Reams Asset Management

Investment Outlook 2022

"Generals are always prepared for the last war" – *anon*.

December 7, 2021, marked, quite unbelievably, the 80th anniversary of the attack on Pearl Harbor. The 1941 surprise attack by Japanese forces on the Hawaiian base of the U.S. Pacific Fleet cost the United States 2,403 lives, with nearly half of the casualties from the sunken battleship *USS Arizona*. President Franklin Delano Roosevelt aptly described the events as "a day that will live in infamy," and the attack heralded the formal start of United States participation in World War II.

Along with the solemn ceremonial duties and remembrances, as well as recognition for the precious few WWII servicemen and women still with us today, discussion about the attack itself turned once more to the questionable Japanese strategy of proactively attacking the United States. The primary impetus for Japan was straightforward: to solidify its position as regional hegemon following significant expansion of its empire in the 1930s and, more proximately, to access crucial natural resources in the Dutch East Indies (modern day Indonesia) and the Philippines (a U.S. colonial dependency at the time). After a decade of U.S. isolationism following the First World War, the United States had finally begun to push back on Japanese expansion. Following Japan's incursion into the southern part of French Indochina, the United States imposed sanctions in July 1941 that froze all Japanese assets held in this country and effected a *de facto* oil embargo on Japan, which previously sourced 80% of its oil from Standard Oil of California. Largely cut off from two key inputs to its war machine, money and oil, Japan found its position untenable.

Calculating that a conflict with the United States was inevitable, Japan's initial plan was to invade British territories in Southeast Asia, the Dutch East Indies, and the Philippines; wait for the U.S. naval fleet to approach in response; and then attack the U.S. fleet at the Marshall Islands. This more orthodox plan lost out, however, to a preemptive surprise attack on Pearl Harbor, which Japan believed would decimate the U.S. Pacific Fleet in one fell swoop. On this last point, Japan made a fateful strategic blunder. Though all eight major U.S. battleships in the Pacific were in port that sleepy morning, in addition to dozens of destroyers and cruisers, the three Pacific-side aircraft carriers (the *Lexington*, *Enterprise*, and *Saratoga*) were elsewhere at the time. Accounts from Japanese veterans and intercepted communications all point to the fact that Japan was monitoring ship movement in and out of Pearl Harbor and knew in advance that the aircraft carriers were not there. The morning of Sunday, Dec. 7 was indeed deliberately chosen as the date for the surprise attack, as most ships did not depart on a Sunday. With a full house of idle battleships, then considered the most potent weaponry in the entire U.S. Navy, the urgency to proceed was too great for Japan to postpone to a later date in hopes of catching the carriers in port.

In this sense, Japan was leaning heavily on a historical sense of what was effective during the most recent global conflict, the horrific World War I of 1914-1918. The then-new dreadnought battleships, particularly the British fleet, had played a key role due to their ability to carry heavier artillery than anything else at sea, forcing Germany to play catch-up and pursue an increasingly expensive arms race. By 1941 the world was a very different place, however, and aircraft with better range and reliability had rapidly emerged as the leading military vehicle. The large battleships were still valuable, but they were also large targets and were vulnerable from the air and submarine torpedoes. In World War II, despite heavy fortification and protection, more than two dozen battleships were sunk, the majority by aerial attacks from dive bombers and torpedo-equipped planes. By the end of the war, production of battleships had effectively ceased and the aircraft carrier, housing hundreds of aircraft with greatly expanded striking range, would prove to be far more vital for launching WWII operations.

Indeed, the aircraft carrier – whose efficacy was proven by the Pearl Harbor attack itself – would play pivotal roles the following year as the United States eventually gained the upper hand in the Pacific theater after fierce battles at Coral Sea and Midway Island, and later during the pivotal Guadalcanal Campaign.

The quote that prefaces our 2022 Outlook, often misattributed to U.K. Prime Minister Sir Winston Churchill, is an old adage that has been rephrased countless times over many years. The attack on Pearl Harbor is a textbook example of being prepared to fight the last war, insofar as the Japanese military believed that destroying battleships was of paramount strategic importance as the age of air superiority was dawning. Although military in origin, this proverb has almost universal application beyond the battlefield. Our thinking as humans is guided largely by experience and knowledge of what has come before us. History can be a useful guide, and pattern recognition and heuristics are invaluable tools for problem solving. But more often than not, experiences are unique, today's context is different than yesterday's, and no two situations are perfectly alike.

Turning to the capital markets arena, 2021 was quite a unique year, and 2022 could be even more so. The great reopening following the COVID-19 pandemic of 2020 was supposed to lead to extraordinarily strong GDP growth and economic strength. While the economy did rebound sharply, it also did so in a rather uneven and somewhat haphazard fashion. Despite the vaccine rollout, COVID, most unfortunately, never went away and we are still dealing with its myriad ramifications nearly two years after its emergence. Meanwhile, long-gestating fears of inflation finally materialized on the heels of many years of expansionary monetary and fiscal policy worldwide. U.S. inflation exits 2021 at the highest point in 39 years, yet interest rates have remained almost defiantly low, in sharp contrast to historical precedent and traditional economic theory.

Equity markets continued to find reason to cheer, with the S&P advancing 28.7% in calendar year 2021. The rally that commenced in late March 2020 scarcely paused through 2021. Risk assets of all kinds were up, while investors gravitated to new mediums like cryptocurrencies, meme stocks, special purpose vehicles, NFTs, and an assortment of non-traditional speculative vehicles. While we at Reams take a dim view of most of these asset classes, if we are to use that term generously, in 2021 they defied both gravity and fundamental investment analysis on their way to strong gains. When this party will end is anyone's guess, but the music is still playing.

The rise of inflation and stretched valuations across most spread sectors presented a significant challenge to the bond market in 2021, with the Bloomberg Aggregate Index posting a rare negative annual return of –1.5% for the calendar year. Of course, 2020's strong total return across broad fixed income indices made for an inherently challenging follow-up and for the two-year period, overall returns are still well above historical averages. Nevertheless, that provides little solace for those living on fixed incomes and attempting to preserve capital, all the while watching equities and other assets appreciate seemingly without limit while their purchasing power erodes.

Looking forward, consensus around capital markets expectations is weaker than we can recall in recent memory. Estimates for major economic data are shifting rapidly as economies around the world settle into some sort of post-COVID equilibrium. The specter of inflation, a non-issue in the United States for nearly 40 years, is also making this guessing game all the more difficult this year. One thing most participants agree on is that the U.S. Federal Reserve has quite the predicament on its hands, and one that many would posit is largely of its own doing. Tapering asset purchases first and then adopting a more hawkish stance in combating inflation via hiking the Fed funds rate, all while doing no harm to the economy or asset values, seems to be a rather narrow needle to thread.

The reality is that the U.S. economy, and the world more broadly, is in a state of flux along any number of dimensions. No one knows what inflation, employment, or GDP will look like in 2022. Our crystal ball is no better than anyone else's: one reason why at Reams we do not bother much with predictions about macroeconomic data points. We have witnessed enough in our 40 years of managing client assets, not to mention the past two years alone, to know that simply because something has or has not happened in "X" years, does not preclude it from happening in the coming year. So just because higher inflation caused a certain outcome for interest rates, the stock market, or the economy as a whole back in the 1970s and 1980s, does not mean that the same reactions should be expected this time around.

At Reams, we are students of history and are respectful of it. There are lessons to be learned from what has already happened, but these cannot be extrapolated and applied blindly to new situations. We often trade tactically based, in part, on "typical" historical patterns or relationships across certain assets, but these do not dictate our strategic views and positioning. To continue the analogy from above, we need to be ready to fight the next war, not the last one. At this particular moment in time, we would caution investors to avoid dogmatic adherence to long-held assumptions and inflexibility to evolving conditions on the ground. Remain diligent, defensive, and opportunistic in the coming year, and fear no circumstance no matter how daunting it may seem.

What follows is our attempt to lay out key economic data and issues we are tracking, gauge where consensus estimates are, what tail risks exist to that consensus, and what opportunities may present themselves going forward.

Reams' Key Areas of Focus for 2022

Inflation emerged with a vengeance in 2021, but questions regarding its root causes and expected longevity will be critical to assessing capital markets in 2022.

- Inflation quickly skyrocketed in 2021 to levels that were well above previous estimates and continued to run hot throughout the year. Drivers included pent-up consumer demand, supply chain shortages, and pockets of tightness on the labor market.
- The Federal Reserve termed inflation as "transitory" during much of the year, but reality eventually took hold as Consumer Price Index (CPI) readings well north of the Fed target of 2% continued to roll in. Moreover, various components of the CPI, most notably housing/shelter (as expressed by owner's equivalent rent), are lagged statistics that will likely continue to contribute to elevated inflationary pressures.
- While Treasury rates initially moved upward, as might be expected, the second half of the year paradoxically saw rates move haphazardly and the yield curve flatten despite rising inflation concerns. This could be due to the belief – misplaced or otherwise – that the rise in inflation will be temporary and easily containable, or perhaps that runaway near-term inflation could elicit a strong hawkish response from the Fed, leading to lower long-term growth prospects. Conversely, a risk-off backdrop may lead to lower and persistently negative real yields.
- The unemployment rate in the U.S. continues to plummet and is around 4.0%, reflective of strong labor markets. With the participation rate still soft and shifting demographics related to baby boomers retiring, elevated upward pressure on wages could be more structural in the near-term and keep inflation elevated beyond the Federal Reserve's stated timetable, potentially undermining the GDP growth recovery story.

Federal Reserve policy is now under heated debate, even from within; mixed messages and questionable efficacy could produce greater uncertainty moving forward as fiscal and monetary accommodation wane.

- Accommodative Federal Reserve policy has persisted, but now the bond purchase program has begun a "taper" process that will be completed in early 2022. This direct expansion of the Fed balance sheet has heretofore provided a *de facto* floor on asset valuations, whereas now incremental buyers for government debt and agency mortgage-backed securities must step up, with potential knock-on effects for risk assets.
- While the Federal Reserve has taken pains to say the taper program does not foreshadow rate hikes, elevated inflation concerns may force the Fed's hand earlier than anticipated. Even within the Board of Governors, there is wide variance of opinion as measured by the "dot plot," which contains each member's estimate of the number and pace of future rate hikes over the next three years, along with the terminal long-term rate.
- Given the ever-shifting nature of the Federal Reserve's goalposts, not to mention the conflation of its dual mandate (full employment, price stability) with a shadow imperative to prop up risk assets, the Fed's statements and actions over the coming year will undoubtedly influence interest rates and in turn capital markets. The uncertainty of the Board's membership, prioritization of (at times) competing objectives, and a historical tendency to react belatedly to the previous year's concern may roil markets if the efficacy of the Federal Reserve is called into question or an obvious policy error is enacted.
- Meanwhile, direct fiscal support in the United States has helped GDP and consumers in the form of three stimulus payments during the pandemic as well as increased unemployment benefits and enhanced child tax credit payments. These programs were intended as short-term, emergency measures and have now run their course. With the "Build Back Better" legislation fizzling out as 2021 drew to a close, additional large scale direct spending appears unlikely heading into a midterm election year.

The COVID-19 pandemic hasn't left the building. Its effects, economic and otherwise, are still being felt, while the long-term health and policy-response ramifications are unknown.

- COVID-19 concerns abound with yet another spike in cases and hospitalizations at the end of the year due to yet another omicron variant. Despite massive vaccination programs launched nearly a year ago, availability and participation have been uneven. The virus lingers and continues to have far-reaching health and economic implications globally.

- The ongoing virus fears have prevented many businesses from fully or even partially reopening and curtailed many events and in-person gatherings that impact economic activity. Excess deaths, concerns over contracting COVID, and disruptions to education and childcare services have also combined to keep would-be workers at home and out of the labor force.
- Lastly, vaccine mandates and strict policies in the workplace may exacerbate an already fragile workforce picture, creating additional labor shortages in stressed areas such as healthcare and consumer services. This may continue to pressure wages higher, adding more fuel to the inflation fire.
- The true economic cost of this pandemic may never be fully known, but 2021's rapid GDP growth may dissipate almost as quickly as it arrived, as the reality of a pervasive health threat alters and restricts consumer preferences and behaviors in 2022, and perhaps more permanently.

Capital markets have largely ignored disturbing Chinese real estate woes, geopolitical saber rattling in key areas, and political instability in several emerging markets. When any of this begins to matter is a fair question, but the potential impact is not priced into current valuations.

- Decades of aggressive Chinese real estate construction, funded by massive debt issuance, may be coming home to roost with the implosion of dubiously capitalized Chinese real estate entities. Though the government has indirectly intervened in the case of one, this may be the tip of the iceberg of a larger problem that could have a cascading effect.
- Mounting tensions between the United States and China due to due to a confluence of events, including increased attention on the disputed status of neighboring Taiwan as a sovereign state, have been met with a collective shrug thus far from U.S. capital market participants.
- Elsewhere, geopolitical hotspots remain abundant in many emerging market areas, including South America, the Middle East, and Russia/Ukraine.
- Some of this backdrop is reminiscent of 2007, when early issues related to housing and subprime securitizations were dismissed, ignored, or rationalized. While every situation is inherently different, and geopolitical risks are ever-present, global discord appears to be on the rise. If the trend continues, this could elevate volatility and manifest in severe pricing dislocations relative to expectations or current valuations.

What is the consensus viewpoint?

	2021 Actual	2022 Consensus	2022 Downside	2022 Upside
GDP Growth	**4.90%**	**3.90%**	**2.50%**	**4.75%**
Unemployment Rate	4.20%	3.90%	4.50%	3.70%
CPI Inflation Rate	6.80%	3.70%	2.75%	6.00%
Federal Funds Target Rate	0.25%	0.82%	0.25%	1.25%
10-Year U.S. Treasury Note	1.51%	2.04%	1.20%	2.70%
IG Corp OAS Spread	+92	----	+145	+70
ML High Yield YTW	4.28%	----	5.75%	3.70%
VIX Index	17.22	----	35.00	12.00

**Consensus Economic Forecasts based on Bloomberg Survey Results as of December, 2021. Federal Funds Target Rate represents upper band guidance.*

For 2022, surveyed economists (per Bloomberg, see chart above) collectively forecast GDP growth of 3.9%, a similar level as last year's estimate, which ultimately proved too conservative. With fourth-quarter 2021 GDP yet to be reported, full-year 2021 economic growth could come in close to 5.5%, which would represent the highest year-over-year mark since 1984. To be sure, the natural bounce-back effect from 2020 significantly aided 2021's result. Still, year-over-year (YoY) GDP growth of 5% (or more) followed by another year of roughly 4% (projected) growth in 2022 equates to a substantial expansion of the U.S. economy. This has been the deliberate impact of accommodative and experimental monetary policy coupled with massive fiscal stimulus. The resultant debt binge may portend problems down the road, but for the purposes of near-term economic activity, the programs were successful in their primary objective. The pent-up demand from consumers was unleashed, albeit not in a linear fashion, due to the COVID-related waves of economic activity and supply chain disruptions in many areas. The housing sector continues to be a large contributor to GDP growth, as home prices and new construction march ever higher due to low supply, increases in labor costs and raw material prices, remote work flexibility, and of course exceptionally low mortgage rates.

The unemployment rate decline was one of 2021's most encouraging statistics, plummeting from a starting point of 6.7% to just less than 4.0%. Further reduction will be increasingly challenging, however, with the consensus estimate indicating a year-end 2022 rate of 3.8%. Outside of this positive trend in the headline unemployment rate, the labor market faces some distortions underneath the surface. Total employment in several industries remains well below pre-COVID levels – healthcare, hospitality, and childcare, to name a few examples – and labor force participation has yet to fully recover. As the labor market continues to realign itself in a post-COVID world, this has led to a somewhat strange dynamic where some industries have not yet regained (and may never regain) all of the jobs that were lost during the pandemic, while others are struggling to find enough workers to fill open positions. This scarcity of available labor in certain areas has led to higher wages, as well as staffing headaches for businesses and likely some suppression of economic output along the way. The challenging labor picture is unlikely to improve unless the dislocated and disaffected working-age population returns to the workforce in large numbers.

Another major surprise in 2021 was the rapid increase in inflation as measured by the CPI. While the post-COVID economic recovery was expected to briefly lift prices, the duration and magnitude took many by surprise. The headline index now runs at a whopping 7.0% YoY rate, buoyed by sharply higher energy and food prices, as well as the rising costs of shelter/rent. This last component of CPI, which uses owners' equivalent rent as a proxy, is a lagged statistic that will likely stay elevated well into 2022, contributing significantly to run-rate CPI that is projected at 3.7% for 2022, well above the Federal Reserve target of 2.0% annually. Supply chain shortages, most critically in semiconductor manufacturing, have hurt output in a number of sectors, including automobiles, which spilled over to incredible increases in used and rental car prices. Relief to supply chain shortages could bolster the "transitory" inflation argument, but the clock may have already run out on that particular narrative.

Interest rates rose in the first quarter of 2021 in sympathy with inflation, but quite unexpectedly retraced a significant portion of the move higher during the remainder of the year despite inflation prints and inflation expectations continuing to ratchet upward. At the close of 2021, the 10-year benchmark Treasury rate stood at 1.51%, up +59 bps from year-end 2020. This rate movement was significant but was mitigated in part by the continuing accommodative backdrop. The Federal Reserve communicated in late 2021 a desire to taper its asset purchase program more quickly than initially envisioned, purchasing $30 billion less each month and concluding by March of 2022. At that point the Federal Reserve will not be purchasing Treasurys (or agency mortgage backed securites, or MBS) which, along with a series of expected rate hikes, points to higher rates moving forward, as evidenced by the consensus projection of a 2.04% 10-year rate by the end of 2022. Essentially, this estimate encompasses several Fed rate hikes in 2022, though remains shy of the 2.50% consensus terminal Fed funds rate currently projected in the Fed's "dot plot."

The Chicago Board Options Exchange (CBOE) Volatility Index, or VIX, a key measure of equity volatility, spiked during the first quarter of 2021 but was generally far more subdued than in 2020. Late year jitters lifted the index to 17.2 at the close of the year, suggesting expectations of more volatility to come with accommodative policies receding. A VIX level above 30, reached briefly in early December 2021, would be indicative of a risk-off environment. Such a backdrop, on a sustained basis, would likely present opportunities in the fixed income markets for opportunistic trading.

Elsewhere, global GDP is projected to rise by 4.4% in 2022, down from nearly 6% in 2021 but still well above the pre-COVID average of 3.6% from 2014 through 2019. The European Union is in line with the global figure, with forecasted GDP growth of 4.3%, while China's GDP is expected to grow at a 5.2% rate. This figure is notable for China because this level, while still strongly positive, would represent a marked slowdown versus previous years and China's lowest growth rate in 30 years of data, excluding 2020's COVID-impacted print. The 4.4% global figure, with China contributing less than it has historically, suggests that other markets, both developed and emerging, have fairly aggressive GDP growth estimates.

Consistent with Reams' traditional approach to scenario analysis, we prefer to focus on the factors that might cause results to deviate from the consensus, either to the upside or downside.

What is the downside case (in interest rates) to consensus?

Despite a rise in rates in 2021, lower interest rate scenarios again appear improbable for 2022. Still, as we alluded to earlier, past is not prologue. Even in 2021, despite the overall move higher, there were several shorter periods where rates declined on data points large and small. The most salient case for lower rates starts out with the fact that, all else equal, there is a lot of incentive to keep rates low – some might say artificially low – among many interested factions. Many borrowers, especially high yield issuers or emerging market sovereign nations, rely on functioning capital markets for liquidity and have survived, if not thrived, under the current low rate regime. Investors also cheer at low rates, as speculation is encouraged and risk-taking deemed prudent with paltry returns on low-risk assets as the alternative. Lastly, the Federal Reserve would love to have every excuse not to hike rates, hence the nearly year-long, recently concluded campaign of dismissing inflation reports as merely "transitory."

The most obvious case for rates to head lower stems from the emergence of a sudden or significant risk-off trade. If market participants become spooked, uncertainty is elevated or negative events/data shine a new and unfavorable light on valuations, then risk assets sell off and, traditionally, investors seek out U.S. Treasurys as a refuge. This is typically done irrespective of the prevailing yield levels of U.S. Treasurys, as return *of* principal takes precedent over return *on* principal. What type of risks could spur such sentiment change? There are undoubtedly many and varied scenarios but for the sake of brevity, we will focus on two of the more plausible events: the re-emergence of COVID-related risks and the possibility of China causing a risk sell-off due to either contagion of their real estate debt woes or geopolitical saber rattling.

Since its onset nearly two years ago, the COVID-19 pandemic has irrevocably changed life and influenced behavior, beyond of course the human toll that sadly continues to mount. While most businesses have reopened, the various waves of increased cases and hospitalizations, despite a largely successful vaccination program, have caused periodic bouts of risk indigestion for the capital markets. Although these have been cyclical in nature, the omicron variant renewed concerns that COVID is not going away, and in fact may never truly go away completely, which continues to limit travel, leisure, and other service sector activity. Business activity continues to be subdued, the desire to work remotely remains popular, and large indoor gatherings are still highly limited. Various European countries have reinstituted curfews, lockdowns, or closures in the wake of yet another case spike, and such policies could have a material impact on economic output and employment over the next year.

The second key risk factor for 2022 is once again China. Longtime Reams Outlook readers will nod knowingly that China has been a near constant mention in this space, more often than not delivering minimal impact on subsequent capital market performance. So why is this year potentially different? For one, beginning in summer 2021, we have witnessed a rash of high profile credit blow-ups related to Chinese real estate developers, most notably one now in default with a whopping $300 billion in liabilities against questionable assets. While the Chinese government ultimately stepped in to ensure orderly proceedings, this real estate bubble may indeed have popped and the consequences may reach beyond China's shores. China's GDP growth is also notably slowing, with 2022 GDP estimates below the 6.0% mark for the first time in decades (excluding 2020). If China GDP disappoints further, or the widely anticipated gradual slowing of growth is anything but gradual, the impact on global economic activity and capital markets could be profound. Lastly, relations between the United States and China continue to be strained and the sovereignty status of Taiwan remains a potential flash point. Any geopolitical disruption could be all it takes to send equities in a tailspin, with rates falling in sympathy.

What is the upside case (in interest rates) to consensus?

It is worth noting that many of the conditions for the "upside" rates case last year – accelerating inflation, stronger than anticipated GDP growth, and plummeting levels of unemployment – were actually met in 2021 and in most cases, exceeded even the high-end estimates. While this did lead to higher rates year-over-year, the increase was far more muted than historical context would have suggested. For 2022, the same underlying conditions may again be the most obvious recipe for higher than expected rates. Elevated inflation levels, propelled by wage growth, tight labor markets, strong demand for goods and services, and escalating consumer prices, could present a major challenge in 2022. If the current inflation trend proves to be more structural than transitory, and perhaps the Fed is too slow to react to this new reality, then sharply higher rates could ensue.

After a modest head fake in 2021, 2022 could be the year where rates level-set with the realities of a hot economic backdrop. The taper program is clear evidence of the Federal Reserve pulling back, albeit gradually, from having its thumb firmly on the scales of capital markets. This action alone will require additional buyers of both government and mortgage-backed debt to surface and these would-be buyers may demand an extra premium. Though fiscal spending will be lower year-over-year after the expiry of several stimulus efforts, the U.S. government still has a heavy new issuance calendar ahead, particularly in light of the recently passed $1.2 trillion infrastructure bill that represents a hallmark of the Biden administration agenda. A further reconciliation bill appears unlikely, but if enacted could trigger additional deficit spending that would spur even greater government debt issuance. Lastly, persistently high inflation readings are causing forecasts for near-term rates to adjust upwards rapidly, including those of the Federal Reserve board members via the so-called "dot plot" of projected Fed funds rates.

The Federal Reserve has been extremely accommodative to investors over the last decade plus, so much so that "Don't Fight the Fed" has become a bedrock belief for bullish speculators. This approach has been borne out in equity returns over the past decade and, as evidenced in late 2018 and early 2019, the Federal Reserve is reluctant, if not outright resistant, to undertake proactive steps that might cause asset valuations to falter. Thus, the willingness of the Federal Reserve to curb excessive inflation in a timely and effective manner is very much in question. The global debt binge since the Great Recession of 2008-'09 has made borrowers of all stripes accustomed to low rates, and the ability of borrowers to withstand the harsh realities of higher rates is a great unknown. In any event, persistently high inflation, a belated and/or ineffective Federal Reserve response, or simply a more normalized real rate environment would likely beget higher nominal rates over the intermediate timeframe. Short-term economic momentum could potentially end rather abruptly in such a confluence of events.

Corporate Sector Outlook

For corporate bonds, it was a tale of two halves in 2021. The first half of the year saw an extension of the same spread tightening trend that closed out 2020. The second half of the year presented a more challenging backdrop, however, as spreads drifted notably wider in August and November and investment-grade spreads finished the year largely unchanged. From a starting index spread of +96, investment-grade (IG) corporates tightened by -4 basis points (bps) to finish the year at +92. In terms of excess return, IG corporates outperformed U.S. Treasurys by +61 bps over the course of the year, with a sharply negative November offset by a positive year-end December rally to end the year on a more upbeat note.

Not all bonds were equal, of course, with long-maturity credit faring far better than bonds at the front and intermediate portions of the curve. Ten-year plus corporate bonds actually tightened by -11 bps. Somewhat paradoxically, the credit curve flattened in the first half of the year even as Treasury rates were rising and the yield curve was steepening. Theoretically, higher inflation concerns would be a bad construct for long-dated corporates, but supportive technical factors (low supply and high demand) kept bids for long corporate paper robust.

Investment-grade issuance normalized following 2020's record debt issuance, but the $1.6 trillion of new debt in 2021 still represented solid growth over 2019 pre-COVID levels. Issuance came in very close to expectations for the year, and 2022 estimates call for similar levels of corporate supply, with the swing factor being corporate merger and acquisition volume and related financing activity. We anticipate continued ramp-up in deal volume and shareholder-friendly activity such as stock buybacks and dividend increases.

Over the course of 2021, contribution to duration (CTD) from the corporate sector has steadily declined across Reams portfolios, as valuations appeared very rich in both a historical context and based on underlying fundamentals. High yield valuations remain even more stretched, and these smaller issuers are generally more susceptible to the most devastating impacts of higher inflation, namely elevated labor costs and crippling supply chain shortages.

Despite this reduction in CTD, portfolios maintained meaningful exposure on a percentage basis but rotated into slightly more defensive sectors and/or segments that have modestly underperformed. Our current bias is toward financials and utilities, with a lower weighting to industrials, which carry greater headline risk and likelihood of bondholder-unfriendly activity. Thus, our corporate holdings are skewed toward lower beta names that are typically large, liquid issuers with visible cash flows and solid balance sheets. We suspect that spreads could very easily tighten 10-20 bps over the coming year, absent any unexpected bouts of volatility. Downside risk looms potentially larger this year, however, so caution is warranted and security selection will be paramount.

Securitized Sector Outlook

Securitized products outperformed Treasurys through the first several months of 2021, along with nearly all risk assets. This outperformance was driven by the strong risk-on sentiment, economic recovery, and Fed support that began in spring 2020 and continued into 2021. However, during the latter part of the year, some divergence of performance occurred within the securitized sectors, with agency MBS experiencing exceptionally poor performance versus Treasurys. In contrast, other sectors within the securitized space maintained solid performance versus Treasurys throughout the course of 2021.

Since the spring of 2020, the Fed has attempted to support markets and the economy by consuming a steady diet of $40 billion in agency MBS and $80 billion of Treasurys per month. Through the first half of 2021, agency MBS continued to benefit from the Fed's heavy hand pushing spreads to the lowest levels on record. During that time, many agency MBS securities had an alarming negative yield in a wide variety of common scenarios. Since mid-year, however, the agency MBS market began to respect the myriad of risks facing investors, most notably impending changes in Federal Reserve policy and increased interest rate volatility.

As asset prices, economic strength, and inflation rose throughout the year, the Fed began to slow its bond purchases with the tapering set to conclude in March 2022. The uncertainty around the Fed program led to significant recent underperformance in those securities most directly impacted by the Fed's actions. In addition, although home-refinancing speeds started to decline, they remained stubbornly high through most of the year, which proved a significant headwind for a market priced well above par. Finally, a significant increase in Treasury rate volatility late in the year served as yet another reason for agency MBS to perform poorly. Ultimately, the -68 bps excess return versus Treasurys realized for calendar year 2021 was surpassed on the downside just five times since 1990.

However, even with their recent underperformance, Reams considers agency MBS to be attractive, given the historically tight spreads observed in mid-2021. That said, the poor performance has been swift and significant on a historical basis, so we believe it is prudent to begin adding some limited exposure to conventional agency MBS. Overall, the lack of obvious opportunities encourages our focus back to our long-term bias toward short-dated (1-5 year) positions in asset-backed, commercial mortgage-backed, and agency multi-family MBS. These biases are rooted in the strong structural support, collateral quality, stability of cash flows, and liquidity that are valuable to any high quality fixed income portfolio.

For more information regarding Reams Asset Management, please contact us at 463.777.3900.