

Fourth quarter 2022 outlook

The three sisters: Fed, inflation and rates



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The financial markets have been turbulent this year, and the fixed income and equity markets are more highly correlated than usual. We think the U.S. Federal Reserve is nearly done hiking rates, allowing the now higher yields to build total return. We continue to favor credit sectors, especially higher quality segments of high yield and senior loans, as well as preferred securities. However, security selection is more important than ever.

KEY TAKEAWAYS:

- Our outlook is favorable, since we believe rates are unlikely to move much higher and yields have already climbed substantially.
- Even higher quality, core strategies can now provide attractive income.
- We favor credit sectors, especially higher quality segments of high yield and senior loans, as well as preferred securities.

THE FED IS NOT FINISHED

The Fed hiked rates twice in the third quarter – 75 basis points (bps) each in June and July – to help fight soaring inflation. That makes five hikes in 2022 for a total rate increase of 300 bps.

We don't think the Fed is done yet. Our current forecast calls for a 75 bps hike in November, 50 bps in December, another 25 bps increase in early 2023 and potentially one additional 25 bps hike next year before pausing. While the Fed's projections anticipate potential cuts in 2023, we believe the funds rate will remain between 4.50% and 4.75% until 2024.

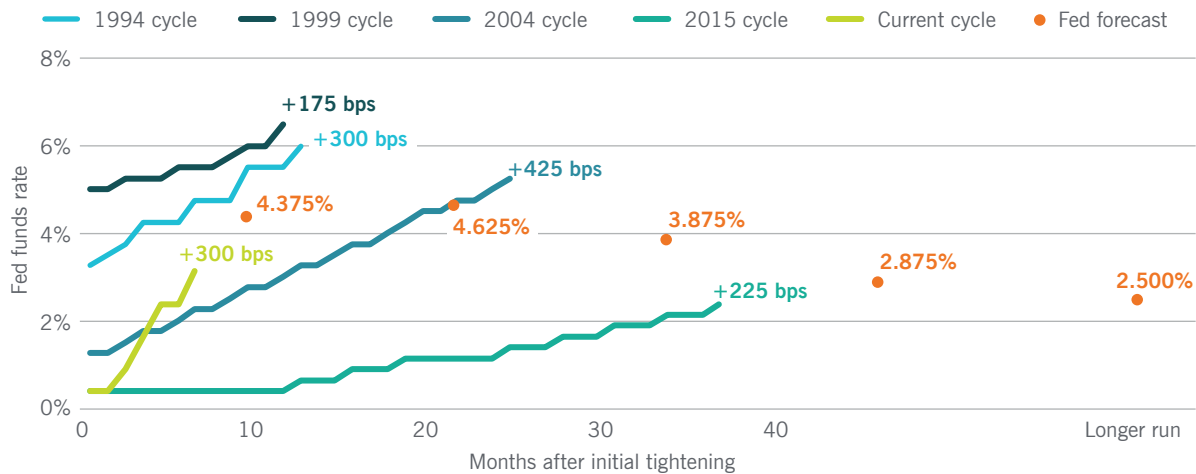
Compared to previous cycles, the Fed has moved much faster and in greater increments to combat persistently high inflation (Figure 1).

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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Figure 1: The Fed is moving much faster

Path of Fed funds target rate compared to past cycles



Data sources: Bloomberg, L.P., Federal Reserve Projection Materials, 21 Sep 2022. Fed forecast represents the median forecast of each Federal Open Market Committee participant for the midpoint of the fed funds rate at year ends 2022, 2023, 2024 and longer run. Month 0 shows first rate increase.

INFLATION REMAINS HIGH, WITH MODERATING EXPECTATIONS

Persistent inflation is driving the Fed’s strong action, and the good news is that inflation expectations have moderated (Figure 2). This is important because the expectation that inflation will continue can itself create a self-fulfilling prophecy. Consumers bid up prices as they believe costs will continue to soar.

In addition, commodity, shipping and high-frequency measures of housing prices have all moderated recently (Figure 3). We think the Fed will be able to tame inflation, but wages remain the wild card due to the short supply of workers compared to the number of job openings.

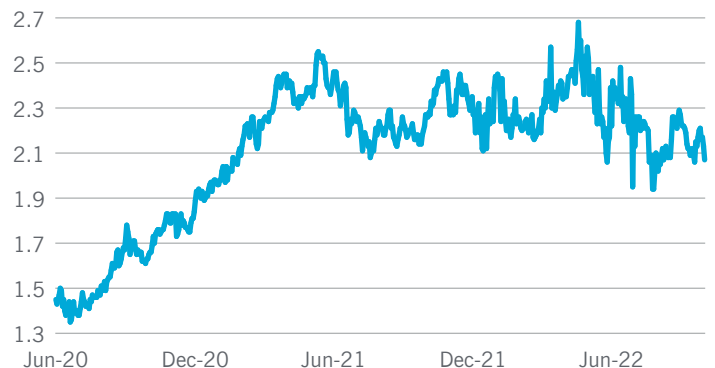
Going forward, bond returns should mainly be a product of two key factors: interest rate movements and yields. Our outlook is quite favorable, since we believe rates are unlikely to move much higher and yields have already climbed substantially.

MOST OF THE CYCLE IS BEHIND US

While every hike seems to roil the markets, clearly most of the cycle is already behind us. The Fed funds rate sits at 3.00% to 3.25%, and the terminal rate is projected to be 4.50% to 4.75%.

Figure 2: Inflation expectations have moderated

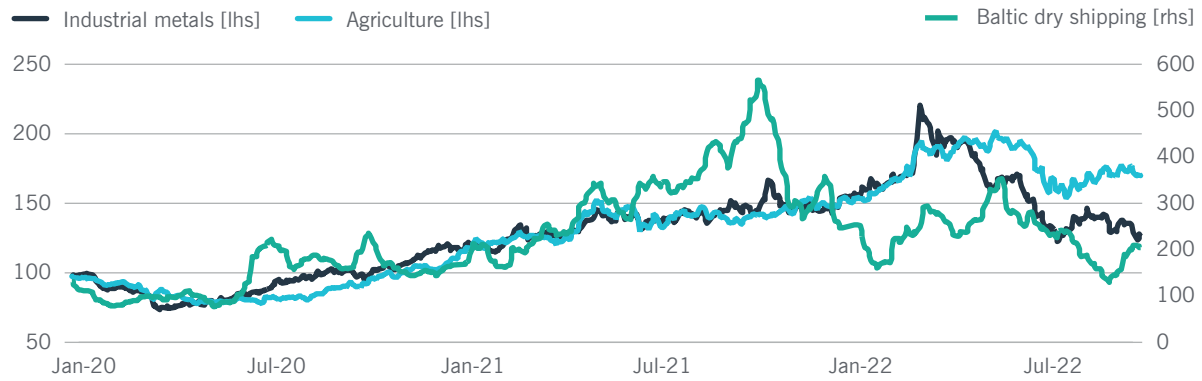
Fed’s 5-year forward 5-year breakeven inflation rate



Data source: Bloomberg, L. P., 30 Jun 2020 – 30 Sep 2022. Past performance does not predict or guarantee future results. The Fed’s 5-year forward 5-year breakeven inflation rate measures the 5-year inflation expectations 5 years into the future that is considered by the Fed in its policy decision making.

In addition, it is important to remember that the fed funds rate primarily impacts the shortest segment of the yield curve (Figure 4). Intermediate- to longer-term market yields have already priced in anticipated Fed actions, as well as the resulting decline in economic growth. We anticipate the 10-year Treasury yield to be at 3.75% by year-end 2022, and declining to 3.25% by the end of 2023. This diminishes the potential negative impact of rising rates on bond prices.

Figure 3: Commodity and shipping prices have moderated more sharply recently



Data sources: Bloomberg, L. P., 01 Jan 2020 – 30 Sep 2022. Past performance does not predict or guarantee future results. 100 = end of 2019.

HIGHER YIELDS BUILD INCOME AND TOTAL RETURN

The yield-to-worst on the broad bond market index has soared 3% during the year (Figure 5). This means even higher quality, core strategies can now provide attractive income of more than 4.75%. Adding in the more aggressive sectors can further boost yield potential. However, as the economy cools as a result of Fed action, it is important to carefully select those higher yielding assets using the bottom-up fundamental analysis of a professional asset manager.

CONSIDER ACTIVELY MANAGED CORE AND MULTISECTOR PORTFOLIOS

While the yield on credit-oriented sectors appears very high, many investors may seek diversification during uncertain and volatile market environments. Using multisector portfolios, active managers have the ability to blend opportunities from the more conservative core sectors with smaller allocations of the higher return potential plus sectors.

Using deep fundamental research, active managers drill down into subsectors, industries and individual companies to uncover the fixed income instruments they believe can create the most value for investors.

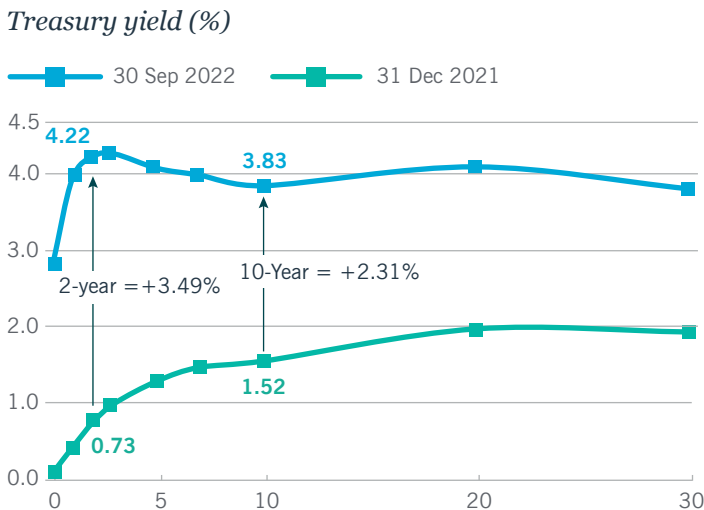
To mitigate the negative impact of rising rates on principal:

Short-term bond funds. The lower duration profile reduces the impact of rates changes on portfolio returns while still benefiting from a wide array of sectors. These funds typically combine higher-quality, short-duration sectors — like U.S. Treasuries, asset-backed securities and mortgage-backed securities — with smaller amounts of higher yielding sectors, such as high yield corporates and emerging markets debt.

For higher income and return potential:

Multisector bond funds. The additional yield potential can help offset price declines due to rising rates. The funds augment a base of diversified

Figure 4: The fed funds rate primarily impacts the short end of the yield curve

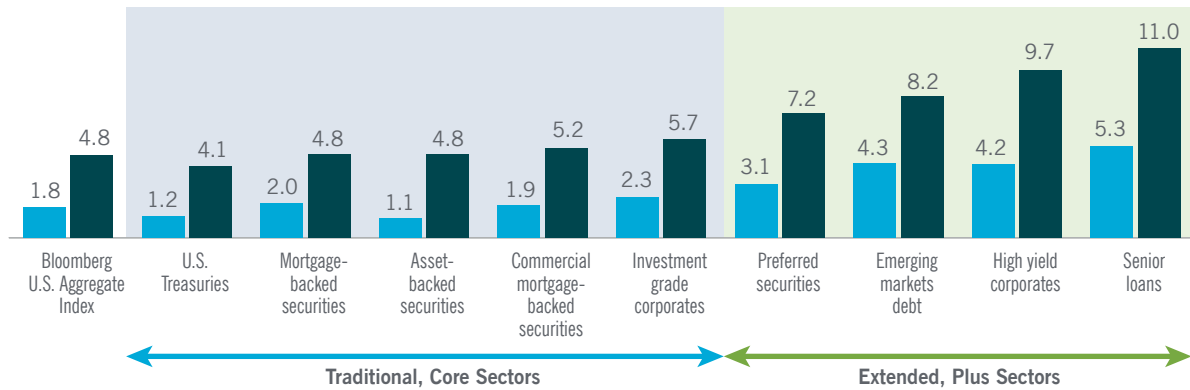


Data source: treasury.gov. Past performance does not predict or guarantee future results.

Figure 5: Yields increased as rates rose

Yield-to-worst (%)

■ 31 Dec 2021 ■ 30 Sep 2022



Data sources: Bloomberg, L.P., Credit Suisse. Past performance does not predict or guarantee future results. Representative indexes: broad bond market: Bloomberg Barclays Aggregate Index; U.S. Treasuries: Bloomberg Barclays U.S. Treasury Index; mortgage-backed securities: Bloomberg Barclays U.S. MBS Index; commercial mortgage-backed securities: Bloomberg Barclays CMBS Index; asset-backed securities: Bloomberg Barclays ABS Index; investment grade corporates: Bloomberg Barclays U.S. Investment Grade Corporate Index; emerging markets debt: Bloomberg Barclays EM USD Aggregate Index; preferred securities: ICE BofA U.S. All Capital Securities Index; high yield corporates: Bloomberg Barclays U.S. HY 2% Issuer Capped Index; senior loans: Credit Suisse Leveraged Loan Index.

higher-quality sectors with larger allocations (typically up to 50%) to below investment grade securities. This approach offers more yield potential than core plus, in return for greater potential volatility.

Core plus funds. The ability to actively adjust allocations to lower-quality segments may increase yield while balancing overall risk. These funds combine a larger portion of higher-quality sectors — like U.S. Treasuries, mortgage-backed securities and investment grade corporates — with smaller allocations (typically up to 30%) to lower-quality

sectors, such as high yield corporates, senior loans and emerging markets debt.

Core/core impact with small amounts of plus sector exposure. These funds focus on higher-quality sectors to maintain return profiles similar to the broad bond market with a low correlation to equities. Core strategies with the flexibility to add small amounts (0% to 10%) of lower-quality sectors can be particularly attractive. Core strategies with an impact investing mandate add the diversification of responsible investing themes.

OUTLOOK

Rates should remain range-bound in the near term

Our outlook remains negative on the global economy. Monetary policy should continue to tighten in the U.S., Europe and other major economies. Some interest rate sensitive sectors, like housing, are already showing signs of deceleration. Core inflation is likely to remain elevated in the near term, forcing the Fed to maintain its rate hiking posture over the next several months. We do not expect a recession to start this year, but believe that the risk of recession will be highly elevated going into 2023. That said, we do not anticipate a deep recession due to strong fundamentals.

We expect the Fed to hike rates by another 125 bps in the fourth quarter, including a 75 bps

hike in November and 50 bps in December. We also expect around two more 25 bps hikes in early 2023. We anticipate a similar profile of rate hikes in the euro area, while we anticipate additional policy easing in China.

We believe interest rates will be range bound in the near term before declining in the second half of 2023. Risk premiums may widen further over coming quarters, providing an opportunity to increase risk exposure in portfolios. Over the medium term, we expect strong fundamentals will help limit the damage to spread sectors. We favor high yield, floating-rate loans and preferreds, with an up-in-quality bias within sectors. Diversified strategies with higher interest rate sensitivity look attractive.

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Endnotes

Sources

Inflation: U.S. Bureau of Labor Statistics Consumer Price Index for All Consumers. **Employment:** Bloomberg, L.P., Bureau of Labor Statistics, Nuveen. **Global debt and yields:** Bloomberg L.P.

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