Key Questions

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What Is the Outlook for Fixed Income in 2022?

Rajeev Sharma, Managing Director of Fixed Income, KeyBank Investment Center

The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

Rising rates, persistent inflation, and ever-present liquidity concerns make for a challenging year for fixed income investors.

As we enter the final weeks of 2021, we look back at the fixed income markets and note year-to-date total returns have mostly been negative, except for a few asset classes at the lower end of the credit spectrum. The faster-than-expected reopening of the economy after shutdowns earlier in the year caused interest rates to surge during the first quarter, followed by a drop in yields as COVID-19 case counts rose. More recently, short-term yields have moved to the highest levels since March 2020 in anticipation of tighter monetary policy.

Looking forward, we anticipate the Federal Reserve will end asset purchases and raise interest rates in 2022 to address persistent inflationary pressures. Macroeconomic environments that include a move from loose to tighter monetary policy tend to lead to higher asset-class correlations and more significant tail risks. As such, we expect 2022 to be a challenging year for fixed income investors, who will have to face the challenges of tighter monetary policy, higher interest rates, and increased volatility. However, there will be opportunities for bond investors looking for income, and those who remain nimble yet disciplined.

Fed outlook

For much of 2021, the Fed spent considerable effort removing some of the emergency policy tools it had utilized to add liquidity to the credit markets during the peak of the COVID-19 pandemic. As we look to next year, the Fed's first priority in normalizing its monetary policy is to wind down its bond asset purchases. Estimating a reduction of asset purchases at $30 billion per month, the Fed would be able to end its asset purchases by March of 2022 entirely.

The Federal Open Market Committee will need to decide the timing of the liftoff (i.e., begin raising interest rates) following the end of the taper program. The Fed has indicated its preference for a time gap between the end of its taper program and the beginning of its tightening cycle. Thus, by increasing the pace of tapering, the Fed will have more optionality to deal with persistent inflation. We project a rates liftoff in July 2022 with increases quarterly after that.

Global markets and policymakers view inflation as likely to remain elevated for the foreseeable future. Recently, the Fed moved away from viewing inflation as transitory after inflation surprisingly increased, and core Personal Consumption Expenditures (PCE) inflation for this year rose 4.2%.

The stronger momentum in inflation combined with a tighter labor market will likely lead to an upward revision of inflation expectations in the future.

If interest rate policy weren't enough, the Fed will also have to focus on personnel decisions in 2022 as there will be at least three vacancies to fill. These individuals likely will be chosen with the expectation that they will focus on the Fed's full-employment mandate, which could potentially lead to a dovish tilt in policy. However, we do not anticipate this changing our rate hikes projection next year.

Higher rates and a flatter yield curve

The one clear trend for 2022 is that the ultra-accommodative policies used by central banks since the onset of the COVID-19 pandemic will be ending.

With recent employment data pointing to tighter labor markets and the highest core Consumer Price Index (CPI) reading in more than three decades, markets have begun to price a Fed rate hike well ahead of the Fed's guidance. The reaction in the front end of the yield curve has been swift, with the 2-year Treasury note yield moving to 0.65%, its highest level since March 2020.

With the Fed projected to liftoff in July 2022, we expect short-term rates to continue their march upward and the front end of the yield curve to further steepen.

We project the 10-year Treasury note yield to move more gradually towards 2% by mid-year and 2.25% by the end of 2022. Long-end yields are expected to rise at a slower pace next year, flattening the overall yield curve.

A flatter yield curve tends to result in lower total returns. Moreover, we expect U.S. Treasuries to underperform spread product such as corporate bonds in a rising rate environment.

Credit outlook

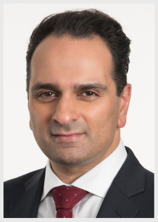
Both high-grade and high-yield credit spreads are likely to begin in 2022 at record tights. Corporate balance sheets are strong, and default rates are expected to remain low. Improving credit fundamentals and rising Treasury yields should lead to modestly tighter credit spreads next year. An anticipated slowdown in net supply could provide a technical headwind for further tightening credit spreads. However, with overall spread compression expected to be modest, investors will need to focus on specific sectors and single-name issuers to achieve outperformance.

Like 2021, coupon income will be the primary driver of total returns for 2022. A faster pace of rate hikes tends to spur more volatility of less liquid securities and riskier asset classes, such as high-yield and bank loans. Our recommendation is to focus on high-quality, short- and intermediate-term maturities in the high-grade corporate bond market that are less vulnerable to rising bond yields.

Over the past year, we have continued to see strong demand for taxable municipal debt as an alternative to corporate bonds. Taxable state and local government debt can offer portfolio diversification, but we view municipal debt as rich to comparable corporate debt and expect this trend to continue in 2022.

Next year will be a challenging year for the fixed income markets, given the prospect of higher rates, increased volatility, and liquidity challenges. The persistence of inflationary pressures is leading the Fed to end asset purchases and move towards raising rates. Credit spreads are likely to remain tight in 2022. However, the net bond supply is expected to shrink. The expected volatility in the markets next year can provide opportunities through dislocations and inefficiencies across fixed income asset classes.

For more information, please contact your advisor.



About the Author

Rajeev Sharma is Managing Director of Fixed Income Investments at Key Private Bank. In this role, Rajeev is responsible for overseeing and managing Taxable and Tax-exempt Fixed Income investments, including common trust funds, institutional model strategies and individual fixed income portfolios for both institutional and high-net-worth clients.

Rajeev has 20 years of Fixed Income experience. Prior to joining KeyBank, he was Head of Fixed income at Foresters Investment Management Company. He served as the chief corporate bond strategist and lead portfolio manager responsible for all corporate bond exposure across the mutual fund and life insurance suite of products. As Director of Fixed Income and overseeing managed fixed income and money market funds he was instrumental in launching a short duration bond strategy, co-manager on the Limited Duration Bond Fund, and the Total Return Fund, a mixed asset allocation fund.

Rajeev also brings prior experience as senior credit analyst at Lazard Asset Management, associate director of corporate ratings at Standard & Poor's Rating Services.

Rajeev received his Bachelor of Science degree in Electrical Engineering from Drexel University, a Master of Science degree in Electrical Engineering from the University of Pennsylvania, and an MBA from Cornell University.

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