High Yield Whitepaper

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Welcome to CAMRADATA’s High Yield Whitepaper

The hunt for yield by pension funds and insurers continues. In spite of the uncertainty caused by rising inflation and the war in Ukraine, long-term asset owners are not yet ready to lock in negative returns from traditionally safe payers such as sovereigns. Below investment-grade credit, however, it is a moot point whether Leveraged Loans are structurally more attractive now than High Yield. After the Great Financial Crisis, European institutional investors en masse have remained more cautious on Loans. This may have been unwarranted bias.

Going forward, rate rises put pressure on bad credit, howsoever it is structured. The last ten years have seen many zombie companies survive because of central bank largesse. Both High Yield and Leveraged Loan managers will have to demonstrate their prowess in credit analysis and issue selection.

The world today sees an economic upswing post-pandemic crashing into a hasty energy embargo on Russia and potential harvest disruption across Europe’s bread basket. Food shortages will be felt in Emerging Markets beyond Europe, across Arabia and North Africa (hunger played its part in the Arab Spring). This environment is complex enough and fast-moving, influenced by many factors way beyond creditors’ control. One potential friction is the energy policy of nations in response to the war in Ukraine against their longer-term commitment to decarbonisation. Since the Paris Agreement, few nations have introduced energy policies to change the daily lives of their populace or disrupt industry. The spend on decarbonisation does not match the need. That is unlikely to continue this decade. Countries and companies that do not achieve positive disruption before 2030 are likely to have change imposed upon them by environmental and meteorological trends. Yet the war in Ukraine is a reminder that nations do not and cannot always act in concert, even when there is a greater crisis hanging over us all. This CAMRADATA whitepaper will ask how bond investors make selections given current and long-term pressures on energy supply.

High Yield Roundtable

The CAMRADATA High Yield Roundtable took place in London on 11th May 2022.

Credit is not cheap anymore. For a typical BBB company in the U.S., the cost is about 220bps higher than twelve months ago in mid-May 2021.

The CAMRADATA Credit Roundtable 2022 thus began with the question of whether the era of 'lower for longer' is now over. For Stephen Marsh, credit portfolio manager for T. Rowe Price, the answer is yes. He told the panel that both governments and central banks had done a huge amount of stimulus to ward off the worst effects of Covid. "We are now going through the hangover phase," he said. "Central banks have been fixated on inflation, not just in food and energy but also wages. There are two jobs for every jobseeker in the US right now."

Marsh said that there were two ways to go with financial repression: tax people more heavily or inflate your way out. "I don't think anyone in the world wants the former." At the same time, he felt that the rapidly emerging gap between inflation and the base rate was something the Federal Reserve wanted to control. Marsh gave a base-case estimate of 3.25% for the Fed's terminal rate but reckoned it would have to be raised further to curb inflation, reaching close to 3.75% by late next year.

> *"Alice Lee, liquid credit manager researcher at WTW, said rates markets were clearly going in one direction, although she questioned whether this could be classified as a regime shift."*

Jakob von Kalckreuth, portfolio manager at Credit Suisse Asset Management's Credit Investments Group, believed that the decoupling of the ECB from the Fed was possible. "For years rates have been too low for what the German economy needs," he said. "It has been hampered by the Mediterranean countries, although they are now picking up, especially Spain." Nevertheless, von Kalckreuth expected the ECB to disappoint the hawks.

Christopher Kempton, head of EMEA client portfolio management for Credit Suisse Asset Management's Credit Investments Group, said that while the inflation story had been accentuated by the Russian invasion of Ukraine in the last two months, it had been a major theme for the last 12-18 months.

Alice Lee, liquid credit manager researcher at WTW, said rates markets were clearly going in one direction, although she questioned whether this could be classified as a regime shift. She said it was, however, a really good time for investors to adopt this mindset and think about the long-term positioning of their portfolio.

For Scottish Widows, David Will, fund manager assessor for its £190bn book of DC pension assets with third-party managers, said he was concerned about the heavy chance of policy error

“The CAMRADATA panel then discussed recent search activity for credit mandates.”

from central banks. “I don’t see them reaching market consensus for rate hikes,” he said. “In any case, that would affect demand but do nothing to address supply-chain issues.” Will’s fear was that if central banks are not careful, then the economy will dip into recession. “No one now is talking about inflation as transitory, which was a common phrase last year,” said Will.

The Score

The CAMRADATA panel then discussed recent search activity for credit mandates. Xavier Blaiteau, liquid credit researcher at bfinance, said that since Q42020, it had conducted eight searches in US High Yield in all kinds of flavours, including high-alpha, broad, short-duration, rating-constrained and systematic low alpha. Blaiteau explained that it was spread-widening and low yield environment towards the end of 2020 that drove asset owners to initiate these searches. bfinance has done one search for European High Yield this year. Overall, High Yield has accounted for circa one-third of the firm’s total searches in fixed income over the last eighteen months.

In Leveraged Loans, bfinance has conducted two searches this year for European clients looking to reduce duration and take advantage of floating-rate issuance. Blaiteau said that clients have historically been underweight Loans in their strategic asset allocation and this was a perfect opportunity to rebalance.

For WTW, Lee said that it had conducted 10 searches in global and U.S. High Yield in 2020-21; and just one in Leveraged Loans. She noted that clients did access Leveraged Loans via multi-sector alternative credit funds [for which WTW has conducted 18 selection exercises over the same time frame]. But she said that while the quality of High Yield issuance has gone up, the opposite was true in Loans. Lee added that the fundamentals in similar securitised consumer credits were more attractive than corporates and a good option for clients looking to lower their duration exposure.

On how to access High Yield markets, Lee told the CAMRADATA panel that WTW has believed for a number of years that a manager holding 300 names in one broad mandate is just bulking up for the sake of defensiveness. “What is the conviction on the last ten names in the portfolio?” Lee challenged. Instead, WTW has been active in approaching managers to create concentrated, high-alpha portfolios and then managing the volatility itself as fiduciary manager of managers. Lee said some big names were on the roster; others had been found within the long/short hedge fund sector and refocussed on the long side of their portfolio.

Regarding loans, Will said he was worried about ‘cov lite’ and, more worryingly, collateral lite offers. “You can manage risk if you are on top of it,” he said, “but recovery rates could be lower than in previous cycles.”

For its own book, Scottish Widows manages European and UK loans inhouse: US and

private placements are run by third-party specialists. The £190bn held for DC pension plans accesses far fewer loans, in part because the majority of those assets in are daily-dealt UCITS funds.

Anja Needham, portfolio manager at SECOR, said that it had done a couple of High Yield searches in the last 18 months for new and existing clients. One search had distinctive ESG criteria. Needham said that generally, exclusive Leveraged Loans mandates were not part of the strategic asset mix for UK pension plan clients. Generally, for schemes that are not fully funded, SECOR likes the US duration exposure of U.S. High Yield as a diversifier in the asset mix for non-U.S. clients. She added that High Yield managers were allowed to go off benchmark into Leveraged Loans but typically took only small exposures.

Needham echoed Lee's perspective on how to access the High Yield market: SECOR hires generalist managers to get credit beta, not alpha. This should be reflected in the fee. She said that SECOR hires niche specialists to provide alpha.

On the choices between High Yield and Leveraged Loans, von Kalckreuth challenged the observations of the consultants. "I see ever-closer alignment of structures in 'cov lite' markets between Leveraged Loans and High Yield," he said.

He argued that Loan recovery rates are better than High Yield. "The good news on Loans is that they have a much more flexible approach regarding extensions and renegotiations," he said. "So defaults are structurally lower." He argued that add-on finance is easier with Loans because stakeholders have a mentality of finding solutions, which all makes the asset class more defensive.

Von Kalckreuth nevertheless stressed that this doesn't mean Loans are a better asset class. Specifically on European High Yield, however, he said he was always sceptical because there tended to be participants with little or no dedicated High Yield expertise in the market.

This has caused extreme tightening in BBs, according to von Kalckreuth, which has driven BB managers to seek out single Bs at 400 bps. "Consequentially, B+ and BB- risk is mispriced," he claimed.

Regarding sensitivity to rate hikes, von Kalckreuth reckoned the duration of High Yield rates in Europe is much shorter than generally assumed. One option can be to sell floating to buy fixed "to build convexity with significant optionality."

From the perspective of clients' top-down strategic asset allocation, Kempton said that High Yield and Leveraged Loans were complementary. The distinction he wanted to emphasize was between generalists and specialists. "Look back at the last few years and it has been difficult to distinguish between managers of Loans because their returns haven't been much different," he said. "In a bull market, you couldn't get much wrong. We are now going into a cycle where picking – credits and credit managers - becomes more important."

Marsh also added that client retention in T. Rowe Price's high yield offering, which has US $40bn assets under management including $14bn in Leveraged Loans, is largely due to the firm's in-depth fundamental bottom-up research that helps to deliver consistent performance. T. Rowe Price's internal asset allocation currently assigns an overweight to Bank Loans versus High Yield but could reduce this back to a neutral

"Anja Needham, portfolio manager at SECOR, said that it had done a couple of High Yield searches in the last 18 months for new and existing clients. One search had distinctive ESG criteria.."

stance later this year.

Marsh said that the market has already priced in significant rate hikes in the U.S. and it's unlikely that the Fed would hike more than what has been priced in. He also added that we could see a slowdown in growth as tighter financial conditions and higher costs weigh on consumer demand.

Lee asked the managers whether we can still rely on duration for protection. Marsh responded that the recent spike in correlation between duration and credit spreads is likely to revert back to normal [where there is an inverse relationship] given the magnitude of rate hikes currently priced in by the market, which means government bonds could rally while credit spreads sell-off. He also added that most of the negative total return for the high yield market so far this year has been driven by the rise in government bond yields while credit spreads haven't widened as much yet. Overall, fundamentals are very strong, businesses have secured their balance sheets last year and default rates are very low, but we need to be forward-looking and delve deeper into individual businesses.

Lee asked the managers how quickly they thought rates will rise. She asked whether Loans will come across as a refinancing risk and what that all means for asset allocation?

Von Kalckreuth does not see Loans as a refinancing risk. "The maturity wall is not an issue," he said. "The very nature of lending means that default is the option of last resort."

He reiterated that uncontrolled insolvencies were a rarity, because participants would look to find solutions, for instance via extensions or refinancing.

Lee said that her worry was not defaults but the deteriorating quality of corporate borrowers. She feared more downgrades in future which could lead to CLOs triggering their CCC limits and forced loan sales.

Von Kalckreuth responded that downgrades per se were not a problem. "The CCC bucket is pretty light right now," he said. "More importantly, a lot of sectors such as leisure are actually with tailwinds coming out of lockdown." He saw these tailwinds as strong enough to overcome the inflationary obstacles in wages, transport and materials. "Spread widening is a reality," he said. "Cashflow coverage decreases but strong companies should not be concerned about paying their interest burden."

Will said he was worried about profit erosion in those companies without pricing power. Needham commented on the high levels of new issuance in recent years – a lot of this had been refinancing, which should decline as rates rise. Demand has also been high (due to the search for yield) but is now waning. She asked how supply/demand dynamics are likely to play out in the short and medium term. Von Kalckreuth responded that corporates issue in both High Yield and Loan markets, shifting between the two as suits their needs. Kempton added that some institutional investors overplay the role of retail loan investors in creating volatility and reminded that this sector made up less than 10% of the market.

Lee returned to securitised consumer credit and the health of US households' balance-sheets. She noted that while house prices in the U.S. were up significantly, they were still affordable. The Covid-era Federal policy of a moratorium on foreclosures helped to keep mortgage defaults low; however, as another indicator of economic health, Lee noted that the financing of residential solar panels in the U.S. had not been subject to government

"Lee asked the managers how quickly they thought rates will rise. She asked whether Loans will come across as a refinancing risk and what that all means for asset allocation?"

protection but borrowers had still paid their way through the pandemic.

In summary Lee claimed that the quality of household borrowers these days is high but underappreciated by market participants. Will added that most mortgages in the U.S. were on a fixed rate so rising rates were not an immediate problem.

Von Kalckreuth was in agreement. He reported that ABS BBB CLOs were offering a 6% return - 400bp over rates – with three-month duration. He contrasted Investment Grade bonds down 12% for the year to mid-May.

Will suggested that a lot of anxieties about CLOs were in fact attributable to CDOs.

"There is an acronym premium," agreed Kempton. Will asked how the asset managers found information flow on the underlying credits in securitised packages.Von Kalckreuth replied that Credit Suisse had strong access, in part because it was not solely a manager but also an arranger. Marsh then returned to differences between regions. He said that European High Yield currently looks attractive relative to the U.S. The European market is comprised of higher-rated and better-quality issuers, while there are a high number of frackers and horizontal drillers populating the North American market.

Marsh also added that cheaper valuations in the European market could allow investors to harness capital gains as the market recovers.

Structurally, he distinguished between indices, especially the older JP Morgan versus BAML or Barclays offerings. Marsh noted that the latter, newer indices are less biased toward the U.S. with a relatively higher allocation to Europe and the rest of the world, thus providing a better representation of the global high yield market. Marsh made the point that growth in European and Emerging Market issuance since 2008 has been around 13% and 21% respectively versus an approximate 3% for the U.S. However, there has been a dearth of new issuance recently as companies had already locked in funding at cheaper rates last year. He also added that T. Rowe Price currently holds a 3-4% overweight to European high yield.

Regarding impacts of the current squeeze on energy because of the war in Ukraine, Marsh said it was a case of analysing company by company to determine who can withstand the higher input costs from supply chain issues, including energy and wages, and who can successfully pass on these costs to the end consumer. He referred back to Will's fears of a policy error, suggesting that the slow reaction by policymakers to get a grip on inflation meant there had already been one. Having said that, Marsh said the recent dispersion in markets , which was due to volatility rather than fundamentals, provides great opportunities for security selection via bottom-up research that could help discover issuers that are attractively valued and fundamentally sound.

Visser then gave an Emerging Markets' perspective on rising inflation. He pointed out that businesses in some countries such as Turkey have been dealing with inflation rates of 20% for years. "We know a Turkish glass manufacturer, for example, that has found a way to increase prices and remain competitive," he said. "Likewise, a South African hygiene services supplier with the business acumen to pass on rising costs."

Von Kalckreuth agreed that there are market leaders in defensive sectors where the position of the issuer determines the ability to pass through costs. He contrasted the High Street, where such margins are more difficult and retailers might struggle to pass on costs.

Marsh gave the example of a bathroom-appliance retailer in the U.S. which was getting behind on fulfilment because of supply chain issues. As its own running costs began to erode profits and margins, the firm decided to cancel nine months' worth of backorders and told customers they could re-order at a higher price or buy elsewhere.

Such examples of how not to run a business brought the CAMRADATA roundtable to ESG issues. Visser said that bottom-up integration of ESG issues not just identified risks but also opportunities as analysts identified those companies

trying to make a difference.

Beyond the usual metrics for financial resilience - interest-rate coverage; leverage headroom; cutback on dividends - Visser said the question for ESG-minded creditors was how allocating to that company might make it greener?

He said that weighted average carbon intensity and other ESG metrics gave a good view on where they stand in the market against peers. Thereafter came the conversations about what each company could do in the short, medium and long term. Marsh noted that some issuers do not even want to engage on these issues. But even among the others, Visser admitted that, when it came to the long term, "you do need a bit of faith in management's ability to transform any company."

He agreed that creditors linking capex deployed to green initiatives was one useful guide to a company's medium-term commitments.

For Credit Suisse Asset Management, Von Kalckreuth said "If I have concerns about an issue on ESG grounds, I won't invest. The incremental alpha – short-term gain - is not worth it. I personally would emphasise the 'G' as governance is the primary driver in credit.

Visser added that bad governance does spill over into a bad environmental record and social behaviour. He gave the example of a Russian metals and mining company, which for years has left mining communities dangerously exposed to by-products of nickel extraction such as sulphurous compounds. Visser claimed the company pushed back on capex for health, safety and sustainability in order to keep shareholders' happy with dividend payments.

Needham asked about regional differences: "When we rank investment managers in ESG, larger European houses tend to have more developed ESG processes; smaller US houses tend to be lagging. Is there a similar difference between European and US issuers?"

Kempton stressed that the U.S. and Europe were not necessarily that far apart but there are differences in nuances such as the focus on the environment and decarbonisation in Europe, whereas in the U.S., social aspects were often more visible.

Marsh replied that disclosure of ESG data was better from U.S. than European issuers, as a greater proportion European high yield businesses are owned by private equity firms that are reluctant to spend on ESG reporting. He made the point, however, that dedicated asset management teams have engaged with issuers to request more ESG data. T. Rowe Price's Global Impact strategies, for example, demand more from not only issuers but also their colleagues internally.

Lee distinguished asset management houses with a handful of ESG-labelled offerings from those with a corporate culture that truly embraces sustainability and aims to find innovative ways to provide solutions to investors that would allow them to achieve their net zero objectives. Her belief was that "ESG is hard to outsource."

Marsh responded that T. Rowe Price has signed up to the Net-Zero Asset Managers initiative and utilises research from 12 in-house responsible investment analysts, which are part of a broader ESG team. Lee added that there was confusion between ESG integration and Impact.

"He recommended sitting down with clients and having a conversation to find suitable targets rather than starting with labels."

Visser agreed. He recommended sitting down with clients and having a conversation to find suitable targets rather than starting with labels.

IN FOCUS

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"The CAMRADATA virtual roundtable went really well, as well as the live events, which was quite surprising! It was informative and interesting, and I know our Fund manager enjoyed being a part of it."

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To find out more – **Natasha Silva** (Natasha.silva@camradata.com) would be delighted to speak to you.

Roundtable Participants

Christopher Kempton

Head of EMEA Client Portfolio Management, CSAM Credit Investments Group

Personal Profile

Christopher Kempton is a Director of CSAM. He joined CSAM's Credit Investments Group ("CIG") in 2018 and is Head of EMEA Client Portfolio Management, where he is responsible for originating and developing credit solutions for institutional investors globally.

Prior to joining CIG, he held responsibilities across portfolio management, and product and business development for alternative investments in New York, London and Zurich. He joined Credit Suisse in 2002, holds an M.B.A. from London Business School and is a CFA Charterholder.

Credit Suisse Asset Management

Company Profile

The Credit Investments Group (CIG), a business unit of CSAM, was founded in 1997 as a specialist manager focused on non-investment grade credit. With the three senior members of the team on their 24th year working together, CIG has become a leader in lending to Upper Middle Market companies.

With substantial scale, an extensive network, and experienced local teams in New York and London, CIG is one of the largest non-investment-grade credit managers in the US and Western Europe.

The full-service group of dedicated credit professionals offers a broad suite of solutions across the risk/return spectrum to meet a variety of client needs from capital preservation to systematic income and alpha generation.

As of March 31, 2022, CIG had assets under management of approximately USD 67.2 billion with a team consisting of more than 60 people.

Roundtable Participants

Jakob von Kalckreuth

Managing Director

European Portfolio Manager

Credit Suisse Asset Management

Personal Profile

Jakob von Kalckreuth is a Managing Director of CSAM. He joined CIG in 2005. Mr. von Kalckreuth is a Portfolio Manager and Head European Trader and a member of the Corporate Credit Committee and the PCO Investment Committee. Prior to joining CIG, Mr. von Kalckreuth worked at CIBC World Markets, where he was an Analyst in the European Leveraged Finance Group involved in origination and execution.

Mr. von Kalckreuth holds a B.Sc. (honors) from the University of Bath in Economics and International Development.

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Roundtable Participants

Stephen Marsh

Vice President – Fixed Income

Personal Profile

Stephen Marsh is a portfolio specialist based in London in the Fixed Income Division. He acts as a proxy for fixed income portfolio managers with clients, consultants, and prospects. He has a broad range of knowledge in fixed income, currency, credit, and derivatives, enabling him to customize solutions for clients and to present at conferences. Stephen is a vice president of T. Rowe Price Group, Inc., and T. Rowe Price International Ltd.

Stephen's investment experience began in 1997, and he has been with T. Rowe Price since 2015, beginning in the Fixed Income Division. Prior to this, he was employed by SEI Investments as head of the European fixed income division and as a portfolio manager. He also has held investment roles at Merrill Lynch, RMB International, and Liontrust Asset Management.

Stephen earned a B.A. (with honors) in business studies, with a major in economics, from the University of Central Lancashire. He also has earned the Chartered Financial Analyst® designation.

T. Rowe Price

Company Profile

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We offer investors a full range of equity and fixed income strategies across multiple asset classes, sectors, styles, and regions. Our experience through all types of market conditions contributes to a proven investment strategy designed to produce strong performance for the long term.

*As at 31 December 2021

Roundtable Participants

Willem Visser

Corporate Analyst

Personal Profile

Willem Visser is an emerging markets corporate analyst in the Fixed Income Division. He also is a vice president of T. Rowe Price Group, Inc., and T. Rowe Price International Ltd.

Willem's investment experience began in 2007, and he has been with T. Rowe Price since 2017, beginning in the Fixed Income Division. Prior to this, Willem was employed by NN Investment Partners as an investment analyst. Willem also was employed by Aegon Asset Management as an investment-grade and high yield credit analyst and by Antaurus Capital Management as a portfolio manager.

Willem earned an M.Sc. in investment management from Vrije Universiteit Amsterdam and an M.Sc. in business economics from the University of Amsterdam.

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We offer investors a full range of equity and fixed income strategies across multiple asset classes, sectors, styles, and regions. Our experience through all types of market conditions contributes to a proven investment strategy designed to produce strong performance for the long term.

*As at 31 December 2021

Xavier Blaiteau

Senior Associate

Xavier Blaiteau is a Senior Associate at bfinance. He joined bfinance in February 2017 as an Analyst for the Public Market team. Previously, he worked for two years for Lyxor Asset Management in the area of manager selection for long-only and liquid alternative strategies. Blaiteau holds an MSc in Finance from ESSCA, France.

David Will

Senior Manager, Fund Manager Assessment

David is a Senior Manager in the Fund Manager Assessment team at Scottish Widows. Prior to joining the group, he worked as an investment consultant where he had responsibility for advising clients on asset allocation, manager selection, liability hedging, strategy implementation and investment governance.

David has over 30 years' industry experience and extensive knowledge of fund manager research across a variety of asset classes. One of his previous roles was that of Head of Manager Research at JLT, now part of Mercer. In addition to fund manager assessment, David is a regular speaker at industry events.

bfinance

SCOTTISH WIDOWS

Roundtable Participants

Anja Needham

Portfolio Manager

Anja is a portfolio manager on the advisory team at SECOR, supporting manager research across public and private credit, with a focus on high yield and emerging market debt.

She has over 10 years of investment management industry experience, including time at Schroders Investment Management. Anja holds a BSc in Natural Sciences from Durham University.

SECOR | ASSET MANAGEMENT

Alice Lee

Senior Manager Researcher

Alice Lee is a senior member of the credit manager research team at WTW and specialises in alternative credit. Her role spans manager selection and working with asset owners to build diversified credit portfolios. She is an investment committee member for a credit-focused fund of funds managed by Towers Watson Investment Management.

Prior to joining WTW in 2011, Alice was an analyst at Mazuma Capital, a Fund of Hedge Funds. She is a CFA Charterholder.

wtw

Moderator

Brendan Maton

Freelance Journalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.
Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles.

Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.
Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

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Why we have become more favourable on duration

T.RowePrice

After adopting underweight duration positions across our investment platforms in the second half of last year, many of our fixed income strategies are adding back duration to neutral or long positions. The reason is simple: We believe that US Treasury yields have likely peaked for the medium term and that now is therefore a good time to own duration.

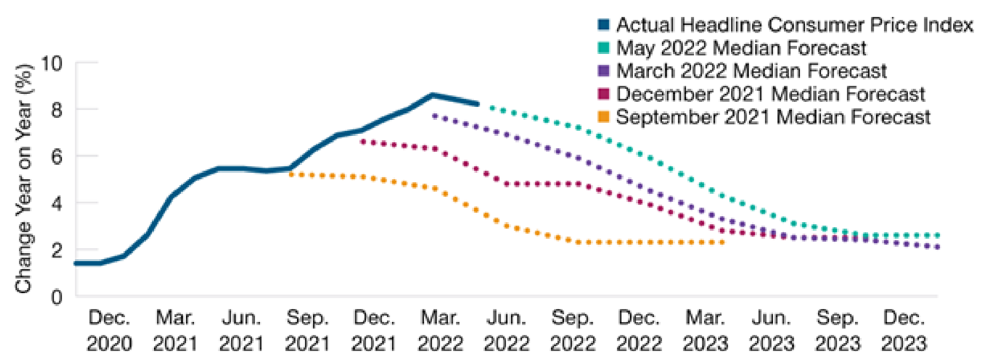
"Predicting inflation has been virtually impossible over the past 18 months...."

Three key indicators suggest a peak has been reached

Growth: We believe the near term outlook for US growth is negative because of the looming prospect of reduced fiscal spending, tighter financial conditions (as seen in sharply higher US mortgage rates, a stronger US dollar, and a weak equity market), and declining purchasing power due to high inflation. All these factors will negatively impact growth over the rest of this year. Indeed, the National Association for Business Economics has already cut its 2022 US growth forecast to 1.8% compared with a median forecast of 2.9% in February, and, more importantly, recent data have begun to disappoint these already lowered expectations. Offsetting these growth headwinds is the very low US unemployment rate, which will likely be enough to persuade the Federal Reserve to continue its hiking path.

Forecasting inflation has been a fool's errand

(Fig. 1) Consumer prices have risen much more than expected



As of April 30, 2022.
There is no guarantee that any forecasts made will come to pass.
Source: Bloomberg Finance L.P.

The second area we look at is inflation. Predicting inflation has been virtually impossible over the past 18 months—the inaccuracy of some predictions has reached almost comical proportions (Figure 1). This has finally begun to change, though: Inflation expectations have stopped moving higher, and when the data have come in, they have mostly met those expectations.

This is a significant development. It tells us that we have probably reached a peak in US inflation and, therefore, a peak in yields. It is an elevated peak, certainly, but—as mentioned above—we are more interested in the rate of change than the level. It is not difficult to see how we got here: Inflation volatility finally prompted the Fed to start earnestly playing catch up last September, then this monetary policy volatility led to interest rate volatility, higher yields, and general market volatility. Now it looks like the tide is beginning to turn.

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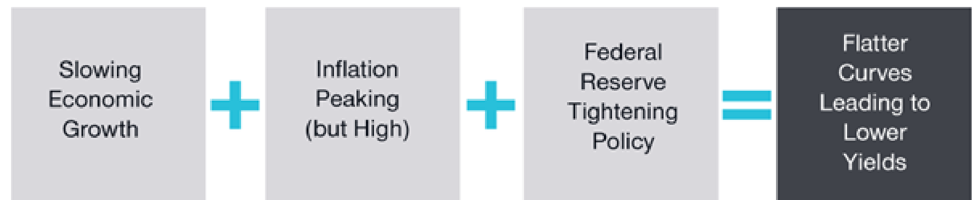
This is also evident in our third area of focus, monetary policy. Although the Fed is expected to continue tightening until next year, in the press conference following its last policy meeting, Chair Jerome Powell flatly rejected a 75 bps hike, opting instead for a 50 bps rise. The pushback against a 75 bps hike, which would have been the most aggressive single policy tightening since 1994, suggests that while the Fed remains hawkish, its hawkishness has ceased to accelerate. And if we have reached a peak in monetary policy hawkishness at the same time that inflation is peaking and growth is slowing, then it is reasonable to say that "Act 1" of the current phase in financial markets has ended—and that it is consequently a better time to own duration (Figure 2).

"Act 1" of the current phase in markets has likely ended

(Fig. 2) The three fundamental drivers point to lower yields



Source: T. Rowe Price.

Overall, then, it seems that the links in the chain that caused yields to rise so dramatically—inflation volatility, monetary policy volatility, rate volatility, and market volatility—are beginning to weaken. It is not yet clear whether the pattern will go into reverse, but in many areas we appear to have reached the point at which things have stopped getting worse. Yields are therefore likely to at least stabilize and may even decline if recession risk rises. The curve flattening trend that typically occurs during Fed tightening cycles is also likely to resume.

Looking to the next phase

The biggest risk to our more positive view on duration is inflation. If inflation continues to surprise on the upside, our belief that now is a good time to add duration will be proved wrong. Here again, however, the data seem to support our view. The differentials between Treasury inflation protected securities (TIPS) and nominal Treasuries of a similar maturity (the market based indicator of inflation expectations) stopped moving higher a few months ago and has begun to move lower. In a further sign of declining inflationary pressures, commodity prices—a leading indicator of inflation—have begun to fall.
As things stand, we expect the Fed to hike by 50 bps in its June and July meetings, then by 25–50 bps in September and 25 bps in every subsequent meeting until March next year. This would take the fed funds rate to above 3% by early 2023, considerably above the Fed's forecast "neutral" rate (the estimated level at which an economy is neither overheating nor slowing) of around 2.4%.

At that point, we believe growth will either stabilize or there will be a recession. The chances of the latter have increased because the Fed is hiking while growth is slowing, although it is difficult to envisage a severe recession while the labour market remains as strong as it is now. In either case—a soft landing or a mild recession—it looks as if the phase of rising yields and elevated rate volatility is over and the next phase in the cycle is about to begin, which is why many of our strategies have been adding duration back to their portfolios.

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Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

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