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Investment Grade Fixed Income | Markets and Economy

Marking the uncertain course of monetary policy and the markets

By: Vishal Khanduja, CFA | & Brian S. Ellis, CFA | July 27, 2021

Boston - U.S. and global economies may continue to strengthen as more people are vaccinated against COVID-19, albeit at uneven rates geographically. We believe the ongoing global recovery and accommodative policies of major central banks should support risk markets in the near term. Looking out a few quarters, however, we think markets could become increasingly volatile depending on the course of monetary policy.

Is inflation a moving target?

Federal Reserve Chair Powell has stressed that recent price pressures have been driven by pent-up demand, supply-chain bottlenecks and "easy" comparisons to pandemic-deflated price levels — effects that will dissipate with time. But if inflation proves to be more persistent, the Fed will likely move up its timetable for tightening. As events unfold, we will watch how individual Federal Open Market Committee (FOMC) members react to inflation data — how comfortable each of them will be with above-target inflation, and for how long.

The Fed adopted an average inflation-targeting (AIT) strategy last summer, saying it would let inflation run "moderately" above its 2% target for "some time" following periods of persistently below-target inflation. We are now in a period when FOMC officials will be defining the specific conditions for meeting AIT. Most likely, they will have differing views on this, which could make it harder to communicate the Fed's policy intent to markets. Since the end of last year, our thinking was that the Fed would hold policy steady through at least the first half of 2024. We still expect the central bank to remain dovish — even a rate hike by the end of 2023 is a long way out.

Earlier QE tapering likely

However, we believe the FOMC will start tapering its quantitative easing (QE) program sooner than we originally anticipated. The U.S. recovery has surprised on the upside, and we are seeing signs that inflation may be more persistent than we thought a few months ago. While we expect current labor-supply constraints to diminish, labor demand could stay strong, fueling wage inflation which tends to be sticky. In addition, home prices may remain elevated given limited inventories and the shift toward remote work, which is likely to continue post-pandemic.

Two other factors support our expectations of earlier tapering. First, the Fed's mortgage-backed securities (MBS) purchases have contributed to a housing boom that now appears to be benefiting institutional buyers and investors more than ordinary homebuyers. Second, we anticipate that Congress will use the reconciliation process to pass a multi-trillion-dollar deficit spending bill later this year — with or without passage of the $1.2 trillion bipartisan infrastructure bill. This type of bill may be quite bullish for risk assets in the long run but could push inflation and bond yields higher in the nearer term.

Positioning for possible volatility

Consistent with economic recovery and the inflation and yield implications of the significant deficit spending we expect, we would position for yield-curve steepening, with an underweight to duration. While we previously favored higher-quality corporate bonds, lower-quality segments of the credit markets now offer attractive opportunities in our view. There may still be room for spread compression here, particularly in select BBB- and crossover credits that are benefiting from the sustained reopening.

In the high-yield market, we see value in some *rising star* candidates that could be upgraded to investment grade, as well as select BB- and B-rated credits that are attractive in a low-default environment. Within non-investment grade, our emphasis has remained on bank loans over bonds, in part due to their lower sensitivity to interest rates.

Bottom line: We believe a focus on generating portfolio returns through credit risk versus duration risk is appropriate for the current environment — an environment characterized by strong economic and corporate fundamentals, talk of tapering at the Fed and a "go big" spending mentality in Washington. We expect this approach, combined with the flexibility to adjust positioning within and across sectors, can benefit fixed-income portfolios in the months ahead.

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