relationship between the 10-year Treasury yield and the S&P 500 dividend yield. The 10-year Treasury now yields +1.96% more than the S&P 500 dividend yield, the biggest differential since +2.18% in April 2010 – when the 10-year Treasury was similarly trading near 4.00%. As evidenced by the data below, peaks in this relationship are typically followed by outperformance in bonds vs. stocks.

Over the long-term, the greater risk in stocks should produce greater returns. However there are times, like today, where the prospects for fixed income compare more favorably.

The cumulative two-year total returns on stocks and BBB corporate bonds subsequent to the last peak in this relationship look similar:

S&P 500:	+22.76%
ICE BofA BBB US Corporate Index:	+20.38%

On the other hand, the cumulative two-year total return on stocks and BBB corporate bonds subsequent to the last trough in this relationship looks much worse:

S&P 500:	+105.42%
ICE BofA BBB US Corporate Index:	+15.24%

Additionally, when financial markets are generally selling risk as is the case today, fixed income reliably outperforms stocks.

For example, YTD returns in 2022:

S&P 500:	-20.24%
ICE BofA BBB US Corporate Index:	-17.34%

Another recent example would be the COVID-induced sell-off in early 2020 (02/19/2020 - 03/23/2020):

S&P 500:	-33.79%
ICE BofA BBB US Corporate Index:	-15.37%

Taken together, we think bonds are currently attractive as indicated by the 10-year Treasury yield vs. S&P 500 dividend yield spread and the general risk-off sentiment in the stock market. In times like this, historical evidence suggests investors can reduce downside exposure while preserving much of the upside potential by investing in bonds.

Fixed Income Market Conditions and Portfolio Positioning at this Time

The third quarter witnessed heightened volatility as stubbornly high inflation and monetary policy tightening illuminated global growth concerns. Interest rates moved higher again as the Fed raised their fed funds rate by 75 basis points in both their July and September meetings, while continuing to signal that inflation was too high. The Fed has consistently stated they would continue to tighten monetary policy in future meetings, believing it is better for the economy to experience some short-term pain versus a long-term battle with inflation, and thus, we look for additional rate hikes at their next meeting on November 2nd.

As was noted earlier in the letter and as it has been the case all year, interest rates rose across the yield curve as the Fed remained hawkish. Corporate credit spreads remained relatively flat during the quarter as interest rates pushed higher. Per the Bloomberg US Credit Index, corporate credit currently sits at +157 basis points versus comparable US Treasury yields. While spreads remained flat overall, sector performance was varied with cyclical, economically sensitive sectors underperforming and defensive, higher-rated sectors outperforming. Looking ahead, while yields have become more attractive, volatility is expected to remain as the market oscillates between concern about recession and inflation. That said, we believe credit selection becomes paramount in this environment, as the focus will shift toward fundamentals and the ability of corporates to navigate this macro uncertainty.

While the labor market is very strong, the economy is starting to slow as the Fed continues to bring inflation back under control. Inflation data will continue to drive the macro narrative and the markets. It continues to be our view that interest rates could drift slightly higher as the Fed remains hawkish and as inflation remains elevated. Our baseline case continues to be that while growth slows, so too will inflation in the closing months of 2022.

We once again want to take this opportunity to acknowledge that fixed income returns have been challenging this year. However, higher interest rates have also presented investors opportunities for increased income and yields in the future. There remain no positions in the portfolios with any credit concerns or sustainability concerns through the market cycle. As a result, while there has been price decline, the income potential has improved. Capital preservation continues to be our foremost priority followed by providing a suitable and predictable income.

If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

Thank You

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