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Investment Insights Monthly

From The Desk of Bill Hornbarger, Chief Investment Officer February 2022

Higher Yields Aren't Necessarily All Bad

Spend a few minutes watching the financial news and inevitably the conversation will turn towards the Federal Reserve and the potential for higher interest rates in the very near future. With inflation at the highest level in 40 years and tight labor markets, the market is bracing for multiple rate hikes beginning in March as the Fed winds down its tapering program. The futures markets are currently pricing in six interest rate increases in 2022 and a year-end Fed funds rate of 1.50%, with higher rates projected in 2023.

Many investors are fearful of higher yields on concerns that they will create a headwind for the equity market and negatively impact the value of existing fixed income holdings. Equities typically have experienced heightened volatility around the start of Fed rate hikes but have tended to make new highs within 6-12 months. Historically, a higher Fed funds target rate has been accompanied by higher bond yields. While there isn't a perfect one-for-one correlation between degree and timing, the 10-year Treasury yield has increased in each cycle of multiple rate increases over the past 40 years (see chart 1).

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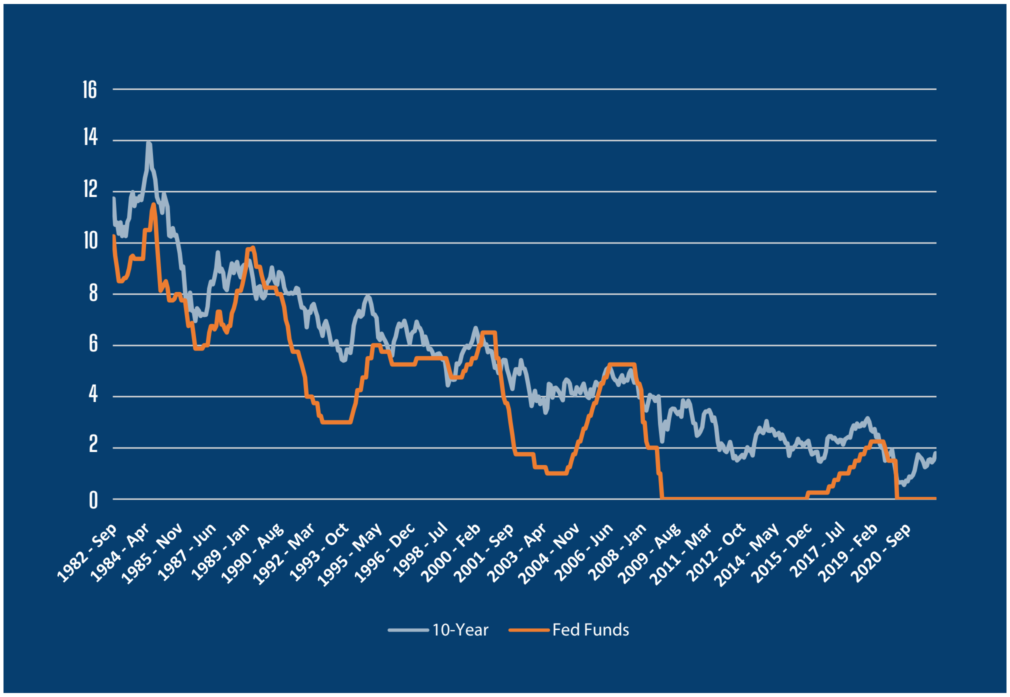
Chart 1: 10-Year Treasury Note Yield at Constant Maturity (%)

Federal Open Market Committee: Target Rate Lower Limit (%)



Source: Haver Analytics

There is a relatively recent cycle that we can look at for some hints as to how the markets might react. From December 2015 to December 2018 the Fed increased rates nine times with the Fed funds rate increasing from 0% to 2.25%. Over that same time frame, the yield on the 10-year Treasury slightly more than doubled, increasing from approximately 1.50% to a high of 3.23%. And, the 10-year yield declined through the first part of that tightening cycle but, in aggregate, yields increased. The S&P 500 fell in the wake of the first rate increase, but steadily moved higher over the balance of that cycle, increasing from a low of 1,829 in February 2016 to a high of 2,930 in September of 2018. While we are not suggesting that history will repeat itself, there are some similarities in the two periods with the Fed funds rate at 0% initially, the 10-year Treasury yield below 1.50%, the S&P 500 price/operating earnings ratio above 20 times, and foreign developed yields below U.S. yields. The biggest difference this time is that inflation is significantly higher.

With that as a backdrop, we would suggest that investors could benefit from higher yields. Low nominal bond yields and negative real bond yields have been a challenge for investors in multi-asset portfolios since the period prior to the Global Financial Crisis. Starting yield is one of the best predictors of fixed income returns (see chart 2) and as yields have steadily declined, the returns from fixed income have also. The trailing returns for the Barclay's Aggregate bond index over 3-,5-, and 10-years were 3.20%, 2.75%, and 2.47% respectively, and a current yield of approximately 2% suggests additional return-challenged times ahead.

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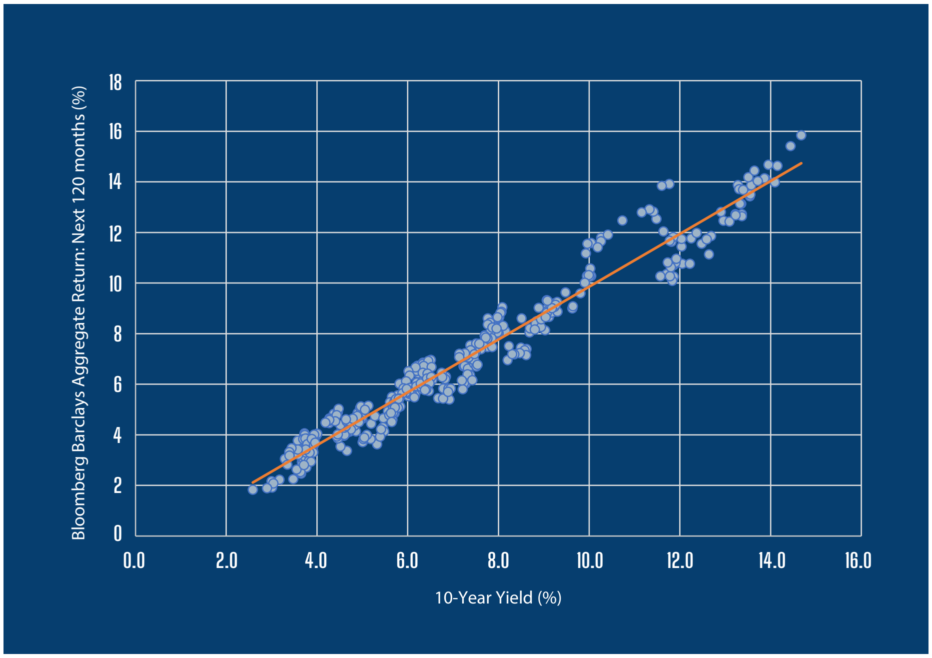
Chart 2: Starting Yield vs. Subsequent Return



Source: Haver Analytics, Morningstar

That level was realized over a full tightening cycle over several years. If inflation begins to moderate in 2023 and the Fed is seen as being ahead of the curve, something similar could play out. While global yields have also been moving higher, international developed market sovereign debt yields remain low relative to the United States. Additionally, the dollar remains relatively strong, suggesting global demand for U.S. dollar denominated assets. Those are things that bear watching closely as potential "warning signs" for the bond market.

Yields have already started to increase in anticipation of the Fed raising rates. The two-year and ten-year Treasuries recently eclipsed 1.50% and 2% yield levels, respectively. The two-year Treasury yielded 10 basis points this time last year and has basically doubled from approximately 75 BPS at the beginning of this year. The bond market is now offering yields last seen prior to the pandemic, and those are becoming a more viable alternative for investors seeking a more stable (than equities) option for their portfolios. With inflation still elevated and the Fed rhetoric turning increasingly hawkish, it isn't unreasonable to think that yields could go higher. We had forecasted 2.25% for the 10-year Treasury this year, a level that looks like it will be achieved in the short term.

How high can rates go? Forecasting bond yields is a difficult proposition, but in the last cycle (2015-2018) yields topped out at 3.23% (basis the ten-year Treasury).

Our approach to fixed income remains unchanged. There is an important role for core fixed income in a portfolio to mitigate equity market risk and provide liquidity in times of equity market stress. Those properties are still valuable, but over the past decade they have come at the expense of low nominal and negative real yields. If the Fed does increase rates multiple times over an extended period, fixed income investors will likely benefit in the form of higher starting yields.

Investors must decide the appropriate allocation to core fixed income based on their own risk and reward profile and time horizon. Within the core fixed income allocation, we recommend a laddered strategy to remove the guesswork of trying to time bond yields. A ladder provides a yield-neutral, disciplined approach to fixed income, coupled with periodic liquidity to potentially take advantage of changing market conditions.

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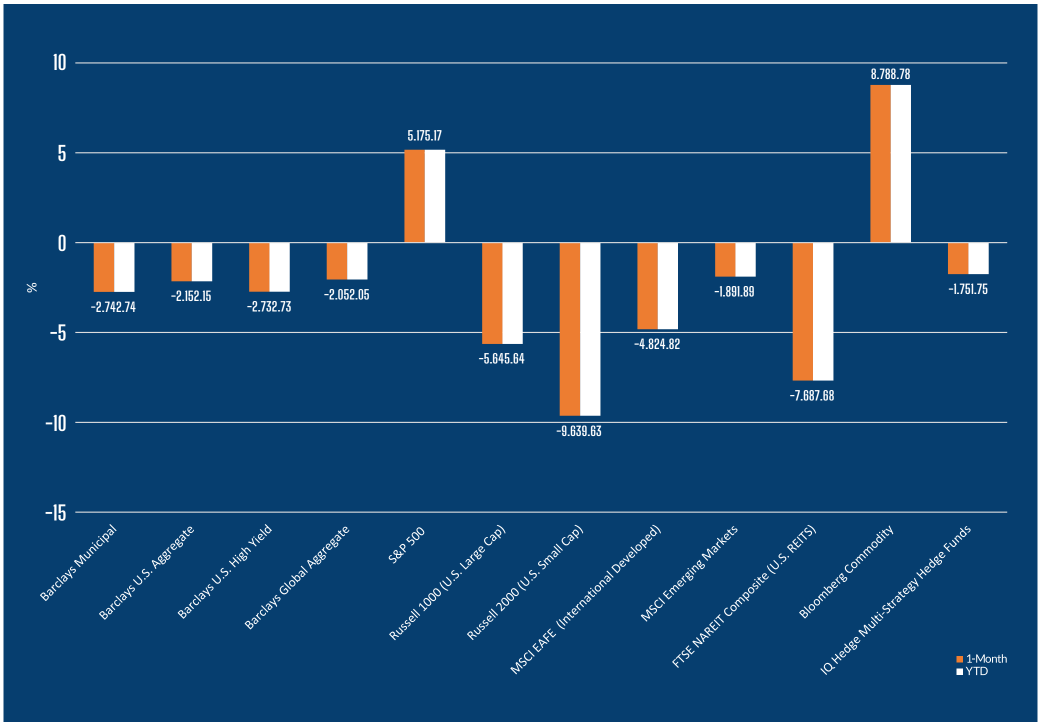
Asset Class Returns as of Januray 31, 2022

Comparing Recent Month and Year-to-Date Total Returns



Source: Morningstar

Fixed Income

- Treasury and sovereign bond yields across the globe surged higher in January leading to a challenging month for core fixed income.
- Credit held up fairly well for the most part considering the carnage in riskier assets.

Equities

- For the first time in a while, U.S. equities lagged non-U.S. equities in January.
- Value trounced growth, and large caps outperformed small caps.
- Most of the selling was in the tech-heavy Nasdaq.
- Non-U.S. equities softened towards the end of the month despite providing relative outperformance versus the U.S.
- EAFE markets tend to be value driven, so that explains a lot of the relative outperformance.
- Similar to the U.S., growth trailed value and small caps lagged large caps.
- Emerging markets fell only 1.9%, largely due to relative outperformance from China and Brazil.
- The stronger U.S. dollar hurt returns.

Real Assets

- Commodities were very strong as inflation fears ramped up and energy prices continued to climb.
- REITS had a poor month and were hurt by weak equity and weak fixed income markets.

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January 31, 2022	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.00%	0.00%	0.00%	0.04%	0.86%	1.08%	0.58%
Barclays Municipal	-2.74%	-2.74%	-2.74%	-1.89%	3.50%	3.46%	3.20%
BBgBarc U.S. Govt/Credit Intermediate	-0.72%	-0.72%	-0.72%	-1.22%	1.90%	1.67%	1.28%
Barclays U.S. Aggregate	-2.15%	-2.15%	-2.15%	-2.97%	3.67%	3.08%	2.59%
Barclays U.S. High Yield	-2.73%	-2.73%	-2.73%	2.06%	6.26%	5.40%	6.21%
S&P/LSTA Leveraged Loan	0.36%	0.36%	0.36%	4.34%	4.88%	4.23%	4.50%
Barclays Global Aggregate	-2.05%	-2.05%	-2.05%	-5.83%	2.36%	2.70%	1.39%
JPM GBI EM Global Diversified	-0.01%	-0.01%	-0.01%	-7.76%	0.28%	2.36%	0.03%
U.S. Equity Indices							
DJ Industrial Average	-3.24%	-3.24%	-3.24%	19.36%	14.47%	14.61%	13.44%
S&P 500	-5.17%	-5.17%	-5.17%	23.29%	20.71%	16.78%	15.43%
NASDAQ Composite (Price)	-8.98%	-8.98%	-8.98%	8.95%	25.05%	20.46%	17.60%
Russell 1000	-5.64%	-5.64%	-5.64%	20.32%	20.51%	16.59%	15.32%
Russell 1000 Growth	-8.58%	-8.58%	-8.58%	17.52%	26.44%	22.28%	18.03%
Russell 1000 Value	-2.33%	-2.33%	-2.33%	23.37%	13.84%	10.48%	12.28%
Russell Mid Cap	-7.37%	-7.37%	-7.37%	13.85%	16.15%	12.81%	13.36%
Russell 2500	-8.32%	-8.32%	-8.32%	5.75%	14.21%	11.49%	12.43%
Russell 2000	-9.63%	-9.63%	-9.63%	-1.21%	11.99%	9.69%	11.33%
Russell 2000 Growth	-13.40%	-13.40%	-13.40%	-15.04%	11.36%	10.93%	11.70%
Russell 2000 Value	-5.83%	-5.83%	-5.83%	14.75%	11.72%	7.92%	10.64%
Non-U.S. Equity Indices							
MSCI World	-5.27%	-5.27%	-5.27%	17.03%	17.16%	13.84%	12.15%
MSCI ACWI	-4.89%	-4.89%	-4.89%	13.70%	15.98%	13.21%	11.24%
MSCI ACWI Ex-U.S.	-3.67%	-3.67%	-3.67%	4.07%	9.59%	8.54%	6.67%
MSCI EAFE	-4.82%	-4.82%	-4.82%	7.52%	9.85%	8.36%	7.44%
MSCI EAFE Growth	-10.50%	-10.50%	-10.50%	1.25%	12.66%	10.76%	8.68%
MSCI EAFE Value	1.06%	1.06%	1.06%	13.63%	6.52%	5.68%	5.99%
MSCI Europe	-4.56%	-4.56%	-4.56%	13.26%	11.38%	9.31%	7.81%
MSCI Japan	-5.07%	-5.07%	-5.07%	-2.16%	8.00%	6.98%	7.63%
MSCI AC Asia	-3.81%	-3.81%	-3.81%	-8.00%	8.40%	8.44%	7.27%
MSCI EAFE Small Cap	-7.31%	-7.31%	-7.31%	2.78%	10.26%	9.01%	9.47%
MSCI ACWI Ex-U.S. Small Cap	-6.24%	-6.24%	-6.24%	6.47%	11.58%	9.38%	8.24%
MSCI Emerging Markets	-1.89%	-1.89%	-1.89%	-6.94%	7.56%	8.68%	4.53%
MSCI EM Asia	-3.48%	-3.48%	-3.48%	-11.96%	9.67%	10.20%	6.95%
MSCI China	-2.95%	-2.95%	-2.95%	-29.17%	3.17%	7.44%	5.97%
MSCI EM Eastern Europe	-6.61%	-6.61%	-6.61%	13.09%	6.30%	8.31%	2.96%
MSCI EM Latin America	7.39%	7.39%	7.39%	6.21%	-4.22%	1.79%	-2.33%
MSCI EM Small Cap	-4.41%	-4.41%	-4.41%	13.93%	13.18%	9.86%	6.20%
MSCI Frontier Markets	-3.53%	-3.53%	-3.53%	15.41%	9.98%	7.70%	7.26%
Hedge Fund Indices							
IQ Hedge Long/Short	-3.11%	-3.11%	-3.11%	3.53%	8.95%	6.43%	--
IQ Hedge Multi-Strategy	-1.75%	-1.75%	-1.75%	-2.13%	3.59%	3.41%	3.15%
Real Assets Indices							
FTSE NAREIT Composite	-7.68%	-7.68%	-7.68%	29.51%	11.83%	10.29%	10.34%
Alerian MLP	11.07%	11.07%	11.07%	47.09%	1.65%	-1.58%	0.60%
Bloomberg Commodity	8.78%	8.78%	8.78%	34.73%	11.01%	5.39%	-2.27%
S&P Global Infrastructure	-1.00%	-1.00%	-1.00%	13.13%	6.81%	7.29%	7.33%
Other							
Oil Price Brent Crude	17.27%	17.27%	17.27%	63.22%	13.80%	10.37%	-1.95%
CBOE Market Volitility (VIX)	60.63%	60.63%	60.63%	-16.41%	18.63%	18.20%	3.59%

Source: Morningstar

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