IR+M INCOME RESEARCH + MANAGEMENT

IR+M SPECIAL MARKET UPDATE
February 2022

March 1, 2022

21' AND DONE

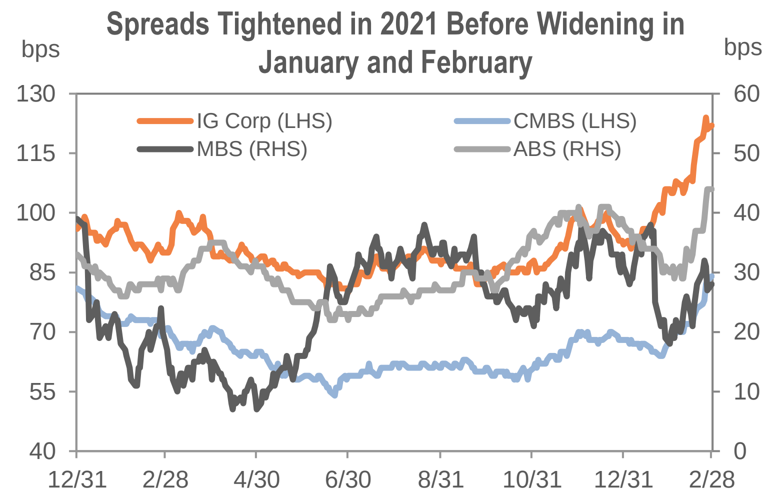
- In hindsight, 2021 had both highs and lows. The economy started to reopen, despite the Omicron setback late in the year. Many people returned to work in person and traveled, and mask mandates eased.
- Risk assets outperformed. The S&P 500 Index returned over 27%, while spreads tightened across most investment-grade sectors. Interest rates rose, but in an orderly fashion.
- The year was not without negatives. Gas prices rose roughly 45% or over $1/gallon, which contributed to energy companies' outperformance. As a precursor to recent events, Russia amassed over 100,000 troops on three sides of Ukraine by year end.

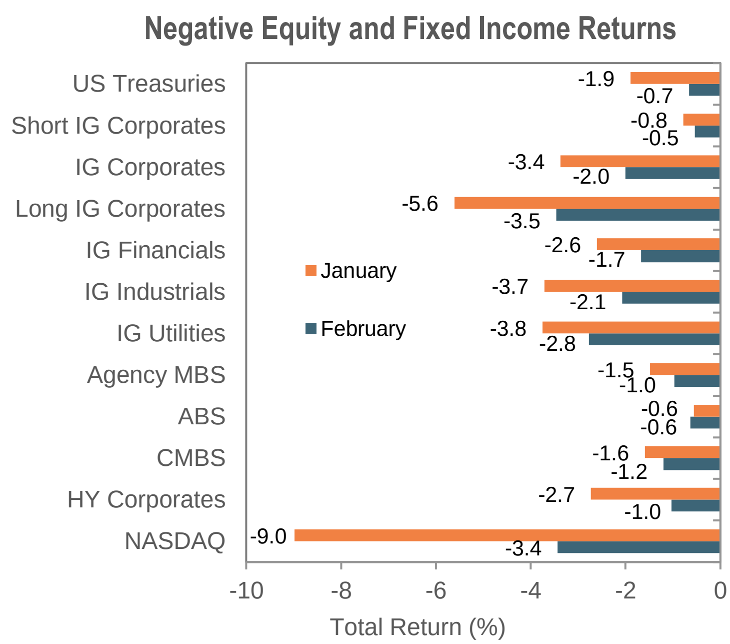
JANUARY JITTERS

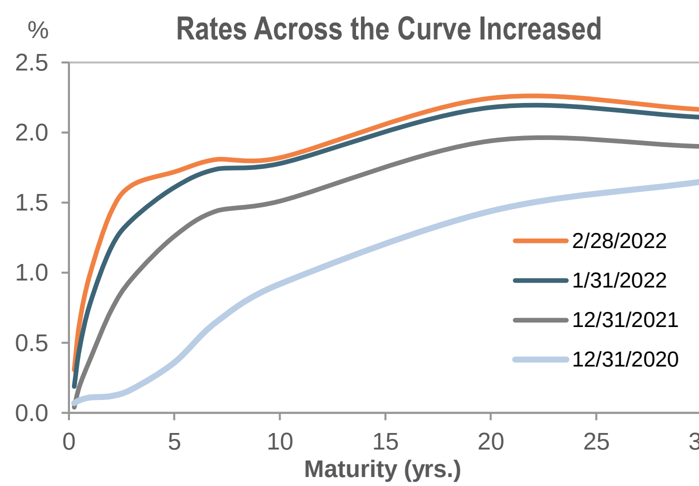
- The January jitters set in immediately with the NASDAQ Index falling 9% and many companies declining by over 20%.
- Treasury rates rose in anticipation of the Fed tightening as CPI soared 7% year-over-year. The futures market priced in multiple Fed rate hikes and pulled forward the timetable for quantitative tightening.
- Bond prices suffered and the Bloomberg Aggregate Index returned -2% in January. Investment-grade spreads widened by 14bps, from 92bps to 106bps. The primary market was still "open," totaling $142 billion, as issuers rushed to price debt ahead of further volatility.
- By the end of January, Russia had 127,000 troops and ballistic missile capability on the border of Ukraine, including in Belarus to the north, and had evacuated its embassy staff from Kyiv.

FEBRUARY FRAGILITY

- February turned out to be a fragile month. Interest rates marched higher, particularly in the front end, as investors anticipated more rate hikes amid the volatility and expectations of higher inflation.
- Risk assets continued to underperform. Equity prices fell another 3%, the Bloomberg Aggregate Index fell roughly 1%, and investment-grade corporate spreads widened 16bps, from 106bps to 122bps.
- Russian President Vladimir Putin ordered a full-scale invasion of Ukraine, vowing to replace its leaders and return the country to Russia's domain. Importantly, since Ukraine is not a part of NATO, Article 5, Collective Defense, is not applicable.
- NATO members have bonded together, imposing sanctions and standing ready to counter any Russian incursion into member states.







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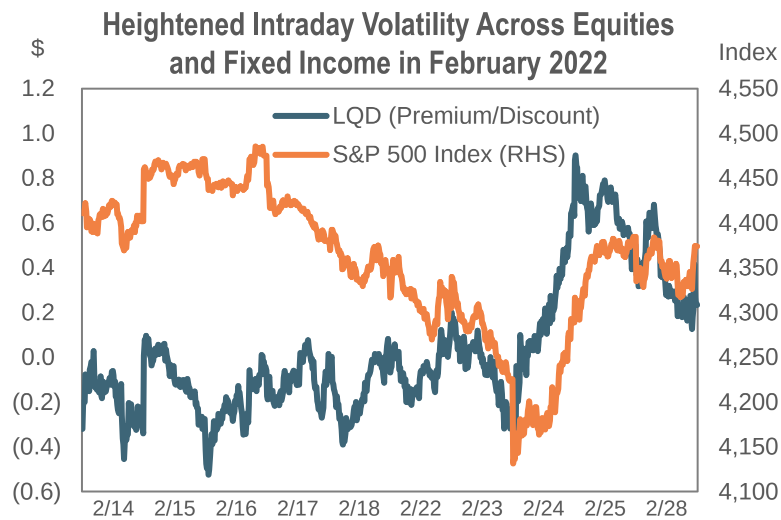
PREPARING FOR MARCH MADNESS



- Historically, March Madness has been synonymous with college hoops, bracketology, and Cinderella stories. Yet this year, March Madness has assumed a much more somber tone due to Russia's invasion of Ukraine.
- The level of tension in Ukraine and concern along the Eastern NATO borders is unprecedented. The markets are volatile, as evidenced by the S&P 500 Index dropping 2.5% the morning of the invasion, closing 4.2% off the low, and rising an additional 2% the next day. Corporate spreads were more resilient, with bids 5-10bps wider intraday, but unchanged versus the pre-invasion level.
- President Biden imposed a first tranche of sanctions last week, which focused predominately on access to financing. Additional asset freezes, restricted access to technology, and constraints on Putin's inner-circle oligarchs have since been announced.
- Sanctions tend to be inflationary since they restrict the free flow of goods and wield a price on domestic growth and costs. The main fallout from a macro perspective will be lower growth and higher inflation, creating a stagflationary environment and boxing in the Fed. Fed Fund futures are still pricing in six rate hikes this year, as the Fed will have to boost yields to quell inflation.
- Commodities are at multi-year highs – despite prospects for lower growth – given the volumes of oil, wheat, nickel, and other commodities that Russia exports. Russia is a major player, accounting for approximately 11% of global oil production and supplying roughly 40% of Europe's natural gas demand. After briefly topping $100, West Texas crude has settled into the mid $90s, and natural gas is hovering near $4.50, $0.75 above year end.
- Wheat, oats, and corn are all off their recent highs, but up compared to a year ago. 5-year TIPS breakevens at 3.15% are near their all-time high – about 20bps higher than year-end. Shorter TIPS reflect more near-term inflation expectations, as the 5Y5Y (5-year inflation, 5 years forward) is exactly in the middle of its 6-month range at 2.55%.

HOPE & OPPORTUNITY LOOKING FORWARD

- Last week's events and ongoing combat have amplified the risk-off markets we have seen year-to-date. We expect continued volatility due to the persistent fighting, reaction of the West to Russian aggression, and longer-term developments in sanctions. Higher inflation and lower growth will likely persist. Longer term, we hope for a new, more stable environment, limited loss of life, and a negotiated outcome.
- These environments can create market opportunities. An old market adage attributed to Nathan Rothschild in 1810 is to "buy at the sound of cannons, sell at the sound of trumpets." Buying amid uncertainty often pays off, as evidenced by events of September 11th, the Great Financial Crisis, and the pandemic. While we have not materially changed the risk profile of any of our strategies, we are closely monitoring market developments and relative value. We have plenty of liquidity in our portfolios – near all-time highs – and if spreads drift wider, we expect to deploy some funds opportunistically.