Q1 2022 | Fixed Income Outlook

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Bond markets fluctuate amid shifting Fed policy

The Fed is pivoting on interest-rate policy and accelerating the unwinding of stimulus amid high inflation.

Economic growth and the policies of global central banks will be key to asset returns in 2022.

We have a positive outlook for investment-grade corporate credit and high-yield markets fundamentals.

Putnam fixed-income views

Shading in the table indicates the change from the previous quarter

	Underweight	Small underweight	Neutral	Small overweight	Overweight
U.S. government and agency debt	●				
U.S. tax exempt			●		
Tax-exempt high yield				●	
Agency mortgage-backed securities		●	○		
Collateralized mortgage obligations					●
Non-agency residential mortgage-backed securities				●	
Commercial mortgage-backed securities				●	
U.S. floating-rate bank loans				●	
U.S. investment-grade corporates				●	
Global high yield					●
Emerging markets		●			
U.K. government			●		
Core Europe government			●		
Peripheral Europe government			●		
Japan government		●			

Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro			●
£ Pound		●	
¥ Yen		●	

Global financial markets were mixed during the fourth quarter. The biggest surprises were the surge in inflation, the Federal Reserve opening the door to faster-than-expected rate increases, and the Omicron coronavirus variant's spread across the world. The broad fixed income market appears set for a challenging time given the expectation for policy to tighten and yields to rise. The rate-sensitive Bloomberg U.S. Aggregate Bond Index languished, returning 0.01% during the quarter. Global bonds, as measured by the FTSE World Government Bond Index, declined 1.10%. That compares with a gain of 11.03% for the S&P 500 Index.

In mid-December, the Fed pivoted toward tighter credit with plans to end its bond-buying program in March while signaling higher interest rates. Most Fed officials penciled in raising the policy rate, which is now set near zero, three times this year. Other central banks around the world have started to normalize interest rates or revealed plans to roll back stimulus policies. The European Central Bank (ECB) said it would slow the pace of asset purchases under its Pandemic Emergency Purchase Program (PEPP) in the first quarter, bringing the program to an end in March. And the Bank of England (BoE) in December raised the policy interest rate to 0.25% from a historical low. Global economic growth — which is expected to slow in 2022 — and the policy stance will be the key factors driving asset returns. Financial market volatility is likely to be high, in our view, and small returns can only be made by riding through this volatility.

The U.S. Treasury bond yield curve has flattened. The Fed's hawkish pivot has pushed up rate-sensitive short-dated bond yields, while the long end of the curve fell due to concerns about the economic impact of rising Covid-19 cases. The yield on the benchmark 10-year Treasury note fell to 1.52% at the end of December, after rising to 1.67% in late November. The yield on the 30-year bond fell to 1.90% at quarter-end. The yield on the 2-year note rose to end the period at around 0.73%. From a value standpoint, sovereign debt is unlikely to be a driver of long-term returns. Market-implied real yields will likely hover near zero or at slightly negative levels in many developed markets over the next few years.

Fed's U-turn surprises bond markets

In early 2022, investors will remain focused on Covid-related news, economic growth, inflation trends, and any changes to the Fed's course to reduce the accommodative policies that have been in place. Fed Chair Jerome Powell has set the stage for a series of interest-rate increases beginning this spring. Most central bank officials, in new projections in December, penciled in at least three 0.25% rate hikes by year-end. The shift — along with accelerated tapering of bond purchases — comes amid signs of broadening inflation pressures and tightening labor markets. Several FOMC members are also advocating for quantitative tightening — i.e., balance sheet runoff. As the Fed tightens and the inflation rate comes down, real rates will rise.

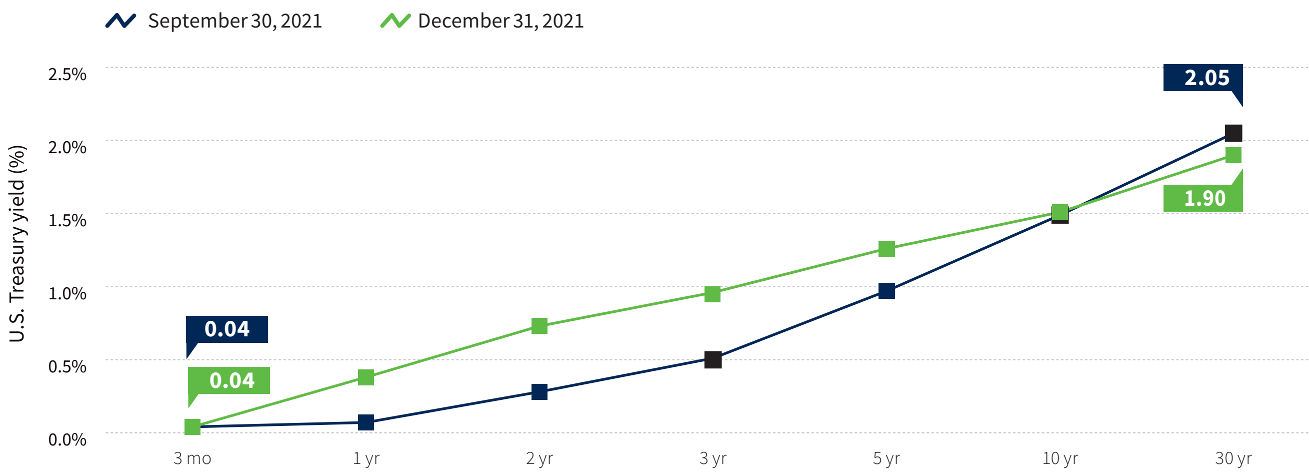
The economy remains resilient despite near-term disruptions in some services from the Omicron variant and in the labor market. Economic growth in 2022 is likely to stay well above trend, in our view. The Fed expects the economy to grow 4.0% this year from an estimated 5.5% in 2021. Fed officials project core inflation at 4.4% in 2021 before declining to 2.7% this year and 2.1% by the end of 2024. Consumer prices rose 6.8% from a year ago in November, the fastest pace since 1982, according to the Labor Department. Against this backdrop, job growth cooled in December and the unemployment rate fell below 4%. The Fed sees the unemployment rate falling to 3.5% for 2022.

ECB seeks flexibility in monetary policy

The ECB has trailed other global central banks in signaling higher interest rates and left its benchmark refinancing rate unchanged at 0% in December. The ECB's governing council said in a statement that "monetary accommodation" is still needed for inflation to stabilize at the 2% target over the medium term. While the ECB's bond buying will be gradually phased out, President Christine Lagarde has reiterated that an increase in interest rates in 2022 is unlikely. The overall message was dovish as the ECB overcommitted on reinvestments, with PEPP reinvestments extended until the end of 2024. This comes as the 19-member common currency bloc continues to face economic uncertainty, elevated inflation, and partial lockdowns from the Omicron variant.

In the United Kingdom, the BoE delivered a surprise rate hike in December. A hawkish Fed, inflation worries, and a gradual unwinding of ECB support have pushed bond yields higher across the euro area. Germany's 10-year bond yields, seen as the benchmark for Europe, rose 33 basis points over the past month to -0.05% in early January. Italy's 10-year bond yield touched a more than one-year high of 1.31% in the first week of January. The yield on U.K. 10-year notes also trended higher to about 1.18% in early January.

The Treasury curve flattened in Q4 on the expectation of the Federal Reserve raising rates in 2022



Source: U.S. Treasury Department. Past performance is not indicative of future results.

China central bank eases policy

China's economy faces the prospect of a slowdown this year. Retail sales and fixed-asset investment growth have slowed even as manufacturing and trade improved marginally. The strict mobility restrictions to curb Covid outbreaks and weakness in the property market are also affecting retail sales and consumer spending. This comes after real estate conglomerate Evergrande Group sought government help in December to manage its growing debt crisis. The official manufacturing Purchasing Managers' Index (PMI) rose slightly to 50.3 in December from 50.1 in November, according to China's National Bureau of Statistics.

With growth ebbing, the willingness to ease monetary policy has increased. The People's Bank of China eased the reserve requirement ratio for banks by 0.5 percentage points to 8.4% in mid-December, effectively making more cash available for bank lending to cushion the economic downturn. The central bank also lowered the one-year loan prime rate to 3.8%. The Communist Party's top decision-making body, the Politburo, has said stability is the "top priority" for the economy in 2022. China's benchmark sovereign bond yield has seesawed in recent weeks, with 10-year notes yielding around 2.82% in early January.

Sector views

Corporate debt: Investment grade and high yield

Investment-grade bonds posted marginally positive results for the quarter. We have a positive outlook for the fundamentals and overall supply-and-demand backdrop of investment-grade corporate credit. Our view on valuation is more neutral, however, given the relative tightness of yield spreads as of year-end.

In early 2022, we have a positive outlook for high-yield market fundamentals and the overall supply-and-demand backdrop. Our view on valuations is more neutral, given the relative tightness of yield spreads in the market as of year-end. Our positive fundamental outlook is underpinned by the ongoing distribution of Covid vaccines. That said, we continue to closely monitor issuers' balance sheets and liquidity metrics, with an eye toward default risk or a credit-rating downgrade.

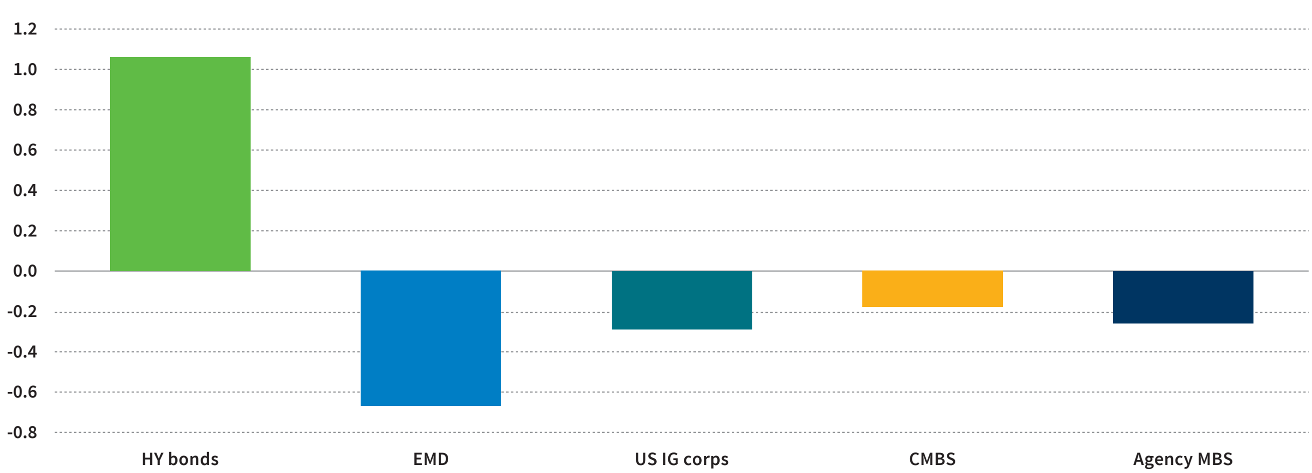
As for supply/demand dynamics, new issuance of high-yield debt totaled $483 billion in 2021, an 8% increase over 2020. At the same time, the asset class experienced five consecutive months of inflows from August through December 2021. Despite the mixed outcome for fund flows, demand from institutional investors for newly issued bonds supports our positive view of market technicals. From a valuation standpoint, the average spread of the fund's benchmark tightened to 3.75 percentage points over U.S. Treasuries during 2021, significantly below the long-term average of 6 percentage points. Despite tight spreads and lower yields, we think the market's income potential remains attractive in the face of much lower global yields.

Trends in the mortgage markets

In the commercial mortgage-backed securities (CMBS) market, we believe there are attractive risk-adjusted investment opportunities available amid an improving fundamental backdrop. By virtue of having real assets serving as collateral, along with the potential for rent adjustments, CMBS have historically performed well during periods of rising inflation. As a result, we believe CMBS may offer attractive relative value to a wide range of investors.

Risk asset volatility increased in Q4 amid persistent Covid waves and a shift in Fed policy

Excess returns* relative to Treasuries, Q4 2021



Source: Bloomberg, as of 12/31/21. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index. Past performance is not indicative of future results. See page 6 for index definitions.

* Excess returns are calculated relative to comparable maturity U.S. Treasuries for each index. Excess return does not always mean "outperformance."

Within residential mortgage credit, we believe a combination of low mortgage rates, high demand, and a declining inventory of available homes is likely to push home prices higher. Given that prices have already risen substantially, we are aware that affordability has become a constraint for many prospective buyers. Consequently, we think the pace of home price appreciation is likely to moderate during 2022. Against this backdrop, we are finding value in investment-grade securities backed by non-agency residential loans, even with tighter yield spreads.

The environment for prepayment-related strategies was challenging in 2021. Despite this, we still have conviction in this allocation for its return potential and diversification benefits. Mortgage interest rates have risen modestly since bottoming in early August. With the Fed pivoting to a less accommodative policy stance, we believe mortgage rates may continue to rise in 2022. Consequently, we think refinancing activity will recede and mortgage prepayment speeds will slow.

Currency views

U.S. dollar to continue appreciating

In December, the Fed dropped its reference to inflation being transitory and emphasized the labor market's strength. It also signaled plans to phase out its bond-buying program by March instead of June. The interest-rate projections — the dot plot — was equally hawkish and pointed to three interest-rate hikes in 2022, three in 2023, and two in 2024. Still, the long-term outlook was unchanged. The central bank's stance on interest rates has been supportive of the dollar. The evolution of the labor market — especially the participation rate — will be the crux for how much the Fed raises rates. In addition, there will be scope for additional hawkishness in the form of quantitative tightening. That may cause the dollar to appreciate against currencies backed by dovish central banks such as the yen, the Swiss franc, and, potentially, the euro. But the pace of this appreciation should be tempered given expectations, positioning, and the strength we've already seen.

Euro may weaken on ECB policy

In December, the ECB said it would slow the pace of asset purchases under its PEPP in the first quarter, bringing the program to an end in March. Additionally, the ECB announced its Asset Purchase Program (APP) would increase to 40 billion euros in the first quarter, decrease during the third quarter, and return to 20 billion euros in the fourth quarter, another hawkish innovation. The ECB will not allow new targeted longer-term refinancing operations (TLTROs) after June 2022. As many existing TLTROs mature in 2023, it is very possible that the ECB balance sheet shrinks by the end of 2022. Beyond that, several factors suggest the doves at the ECB are still in control, somewhat limiting the extent of hawkish policy, but it has created policy flexibility for a further hawkish pivot if necessary. In the short term, growth concerns from the Omicron variant and shutdowns, along with the ECB's policy stance relative to the Fed, will likely further soften the euro.

A hawkish central bank likely to lift pound

The BoE's decision to raise rates came despite uncertainty from the spread of the Omicron variant and mixed messages from Monetary Policy Committee members. Noting ongoing labor and material shortages, the minutes of the December meeting said that labor market tightness implies upside risks to inflation and the economic outlook warrants higher rates. While concerns over variants are high, the economy has adjusted to periods of lockdowns. In the short term, growth concerns from energy supply issues, variants, and shutdowns are likely to dominate. While the more hawkish BoE should provide some support for the pound, it is most likely to be seen versus the euro.

Japan's yen may continue to trend lower

In the very near term, the Bank of Japan remains largely sidelined, and changes to monetary policy are unlikely despite market rumors, in our view. With short-term rates keeping hedged international bonds attractive, we expect hedged yields to attract the bulk of inflows that go into global, especially U.S., bond markets. As the Fed's rate-hiking cycle nears, longer-dated hedges on purchases of U.S. assets have been rising in cost, and hedge ratios are likely being adjusted. As such, the yen has traded through the upper end of its trading range against the dollar to levels last seen in April 2021. From here, prospects of higher rates to counter inflation by global central banks will likely keep the yen weaker in the near term. The currency will likely stabilize when the Fed's hawkishness on rates has peaked.

The Fixed Income Outlook represents the insights of the collaborative process of our 100+ member team and of our senior leadership.

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As of December 31, 2021.

Agency mortgage-backed securities are represented by the Bloomberg U.S. Mortgage Backed Securities Index, which covers agency mortgage-backed pass-through securities (both fixed rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Commercial mortgage-backed securities are represented by the Bloomberg U.S. CMBS Investment Grade Index, which measures the market of commercial mortgage-backed securities with a minimum deal size of $500 million. The two subcomponents of the U.S. CMBS Investment Grade Index are U.S. aggregate-eligible securities and non-eligible securities. To be included in the U.S. Aggregate Index, the securities must meet the guidelines for ERISA eligibility.

Emerging market debt is represented by the Bloomberg EM Hard Currency Aggregate Index, which is a flagship Emerging Markets debt benchmark that includes USD, EUR, and GBP denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The index is broad-based in its coverage by sector and by country, and reflects the evolution of EM benchmarking from traditional sovereign bond indices to Aggregate-style benchmarks that are more representative of the EM investment choice set.

Eurozone government is represented by the Bloomberg European Aggregate Bond Index, which tracks fixed-rate, investment-grade securities issued in the following European currencies: euro, Norwegian krone, Danish krone, Swedish krona, Czech koruna, Hungarian forint, Polish zloty, and Swiss franc.

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FTSE World Government Bond Index (WGBI) measures the performance of fixed-rate, local-currency, investment-grade sovereign bonds.

High-yield bonds are represented by the JPMorgan Developed High Yield Index, an unmanaged index of high-yield fixed-income securities issued in developed countries.

Japan government is represented by the Bloomberg Japanese Aggregate Bond Index, a broad-based investment-grade benchmark consisting of fixed-rate Japanese yen-denominated securities.

Tax-exempt high yield is represented by the Bloomberg Municipal Bond High Yield Index, which consists of below-investment-grade or unrated bonds with outstanding par values of at least $3 million and at least one year remaining until their maturity dates.

U.K. government is represented by the Bloomberg Sterling Aggregate Bond Index, which contains fixed-rate, investment-grade, sterling-denominated securities, including gilt and non-gilt bonds.

U.S. floating-rate bank loans are represented by the S&P/LSTA Leveraged Loan Index, an unmanaged index of U.S. leveraged loans.

U.S. government and agency debt is represented by the Bloomberg U.S. Aggregate Bond Index, an unmanaged index of U.S. investment-grade fixed-income securities.

U.S. investment-grade corporate debt is represented by the Bloomberg U.S. Corporate Index, a broad-based benchmark that measures the U.S. taxable investment-grade corporate bond market.

U.S. tax exempt is represented by the Bloomberg Municipal Bond Index, an unmanaged index of long-term fixed-rate investment-grade tax-exempt bonds.

Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

The Bloomberg U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities.

The ICE BofA 1-3 year U.S. Corporate Index is an unmanaged index of U.S. investment-grade corporate debt with a remaining term to maturity of less than 3 years.

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