NORTHERN TRUST
ASSET MANAGEMENT

GLOBAL BOND MARKET UPDATE: NOWHERE TO HIDE WITH INFLATION, RATE HIKES

INTEREST RATE VOLATILITY LIKELY TO PERSIST, ESPECIALLY WITH SHORTER TERM BONDS, AS CENTRAL BANKS ACT AGGRESSIVELY

Worsening inflation is forcing global central banks to act more aggressively. We've raised our rate expectations in line with market consensus. As persistent inflation hits consumers and higher interest rates trim lending, we believe the odds of a modest recession are equal to the odds of growth. Rate volatility is likely to persist in the front end, with longer maturities stabilizing in line with long-run economic growth potential.

Higher Treasury rates, along with volatility and increasing talk of recession, depressed fixed income returns. Entering the second quarter, we forecasted two-year and 10-year Treasury yields of 2.25%. With inflation reaching historically high levels and consistently hawkish Federal Open Market Committee (FOMC) commentary, we raised our six-month forecast for two-year and 10-year rates to a central tendency of 3%.

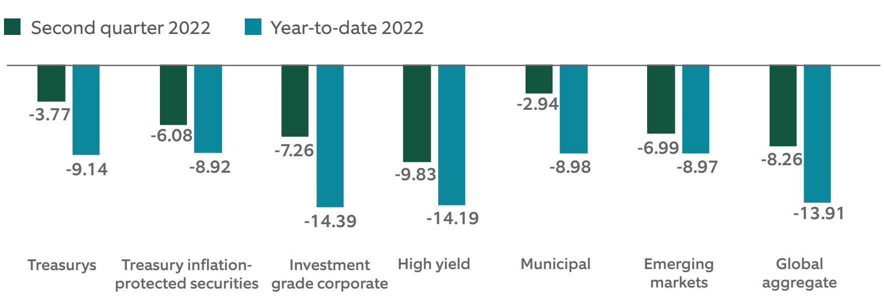
Key Takeaways

- Global bond losses mounted in the second quarter, with persistent inflation, higher interest rates and a rising chance of recession in the U.S.
- Government bonds in the U.S. and Europe had losses due volatility and tight liquidity.
- U.S. high yield bonds had the second-largest quarterly loss since global financial crisis of 2008-2009, as investors fled risk.

EXHIBIT 1: BOND LOSSES MOUNTED WITH RISING INTEREST RATES

Higher Treasury yields, along with volatility and increasing talk of recession, depressed fixed income returns.

Bond Market Returns (%)



Sources: Northern Trust Asset Management, Bloomberg, data from January 1, 2022 to June 30, 2022. Past performance is not indicative or a guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

GLOBAL CENTRAL BANKS: SWIFT MONETARY ACTION

Many global central banks increased their target rates, attempting to slow their economies and control inflation. The Fed raised its rate at the March and June meetings by 0.50% and 0.75%, respectively. The June increase of 75 basis points was the largest rate hike since 1994. Ten of 11 voting members favored the 75 basis point increase, highlighting the committee's desire to do whatever is necessary to lower inflation. Also reflecting their commitment, the Fed's "dot plot" shows a year-end 2022 median dot of 3.4%, up from 1.9% in March. Interestingly, the new projections show a rate cut in 2024. This projection signals to the market that the Fed is willing to raise rates above "neutral" with the aim of achieving their dual mandate of price stability and full employment. Additionally, the Fed announced they would begin running off their balance sheet at a pace twice as fast as their pace following the Global Financial Crisis of 2008–2009.

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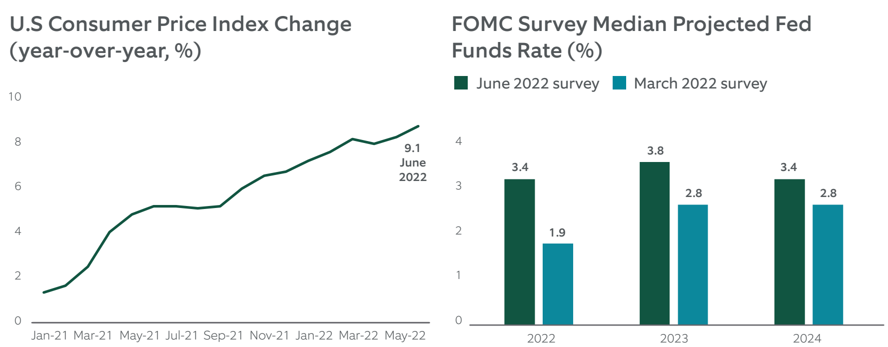
The Bank of England (BoE) resisted the temptation to follow the Fed, opting to continue their consistent 25 basis point path and taking the base rate up to 1.25%. As we saw at the May meeting, the vote was split 6–3 in favor of the 25 basis point hike, with the same three members as in May voting for a more aggressive 50 basis point move. The European Central Bank (ECB) left policy rates unchanged at their June meeting and announced that as of July 1 they would end purchases under their asset purchasing program. The ECB indicated they would begin hiking rates at their July meeting by 25 basis points, but their language for the September meeting hawkishly implied that a larger move of 50 basis points is their baseline before reverting back to a "gradual but sustained" path for normalization. The Swiss National Bank, Bank of Canada, Bank of Australia and numerous other central banks also hiked rates.

EXHIBIT 2: SPIKING INFLATION BOOSTS FED RATE HIKE PROJECTIONS

As inflation has spiked, the "dot plot" surveys of Federal Open Market Committee (FOMC) members show they expect higher Fed funds rates.



Sources: Northern Trust Asset Management, Bloomberg. U.S. Consumer Price Index data is from January 2021 to June 2022.

TREASURYS: MORE VOLATILITY AND HIGHER RATES

Volatility and tight liquidity in the Treasury market persisted into the second quarter. Treasury yields across the curve continued marching higher, with some maturities reaching their highest yields in over a decade. Liquidity remained an issue for the market. Some liquidity levels were at or worse than during the depths of the pandemic. Excess leverage likely played a role in the volatility, although some of the volatility can be attributed to fundamental factors.

The curve inverted in multiple areas, meaning that short tenors offer higher yields than their longer counterparts. Inversion often suggests that investors believe that inflation will remain high in the near term, forcing the Fed to keep raising rates. However, it also signals that investors fear that the increase in near-term rates is likely to hamper future growth, depressing long end yields.

The Treasury inflation-protected securities (TIPS) market had similar liquidity issues and stress when compared to nominal Treasuries. After moving higher in the beginning of the quarter, TIPS real yields increased and the break-even rate narrowed as a sign of the Fed's commitment to fight inflation.

Similar to what happened in the U.S., European Union rates sold off throughout the quarter as market participants began to anticipate aggressive paths for rate hikes in both the U.K. and across both core and peripheral EU member countries (Spain and Germany). However, weak economic data began to affect sentiment later in the quarter, and market participants took on a notably riskoff tone. Two-year and 10-year gilts moved up 49 basis points (from 1.35% to 1.84%) and 10-year yields increased from 1.61% to 2.23% (+62 basis points). A similar theme applied to Germany, with two-year bund yields increasing by 72 basis points (from -0.07% to 0.65%) and 10-year yields increasing from 0.55% to 1.34% (+79 basis points).

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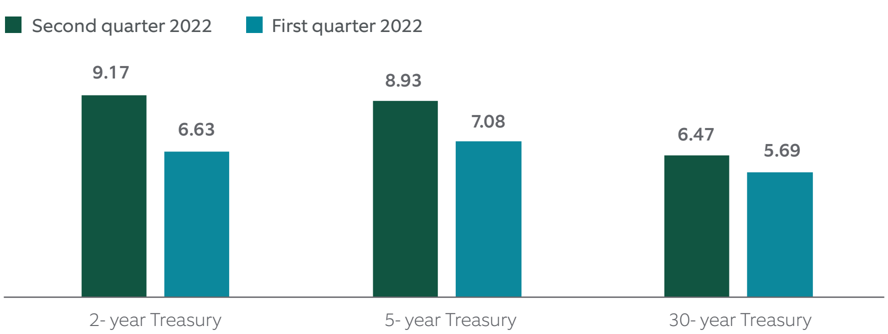
EXHIBIT 3: TREASURY YIELD VOLATILITY ON SHORT END

Yields of shorter term bonds exhibited the most volatility, reflecting concerns that the Fed may raise rates further and that economic growth will slow.

Daily Volatility of Treasury Yields (basis points)



Sources: Northern Trust Asset Management, Bloomberg, daily data from January 1, 2022 to June 30, 2022

SHORT-TERM BONDS: AFFECTED BY SUPPLY-DEMAND MISMATCH

Short end investors continued to prefer floating rate paper over fixed rate securities. Treasury bill issuance fell more than $400 billion during the quarter. The lack of supply and the likelihood of additional rate increases have caused investors to increase their allocations to overnight cash and money market funds, shortening their weighted average maturity. As a result, the Fed's overnight reverse repo program usage increased throughout the second quarter, setting new all-time records.

We still do not expect the usage of the reverse repo program to drop meaningfully until the balance sheet normalization process is well under way. Therefore, we expect a continued supply/demand mismatch, and short government paper will likely continue to trade at or below the reverse repo program's rate. We remain focused on principal preservation, liquidity and yield, with particular attention on liquidity across our portfolios to accommodate any unexpected outflows.

The Bloomberg 1-3 year corporate index lost 1.02% for the quarter, outperforming the intermediate and long corporate indexes. 1-3 year credit spreads as measured by the Bloomberg 1-3 year option adjusted spread widened by 34 basis points, from 59 to 93 basis points. The move in spreads can be attributed to macroeconomic factors such as growth, inflation and monetary policy.

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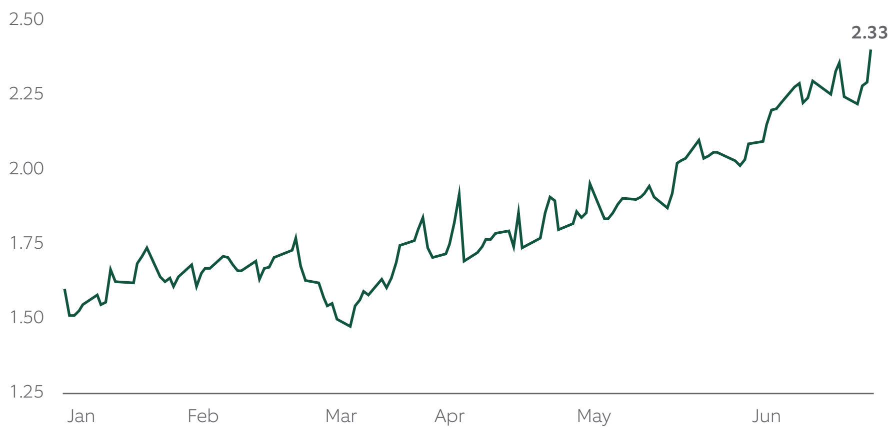
EXHIBIT 4: REVERSE REPO FACILITY USAGE ROSE AND IS UNLIKELY TO DROP SOON

Daily reverse repo facility usage rose, due to a supply/demand mismatch that's likely to persist until the Fed's balance sheet normalization is well under way.

2022 Fed Reverse Repo Daily Usage($ billion)



Source: Northern Trust Asset Management, Bloomberg, daily data from January 1, 2022 to June 30, 2022

INVESTMENT GRADE CORPORATES: HIT BY HIGHER RATES

As interest rates and recession fears rose, investment grade corporates continued to suffer. Investment grade option adjusted spreads widened 44 basis points to end the quarter at 155, the widest spread year-to-date. All investment grade corporate credit ratings fell, led by AAA (-8.22%). Additionally, investment grade funds had outflows every week of the quarter, further depressing bond prices. This is the longest stretch of outflows since 2004. Hedging costs have also been rising, which reduces foreign demand for bonds. The broader economic backdrop and interest rate moves caused a significant decline in investment grade corporate issuance, which often fell below weekly estimates. Companies issued only $263 billion worth of investment grade corporate bonds, bringing the year-to-date total to $716 billion. We continue to like a diversified approach with a focus on value in the "belly" of the yield curve and look to position defensively. Broader market exposure through security selection remains a focus, while we are looking for opportunities to add credits that have widened beyond fair value.

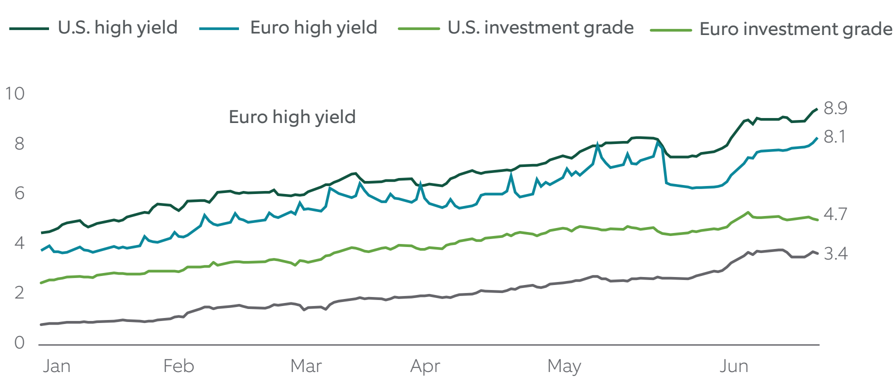
Weaker-than-anticipated German consumer price index statistics, which followed weak U.K. labor market data and purchasing manager index misses in France and Germany toward quarter-end, caused market participants to question the true strength of both the British and eurozone's economies. Sterling option adjusted spreads widened by a total of 60 basis points (from 147 to 207 basis points) and the Bloomberg Euro Aggregate Corporate Bond Index's option adjusted spreads widened by 89 basis points (129 to 218 basis points) as market participants took on a decidedly risk-off tone as the quarter progressed.

The broader economic backdrop and interest rate moves caused a significant decline in investment grade corporate issuance.

EXHIBIT 5: INVESTORS ARE PESSIMISTIC ABOUT CREDIT RISK

As the market prices in an unclear economic growth trajectory, investors are looking to be compensated for the increased credit risk.

2022 Yield to Worst for Corporate Bonds (%)



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HIGH YIELD: ROUGH QUARTER

After one of the best performances in the fixed income market during the first quarter, U.S. high yield corporates reversed course and had their second worst performance since the global financial crisis of 2008–2009. The high yield index's option adjusted spreads widened over 240 basis points, ending the quarter at 569 basis points. Although high yield corporates are less sensitive to interest rates than other fixed income, the broader risk-off sentiment hurt returns. CCC rated bonds fared the worst, recording their largest second quarter loss on record. Spreads on CCC rated bonds widened 418 basis points to close at 1,043 basis points, a level not seen since the summer of 2020. The spread widening also suggests that investors want to be compensated for the increased credit risk. Given the risk-off sentiment, coupled with robust 2020–2021 issuance, the primary market priced a dismal $25 billion of bonds. We continue to have a positive view of the fundamental backdrop for high yield, focusing on the mid-range of the credit quality spectrum to capture potential spread compression. The European high yield market saw even less issuance, pricing a mere €6 billion, the least since the second quarter of 2012. Affected by similar factors, the euro high yield market widened 257 basis points, ending the quarter at 650 basis points. Euro CCC rated bonds were high yield's worst performers, returning -12.07%.

Municipal bonds outperformed for the quarter, as higher yields and slowing new issue supply offset continued fund outflows and attracted new institutional buyers.

MUNICIPAL BONDS: OUTPERFORMED THANKS TO HIGHER YIELDS AND SLOWER SUPPLY

Municipal bonds outperformed for the quarter, as higher yields and slowing new issue supply offset continued fund outflows and attracted new institutional buyers. This modestly lowered municipal/Treasury ratios. The overall municipal index returned -2.94% for the quarter and -8.98% for the first half of 2022, a record loss for the first six months of the year. Shorter portfolio mandates outperformed their longer counterparts during the quarter, due to yields higher by 5 basis points and 25 basis points, respectively, in 1 and 5 year tenors and 55 basis points and 65 basis points in 10 and 30 year tenors, respectively. The muni yield curve steepened by 60 basis points from one to 30 years, ending the quarter at 158 basis points — 117 basis points steeper than the Treasury curve. AAA credits outperformed BBB credits by exactly 2%, as credit and coupon spreads continued widening from their tight levels at the end of 2021.

Municipal technicals started to improve into quarter-end as fund outflows slowed incrementally and higher rates resulted in less refunding issuance. Interest rate risk should typically be neutral to start trending toward long as the quarter progresses, with seasonal cash flows expected to create a net negative new issue environment. With the dramatic steepening of the yield curve in the second quarter of 2022, barbell structures will be increased, particularly in shorter mandate portfolios. Credit spreads widened dramatically in the airport and hospital sector, after record compression throughout the second half of 2020 and full-year 2021, with new issue coming at significant concessions and offering opportunities in select issuers. We generally remain biased to higher rated credits and sectors, particularly state and local general obligation bonds. The overall credit trend for state and local governments looks bright, with strong revenue growth and the final payouts of federal stimulus money resulting in increases to rainy day funds and overall pension funding levels.

Unless otherwise noted all data is sourced from Bloomberg as of 6/30/22.

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