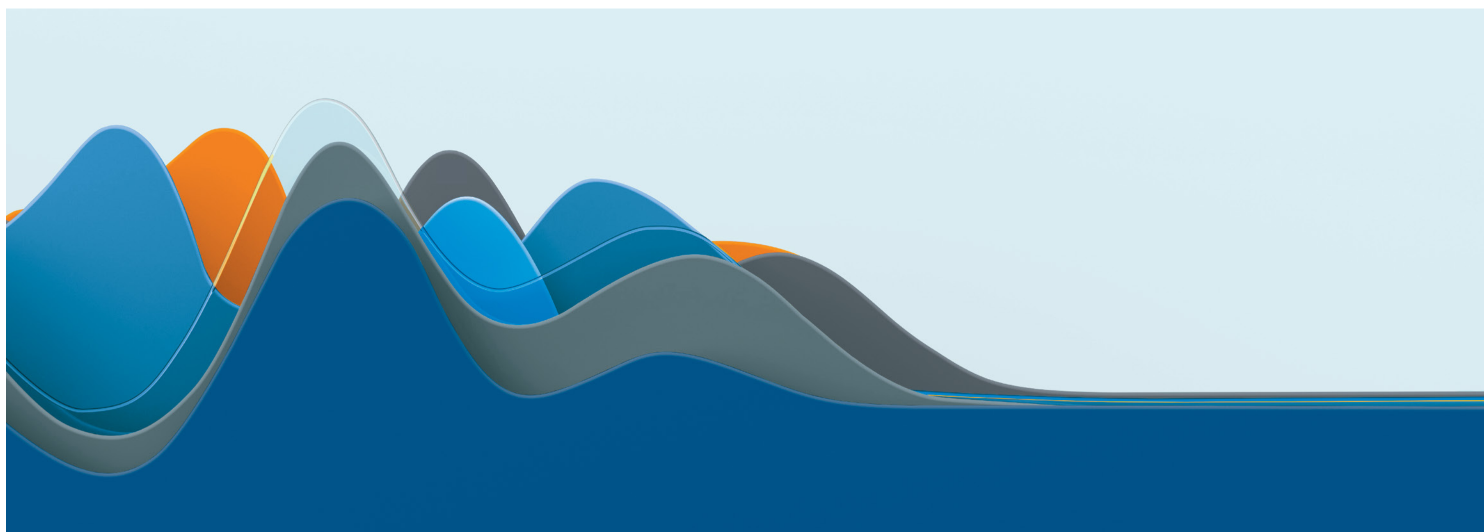
Quarterly Market Commentary
First Quarter 2022



First Quarter Highlights

- Domestic and global growth expectations moderated with the surge in commodity prices following Russia's invasion of Ukraine.
- The labor market continues to tighten; businesses are struggling to find workers despite a steady increase in the labor force participation rate.
- Inflation has continued to move higher. Any hopes of a near-term decline diminished with increasing commodity prices and persistent supply chain constraints.
- The Federal Reserve (Fed) has gone on the offensive and is now forecasting an aggressive hiking campaign for the remainder of this year as well as a reduction in the size of its U.S. Treasury (UST) and mortgage-backed security (MBS) holdings.
- The UST yield curve flattened over the quarter with multiple portions briefly inverting, including the widely followed 2-year/10-year curve. This suggests doubts about the Fed's ability to fight inflation without driving the economy into recession.
- The war in Ukraine and the prospect for tighter monetary policy led to elevated and persistent volatility across asset classes for the majority of the first quarter.
- Investment grade credit spreads widened throughout the quarter until mid-March, when a rally helped the sector offset some of the year-to-date losses.

Duration Positioning

Slightly short

Modest duration underweight in longer styles with a slightly larger underweight in shorter styles.

Credit Sector

Overweight

Overweight Financials and select Industrial sectors, primarily within Energy, Information Technology and Telecom. With expectations for elevated volatility and tighter spreads, we reduced our overweight in late March.

Structured Products

Underweight in Aggregate strategies, Overweight in Government/Credit strategies

Maintained overweights in asset-backed securities (ABS). Maintained underweights in agency MBS allocations in Aggregate strategies while reducing overweights in non-Aggregate styles.

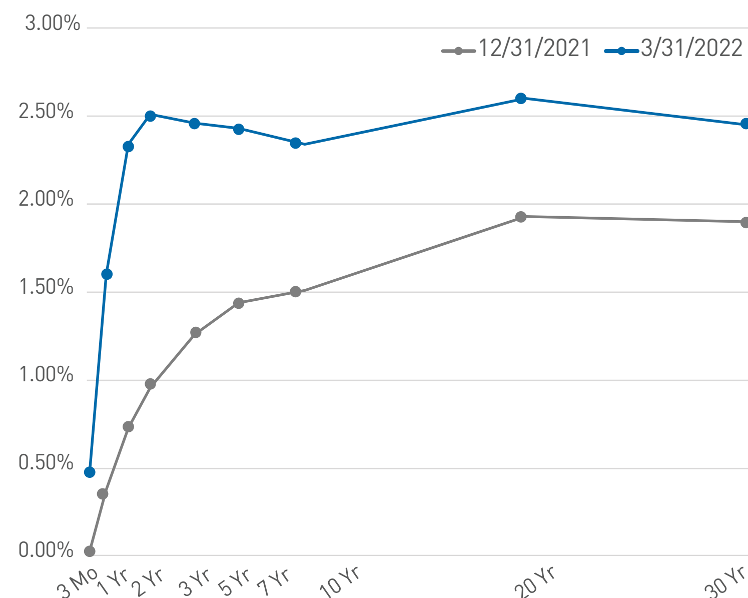
Sector Review

The first quarter of 2022 provided investors with few places to find shelter as volatility surged, and both interest rates and risk premiums moved higher. Markets appeared to wake to the reality that the Fed faces a daunting task in fighting inflation, which will likely result in a pace of policy tightening not seen in decades. Meanwhile, geopolitical tensions have boiled over, with war in Eastern Europe stoking inflationary pressures due to surging commodity prices. Interest rates rose sharply across the yield curve, leading the Bloomberg Aggregate Index to a return of -5.93% (Figure 1). The Bloomberg Aggregate Credit Index generated excess returns of -1.31% as spreads repriced wider by 21 basis points (bps) during the quarter (Figure 2). Securitized sectors fared somewhat better with less negative excess returns.

Monetary Policy: Tough talk, but will the Fed walk the walk?

The Fed used the January Federal Open Market Committee (FOMC) meeting to tee up markets for a rate hike at its following meeting in March. Sure enough, the Fed announced a 0.25%-0.50% increase in the target policy rate on March 16. The FOMC's updated projections and the hawkish tone from Chair Powell indicated many more hikes are expected in the months ahead. The median projection on the Fed's "dot plot" forecast indicates seven 25 bp hikes this year, up from only three hikes from the prior forecast last December. A chorus of Fed officials used recent speeches and media appearances to signal an even more hawkish tone, seemingly setting up markets for the potential of multiple 50 bp hikes. While St. Louis Fed President Jim Bullard's "100 in the bag by July 1" comments in early February seemed aggressive, in retrospect, pandemic-induced policy accommodation measures likely should have been unwound sooner. The Fed is left in an unenviable position of fighting an uphill battle against inflation and, more importantly, needing to reestablish its credibility.

Figure 1. UST Yield Curve
Interest rates rose sharply during first quarter



As of 3/31/22. Source: Bloomberg, L.P.

Figure 2. Sector Comparison
Spreads widened and excess returns were negative across sectors

	Option Adjusted Spread (bps)		Excess Returns %
Sector	Current	Change from Last Quarter	3 Months
U.S. Agency	13.00	5.00	(0.46)
U.S. Credit	108.00	21.00	(1.31)
Industrial	116.00	21.00	(1.44)
Utility	127.00	20.00	(1.68)
Financial Institutions	112.00	29.00	(1.40)
Non-Corporate Investment Grade	62.00	7.00	(0.41)
U.S. Mortgage-Backed Securities	24.00	(7.00)	(0.71)
Asset-Backed Securities	57.00	19.00	(0.31)
CMBS: Erisa Eligible	85.00	17.00	(0.58)
U.S. Corporate High Yield	325.00	42.00	(0.92)

As of 3/31/22. Source: Bloomberg, L.P.

PNC CAPITAL ADVISORS

The policy tightening framework contemplated by the Fed will also address its nearly $9 trillion balance sheet, which has roughly doubled in size from the pre-COVID-19 peak. During the press conference following the March FOMC meeting, Chair Powell stated the Committee made "excellent progress toward agreeing on the parameters of the plan to shrink the balance sheet." The minutes from the meeting noted members supported a passive runoff, with peak caps of $60 billion per month for USTs and $35 billion per month for MBS, a speed well above last cycle's runoff. This would be phased in over the initial months of the wind-down and could potentially include outright sales of MBS once the process is underway. Also notable, in stark contrast to the last episode of quantitative tightening, the Fed's balance sheet will likely spend just three months or less at peak levels compared to three-and-a-half years previously. Even with this more aggressive approach, the Fed's balance sheet will remain outsized relative to domestic GDP.

With inflation continuing to "significantly exceed" its long-run goal, we expect the Fed to maintain a more hawkish posture over the next several meetings. The blunt monetary policy tools at the Fed's disposal historically have operated with a lagged effect; aggressive policy responses are often most effective to address market panics. With significant uncertainty in the outlook and attendant challenges in forecasting economic conditions, the Fed will need to remain nimble to combat persistent inflationary pressure and engineer a slowdown in growth.

Rates and Yield Curves: Slopes, recession tropes and the straight dope

What a difference a year makes! Since reaching peak steepness of the current Fed cycle a year ago, the slope of the 2-year/10-year UST curve has flattened dramatically — even briefly inverting after the quarter's close. The Fed's hawkish rhetoric since late November has pushed up short/intermediate UST rates significantly, reflecting growing expectations of an aggressive tightening cycle over the next 12 to 18 months. With the fed funds target range set at 0.25%-0.50%, the front-end of the curve is remarkably steep and will adjust as Fed policy changes. Given tight labor markets and high inflation, the Fed will be challenged to engineer a soft landing for the U.S. economy. Curve inversions are oft-sighted harbingers of a recession but tend to have long lead times (12 or more months) and require persistent inversion. A better predictor is forward expectations in the UST Bill market, where, as of this writing, the curve remains steep, similar to the fed funds/2-year curve shown in Figure 3.

Figure 3. Spread Comparisons, bps

Front-end curves are historically steep, while longer-dated curves declined and briefly inverted

As of 3/31/22. Source: Bloomberg, L.P.

While yield curves have garnered headlines, two underlying and arguably more important developments in rates markets are influencing our risk positioning. First, increasing commodity prices drove real rates lower as breakeven spreads rose and the 10-year Treasury Inflation-Protected Securities (TIPS) real yield broke through -1% in early March. However, recent breakeven spreads have moderated, and the shift in yields during March has driven the TIP real yield through -20 bps. Real rates have spent most of the last two years below zero due to the Fed's extraordinary accommodation. As real rates rise, financial conditions will tighten and potentially slow growth.

Perhaps even more notable is the evolution of interest rate volatility. The ICE BofA MOVE Index has been in an uptrend since the end of third quarter 2021 as markets adjust to a new Fed policy regime. The index spent most of March at levels over 100, implying daily interest rate changes of more than 6 bps. The 50-day moving average crossed 100 to start the second quarter — an event that has not happened since late 2011/early 2012 during the European sovereign debt crisis. This has contributed to recent underperformance of agency MBS. Additionally, this dynamic has historically coincided with periods of market stress (e.g., the Global Financial Crisis and the dot-com bubble, among others) and Fed regime changes.

Figure 4. Average Option-Adjusted Spreads Comparison

A late-March rally helped offset widening spreads during the quarter

As of 3/31/22. Source: Bloomberg, L.P.

Positioning & Outlook: In Like a Lion...

Tightening financial conditions and elevated volatility are our primary near-term concerns. We entered 2022 with more defensive positioning in client portfolios due to headwinds from the four primary factors that guide our risk-focused investment process — monetary policy, fiscal policy, inflation and volatility.

Preceding the March FOMC meeting, Credit reached a year-to-date negative excess return of 330 bps. However, this quickly reversed as the index option-adjusted spread subsequently narrowed by almost 30 bps in the final weeks of the quarter (Figure 4). Heavy supply during the quarter pressured spreads wider and created better opportunities as concessions (spread discounts to the secondary market) widened. We were active in both primary and secondary markets, adding risk as valuations improved and then actively selling as we exited the quarter given the velocity of the rally. We expect periods of episodic volatility to persist, which should present opportunities to tactically reposition client portfolios when risk/reward symmetry improves.

In Structured products, ABS fared better than Credit overall but weakened during March, which allowed us to increase allocations to the sector given better relative value opportunities based on historical risk/return characteristics. The Agency MBS market underperformed USTs as rates and volatility rose; the MOVE index exceeded 100 for much of March as underperformance persisted. With improved valuations and return symmetry, we continue to evaluate opportunities to reduce our underweight in the Agency MBS sector.

Market dynamics have shifted dramatically considering the Fed has only lifted its target policy rate by 25 bps. Financial conditions are tightening, rate volatility is elevated, and risk assets are struggling to find footing. The war in Ukraine has increased uncertainty and will likely lead to more persistent inflation in the near-term. In periods of high uncertainty, the emphasis of our strategy shifts to capital preservation. While much will depend on the dynamics of inflation and the Fed's reaction, we believe fixed income return symmetry has improved and could once again serve as ballast against more volatile portfolio risk allocations.

Indices

The **Bloomberg Barclays US Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and nonagency).

The **Bloomberg US Corporate High Yield Index** measures the performance of USD-denominated, non-investment grade, fixedrate, taxable corporate bonds, including corporate bonds, fixed-rate bullet, putable, and callable bonds, SEC Rule 144A securities, Original issue zeroes, Pay-in-kind (PIK) bonds, Fixed-rate and fixedto-floating capital securities.

Important Disclosures

"Bloomberg®" and the Bloomberg indices are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the index (collectively, "Bloomberg") and have been licensed for use for certain purposes by PNC Capital Advisors LLC. (PCA). Bloomberg is not affiliated with PCA, and Bloomberg does not approve, endorse, review, or recommend this material. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to the information herein.

This publication is for informational purposes only. Information contained herein is believed to be accurate, but has not been verified and cannot be guaranteed. Opinions represented are not intended as an offer or solicitation with respect to the purchase or sale of any security and are subject to change without notice. Statements in this material should not be considered investment advice or a forecast or guarantee of future results. To the extent specific securities are referenced herein, they have been selected on an objective basis to illustrate the views expressed in the commentary. Such references do not include all material information about such securities, including risks, and are not intended to be recommendations to take any action with respect to such securities. The securities identified do not represent all of the securities purchased, sold or recommended and it should not be assumed that any listed securities were or will prove to be profitable. **Past performance is no guarantee of future results.**

PNC Capital Advisors, LLC claims compliance with the Global Investment Performance Standards (GIPS®). A list of composite descriptions for PNC Capital Advisors, LLC and/or a presentation that complies with the GIPS® standards are available upon request.

PNC Capital Advisors, LLC is a wholly-owned subsidiary of PNC Bank N.A. and an indirect subsidiary of The PNC Financial Services Group, Inc. serving institutional clients. PNC Capital Advisors' strategies and the investment risks and advisory fees associated with each strategy can be found within Part 2A of the firm's Form ADV, which is available at https://pnccapitaladvisors.com.

©2022 The PNC Financial Services Group, Inc. All rights reserved.

FOR INSTITUTIONAL USE ONLY

INVESTMENTS: NOT FDIC INSURED-NO BANK GUARANTEE - MAY LOSE VALUE