

Hike-steria

Fear and Loathing in a Rising Rate Environment

As markets wrestled with the Federal Reserve's (Fed's) more hawkish pivot, investor consternation reached a fever pitch in late January that pushed major stock market indices into correction territory.

The initial catalyst was the January 5 release of minutes from the December Federal Open Market Committee (FOMC) meeting that suggested the Fed may move more quickly to tighten monetary policy. This included both raising the fed funds rate "sooner or at a faster pace than participants had earlier anticipated" as well as reducing balance sheet holdings (aka quantitative tightening) "relatively soon after beginning to raise the federal funds rate."

Markets continued to gyrate, and volatility rose while the Fed was in a quiet period ahead of the scheduled January 25-26 FOMC meeting. Although the Committee presented a more balanced outlook in its written meeting statement, during the subsequent press conference, Chair Jerome Powell's tone was interpreted as more hawkish. Since announcing an acceleration in the wind-down of the Fed's quantitative easing program in November and then again in January, markets have increasingly discounted a more compressed timeframe for the withdrawal of policy accommodation.

Recently, it has felt like pundits are playing a version of liar's poker to see who can predict the most Fed rate increases during 2022 (one forecast equates to a 25 basis point increase at every meeting over the balance of the year!). While we acknowledge Fed policy seems out of step with current readings on employment and inflation, we believe the Fed will withdraw accommodation in a deliberate and measured way as we get clarity on the

economic crosscurrents that are impacting the outlook for growth, employment and inflation. In the FOMC's Summary of Economic Projections from December, the median forecast among participants was for three hikes in 2022; the market is currently pricing in more than five hikes. With an expectation that balance sheet run-off begins in the second half of 2022, we believe four increases in the fed funds rate during the year is a reasonable baseline forecast.

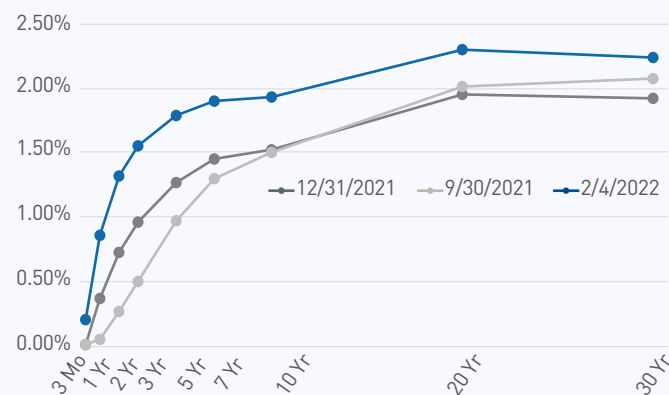
Certainly, much uncertainty remains, and both the Fed and markets will be hypersensitive to the evolution of the economic outlook — the data will likely have beta. As the Fed begins removing policy accommodation, the outlook on economic fundamentals (both growth and inflation) continues to evolve. The preliminary estimate for fourth quarter GDP came in above expectations but was bolstered by a near 5% increase in inventories. The Atlanta Fed GDPNow first quarter 2022 forecast has trended toward zero recently as economic data since mid-December have softened due to lingering effects of the Omicron wave. Survey-based data suggests we are seeing early signs of thawing in supply chains, which should help alleviate some inflation pressures, but this will take time to flow through the data.

Market Update

January 2022 was arguably one of the worst starts to a year for a variety of asset classes. In fixed income markets, the yield curve continued to flatten as front-end rates moved up substantially to reflect anticipated changes in Fed policy rates (Figure 1, page 2).

Figure 1. U.S. Treasury Yield Curves

Front-end rates moved substantially higher to reflect anticipated Fed changes



Source: Bloomberg, L.P.

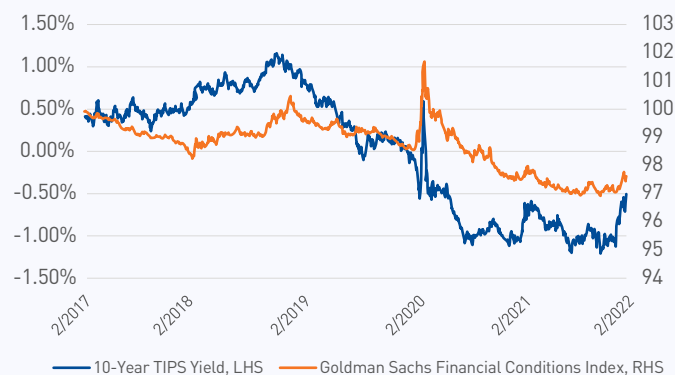
This resulted in the worst total return for the Bloomberg 1-3 Year Government/Credit Index in the last 10 years and the second worst in the last 20 years. The Bloomberg Aggregate Index generated a return of -2.15%, which ranks as the fifth-worst monthly loss in the last 20 years. At the same time, real rates moved up dramatically as the yield on the 10-year Treasury Inflation Protected note approached -0.50% — levels last observed in March 2021. While rates remain deeply negative, financial conditions have begun to tighten modestly. We remain attentive to how risk assets will respond (Figure 2).

During January, lower quality underperformed higher quality in terms of excess return across investment grade, while in high yield BB-rated credits' higher duration led to underperformance from both a total and excess return perspective. This repricing has presented better risk/return symmetry in higher-rated high yield issuers, particularly relative to opportunities in BBB-rated investment grade. Thus far, investment grade markets remain

relatively sanguine. Given our constructive outlook on fundamentals, we will continue to evaluate volatility-induced spread widening events as potential opportunities to reposition client portfolios. Historically, periods of significant negative total return for the Bloomberg Aggregate Index have produced good excess returns for both Credit and Mortgage-Backed Securities over a 3-month horizon (Figure 3).

Figure 2. 10-Year TIPS Yield vs. Goldman Sachs Financial Conditions Index

TIPS yields are spiking to March 2021 levels while financial conditions have tightened



As of 2/4/2022 | Source: Bloomberg, L.P.

Figure 3. Bloomberg Aggregate Index, Average Forward Excess Return when Monthly Total Return was ≤1% 12/31/2001 - 1/31/2022

	1 Month (%)	3 Months (%)
Corporate Credit	-0.09	0.99
Credit	-0.17	0.85
Aggregate	-0.27	-0.03
MBS	0.03	0.32

As of 1/31/2022 | Source: Bloomberg, L.P.

For more information, please contact your PNC advisor.

Indices

The Bloomberg US 1-3 Year Index measures the performance of investment grade, US dollar-denominated, fixed-rate, taxable corporate and government-related debt with 1 to 2.9999 years to maturity.

The Bloomberg 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).

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