# Meet the new Boss, same as the old Boss?

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Jay Powell was renominated to a second term at the Federal Reserve ("Fed") and yet it seems there is new sheriff in town. Powell seems to have quickly changed his tone on inflation, maybe not-so-coincidentally right after meeting with President Biden. Besides a quicker pace of tapering, it seems that earlier-than-expected rate hikes are at least on the table.

As we discussed in our March 5, 2021 piece, we addressed the combination of re-opening and stimulus risk changing the game for interest rates. We just came off the longest sustained US Treasury curve steepening (18 months as measured by the 2s-10s spread) since the steepening event that lasted for over 3 years ending in early 2010. Since then, we have witnessed the largest flattening of that segment of the curve since 2017. Ditto for the 5s-30s spread. Since March 5 through December 3, 2021, the 10-Year US Treasury rate is down 22bps (from 1.57% vs 1.35%) whereas 2-year rates moved up 45bps (from 0.14% to 0.59%).

Interest rates are hard to guess, but we did argue in March that it was time to "dust off the rising rate playbook." This time we want to look more specifically at how different asset classes within fixed income perform leading up to and during a Fed rate hike cycle. There have been three cycles since the inception of high yield short duration indices during which time the Fed has raised its target rate for longer than one year (1994-1995, 2004-2006, 2015-2018). The charts on the subsequent pages further examine performance of short duration credit versus higher quality fixed income.

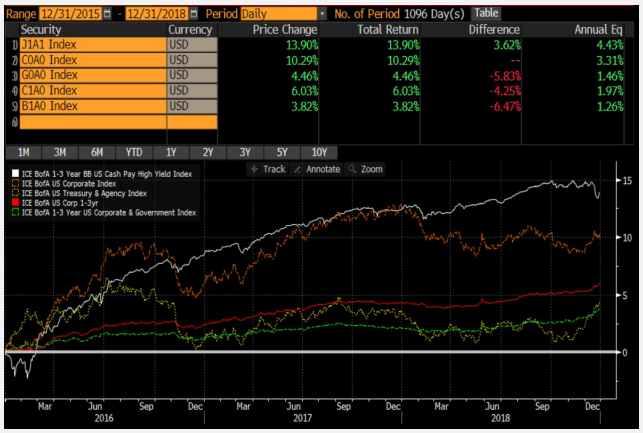
During the one-year period prior to the last three Fed rate hike periods, returns for investment grade ("IG") corporates, IG short duration and US Treasuries were mixed whereas BB-rated 1-3 year bonds either led returns or finished second among this grouping of indices. During all the rate hike periods examined, BB-rated 1-3 year bonds led the way in total returns with a relatively lower volatility…but why? The Fed raises rates when fundamentals are good and BB-rated credits are healthy, but higher coupons are insulated against hikes better than lower coupons.

**How does this shape our outlook for 2022?** We continue to believe that short duration high income credit may be a valuable buffer in a portfolio during both long-end yield curve sell-offs and Fed rate hike periods. We remain comfortable with an outlook of relatively strong economic growth despite the COVID Omicron variant acting as a headwind to growth rather than a catalyst for economic shutdown. We remain optimistic that corporate default rates may continue their decline to near record lows, perhaps sub-1%. The Fed remains a risk that it may commit a policy mistake by hiking rates too far and too quickly, perhaps by assuming most of today's inflationary pressure (we believe incorrectly) is here to stay.

After concluding the third quarter earnings season, we learned from our companies that their supply-chain woes may have peaked. We expect gradual improvement in the supply chain, and gradual improvement in labor availability. Combined with strong demand from healthy consumers, we expect another solid year of corporate fundamentals in 2022.

## Rate Hike Period 12/31/15 – 12/31/18...

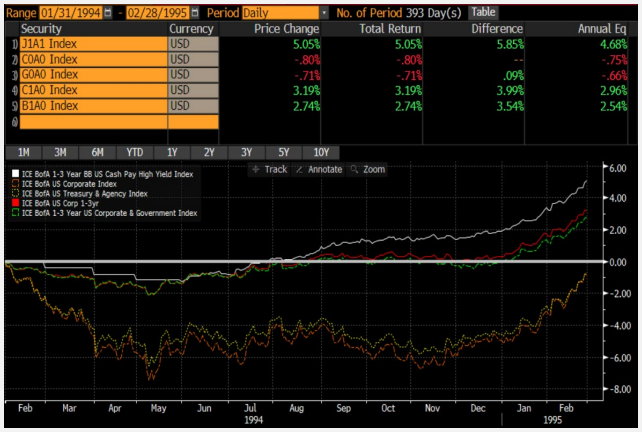



## ...1 year prior to Rate Hike

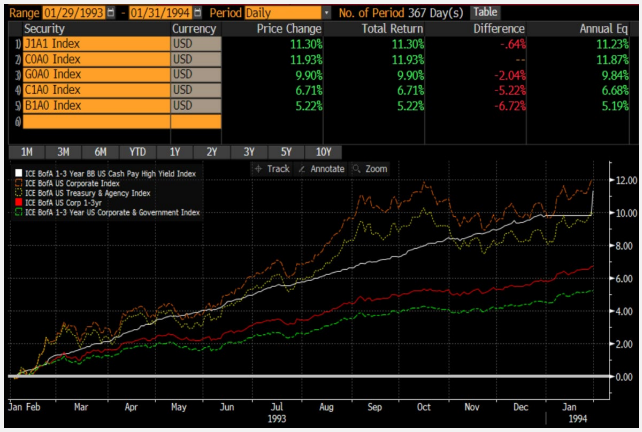

## Rate Hike Period 6/30/04 – 6/30/06...


## ...1 year prior to Rate Hike


## Rate Hike Period 1/31/94 – 2/28/95...




## ...1 year prior to Rate Hike




**Investors cannot invest directly in an index.** Source: Bloomberg. J1A1: ICE BofA 1-3 Year BB US Cash Pay High Yield Index; C0A0: ICE BofA US Corporate Index; G0A0: ICE BofA US Treasury & Agency Index; C1A0: ICE BofA 1-3 Year US Corporate Index; B1A0: ICE BofA 1-3 Year US Corporate & Government Index

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