# Logan Fixed Income



## LOGAN FIXED INCOME MARKET COMMENTARY
## Q4 | 2021 REVIEW

### MARKET ENVIRONMENT

The closing of 2021 feels similar to the end of 2020. Investors view the "future" as a time of complete recovery from the pandemic, and an economy ready to go. The Fed is fully embracing this outlook. We will continue to monitor the market, and its reactions to key releases, especially employment data and GDP. The conclusions of fiscal and monetary stimulus will uncover how strong the economy really is.

Although it is anticipated that the flattening curve will continue to be the dominant theme through the first half of 2022, the Fed may initiate the shrinking of the balance sheet (currently $9 trillion) at the conclusion of its tapering cycle. The lowering of this demand for Treasuries further out the curve will have the effect of raising interest rates with longer maturities.

We observed a distinct change in inflation expectations during the period.

1. Higher inflation pushed implied tightening faster than previous Fed guidance.
2. Chairman Powell's pivot on November 30 during his comments before the Senate Banking Committee when he said it was time to stop talking about transitory inflation and start discussing a faster taper of the Fed's bond purchase program.

The Fed has a different perspective on the COVID variants. It tends to see the impact of the variants (Delta & Omicron) as a source of inflation which has the impact of disrupting supply lines and lowering the size of the labor market. The central banks in Europe view the pandemic as lowering demand and consumption thus slowing inflation in the short run.

The Fed sees slower global growth due to COVID primary as a source of potential new inflation rather than a restraint on the demand side, and therefore as reason to remove accommodation faster.

### PORTFOLIO REVIEW

Treasuries – Yields increased in fits and starts throughout the period, with the front end increasing upward of 40 bps, while the 10-year Treasury increased approximately 6 bps. (source: Bloomberg). This reflects investors pricing in 3 hikes in 2022 and another 3 hikes in 2023, but not seeing long term inflation take hold of the economy. Treasuries underperformed other sectors during the period.
Corporates – Bond spread widening has accelerated across the board during the quarter (source: FactSet), as the most recent COVID variant has pushed investors toward a more risk-off stance to finish the year. Commodity -based sectors such as energy and basic materials led the widening, while technology was most insulated against the down month.
Municipals – Municipals demonstrated strength based on favorable supply technical after the passage of the infrastructure program and ongoing tax hike discussions in Congress. Yields stayed in a tight range throughout the period, even as volatility was observed elsewhere in the bond and equity markets.

Supply expectations faded versus initial expectations of the Build Back Better proposal. We look for a pick-up in supply in 2022.

Commodities (Oil) - Although the outlook for oil demand has dimmed since the late November emergence of the Omicron variant, the milder strain has so far not dented mobility or economic strength across the country. Consumer demand is rising, as gasoline stockpiles have fallen to end the period according to the Energy Information Administration. Oil's recovery has also been supported by OPEC+ taking a cautious approach to restoring output. Domestically, oil drillers are facing record costs at the same time that banks are increasingly reluctant to loan money to the sector (Federal Reserve Bank of Dallas).

## PORTFOLIO OUTLOOK

Treasuries – With Treasury auctions well supported, we do not expect the increase in rates to accelerate much in the year ahead. The curve has flattened significantly, and we anticipate this trend continuing until the first rate hike, but by mid-year we will better understand the impact of COVID, supply bottlenecks, and the labor force on the economy.

Corporates – We see offsetting considerations for the year ahead:

1. Borrowers tend to increase debt before an expected Fed tightening to lock in low rates. This would normally increase expectations for an increase in issuance in the first half of 2022.
2. We have already seen a massive increase in corporate debt issuance from March – May 2020, when Fed QE was at its maximum. That pulled forward several years of borrowing that will offset #1 above.

We do not expect record setting corporate issuance in the year ahead.

Municipals - The sector will have outperformed both Treasuries and Corporates for the past year (source: Bloomberg), and until we observe increased supply, expect the sector to trade in a tight range into 2022.

### Inflation from the commodities perspective

Commodities surged the most in over a decade this year as a rebound in demand from pandemic lockdowns was met with constrained supplies, fueling inflation around the world and forcing governments to act. But 2022 may tell a different story.

The Bloomberg Commodity Spot Index , which tracks 23 energy, metal and crop futures, is ending 2021 with a 27% gain, the biggest since the 2009 recovery from the great financial crisis (source: Bloomberg). Prices for everything from gasoline and corn to copper and lumber have soared, making it more expensive to fill up the tank, build houses, eat meat, manufacture cars and heat homes.

As 2022 dawns, though, there are growing doubts about how far commodities can keep rising as a projected slowdown in economic growth, especially in China, and a rebound in supplies will likely weigh on prices. This year's rally has put inflation at the center-stage of policy-making, with central bankers scaling back the massive injections of cash used to revive economies during the heights of the pandemic. The expectation of rising interest rates also means commodities could appeal less to investors.

As we end 2021, the Fed is monitoring current inflation risks due to:

- supply chain bottleneck due to high levels of Omicron spread/infection
- escalation of Russia/Ukraine tensions which sends gas prices up
- labor shortages pushes wages higher

*This material represents an assessment of the market and economic environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. Forward-looking statements are subject to certain risks and uncertainties. Actual results, performance, or achievements may differ materially from those expressed or implied. Information is based on data gathered from what we believe are reliable sources. It is not guaranteed as to accuracy, does not purport to be complete and is not intended to be used as a primary basis for investment decisions. It should also not be construed as advice meeting the particular investment needs of any investor. Past performance does not guarantee future results.*

*Investments in commodities may have greater volatility than investments in traditional securities, particularly if the instruments involve leverage. The value of commodity-linked derivative instruments may be affected* *by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Use of leveraged commodity-linked derivatives creates an opportunity for increased return but, at the same time, creates the possibility for greater loss.*

*This material represents an assessment of the market and economic environment at a specific point in time and is not intended.*

| U.S. TREASURY YIELDS | 12/31/2020 | 3/31/2021 | 6/30/2021 | 9/30/2021 | 12/31/2021 | YTD Change |
|---|---|---|---|---|---|---|
| 2 YR | 0.121% | 0.160% | 0.251% | 0.289% | 0.726% | -0.605% |
| 3 YR | 0.165% | 0.343% | 0.452% | 0.524% | 0.955% | -0.790% |
| 5 YR | 0.361% | 0.936% | 0.878% | 0.991% | 1.265% | -0.904% |
| 7 YR | 0.643% | 1.411% | 1.220% | 1.323% | 1.436% | -0.793% |
| 10 YR | 0.913% | 1.738% | 1.450% | 1.528% | 1.512% | -0.599% |
| 20 YR | 1.440% | 2.422% | 1.994% | 2.034% | 1.935% | -0.495% |
| 30 YR | 1.645% | 2.324% | 2.064% | 2.091% | 1.905% | -0.260% |
| | | | | | | |
| 10S MINUS 2S | 79.2bps | 157.8bps | 119.9bps | 123.9bps | 78.6bps | |

Source: FactSet