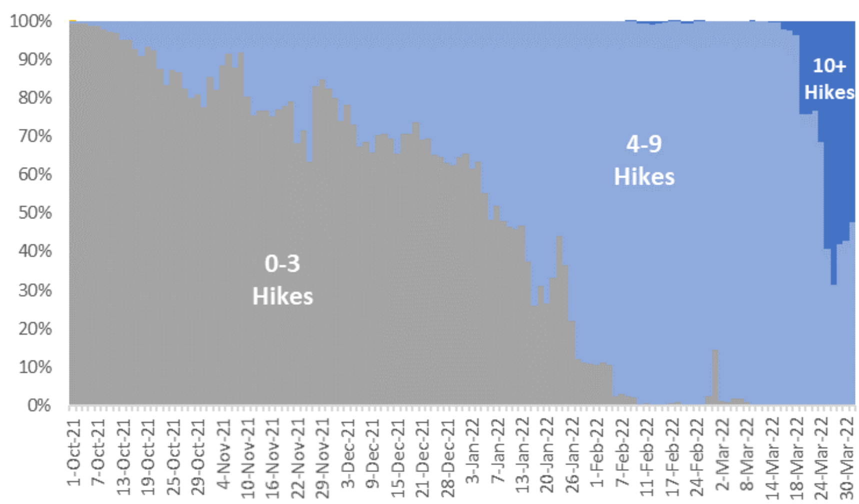
FIXED INCOME

We concluded our Q4 2021 Fixed Income commentary with "bond buyers be warned." And hopefully those with the flexible mandate to take cover did so, because bonds just had their worst three-month period in more than 40 years. The Bloomberg US Aggregate Bond Index declined -5.9% during the quarter. The last time bond holders saw that kind of mark-to-market loss was in September 1980, but that was in the context of the 10-year Treasury yielding 12% – a very different risk-return proposition.

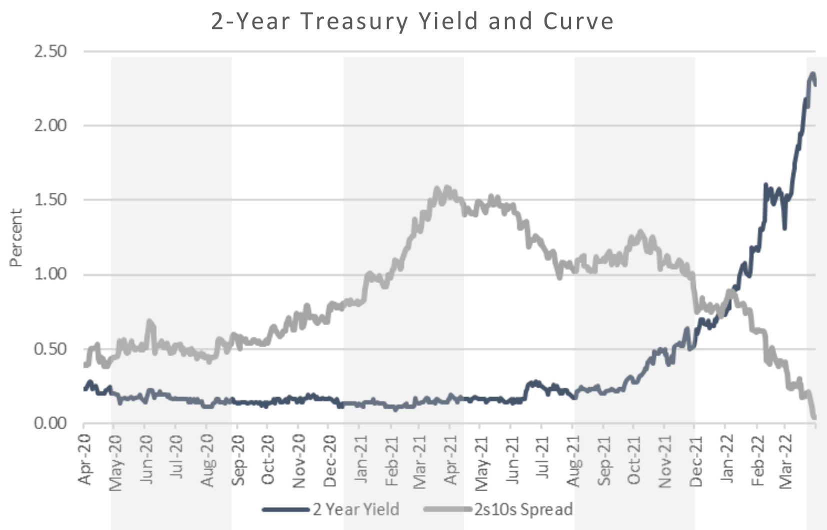
We were not alone in voicing concern. Consensus at the beginning of 2022 was calling for higher yields. But the magnitude of the move caught many by surprise. It was clear bonds would take pain as central bankers choreographed their growing hawkishness in response to multi-decade highs in inflation. But few expected that markets would move from pricing three quarter-point hikes in the Fed Funds policy rate during 2022 to a staggering ten. An important silver lining: this has occurred without visible cracks, so far, in financial markets.

Market Implied Probability of Rate Hikes by December 2022



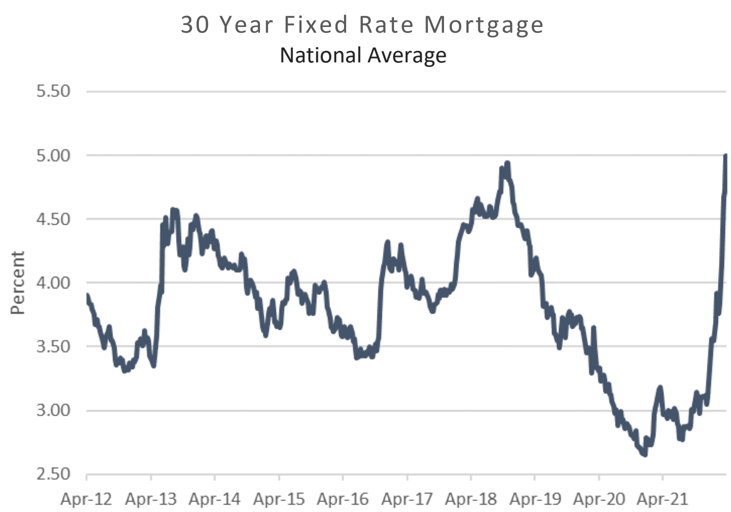
Source: CME FedWatch

While the Fed is only one hike into this cycle, the market is already doing a lot of the work in tightening financial conditions. Two-year yields jumped 155 basis points during Q1 to 2.28%, and 2s10s tightened by 75 basis points, briefly dipping into negative territory.



Source: US Department of the Treasury

The borrowing rate for high quality corporate bonds of a similar maturity widened by an additional 21 basis points. Mortgage rates have topped 5% for the first time in more than decade as also discussed in our real estate commentary. When combined with elevated home prices and tight inventory, this has made "the pursuit of homeownership the most expensive in a generation" according to an assessment by Freddie Mac.



Source: Freddie Mac Primary Mortgage Market Survey

In this context – and the dimming outlook for global growth, the market may have moved beyond where the Fed will go. The last dot plot suggested central bankers envisaged the equivalent of six more 25 basis point hikes, rather than the ten now priced in. Although real returns on bonds remain negative, and therefore unattractive, we think there is reason to be less bearish about the asset class.