Q2 2022 | Fixed Income Outlook

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Bond market swings mirror investor unease

War and interest-rate hikes ignite worries about global growth and send ripples through debt markets.

U.S. Treasury yields will likely trend higher as the Fed signals it will do whatever it takes to curb inflation.

Despite headwinds, we have a cautiously optimistic outlook for some fixed income asset classes.

Putnam fixed income views

Shading in the table indicates the change from the previous quarter

	Underweight	Small underweight	Neutral	Small overweight	Overweight
U.S. government and agency debt	●				
U.S. tax exempt			●		
Tax-exempt high yield				●	
Agency mortgage-backed securities		●			
Collateralized mortgage obligations					●
Non-agency residential mortgage-backed securities				●	
Commercial mortgage-backed securities				●	
U.S. floating-rate bank loans				●	
U.S. investment-grade corporates			●	○	
Global high yield			●		○
Emerging markets		●			
U.K. government			●		
Core Europe government			●		
Peripheral Europe government			●		
Japan government		●			

Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro		●	○
£ Pound	●	○	
¥ Yen		●	

The first quarter was a challenging time for global financial markets. Bonds, currencies, and stocks whipsawed due to myriad factors, including rising inflation, Russia's invasion of Ukraine, and the Federal Reserve's first interest-rate increase since 2018. The Russia-Ukraine War has also pushed commodity prices higher and disrupted the global economic recovery. The Bloomberg U.S. Aggregate Bond Index — a benchmark for government and corporate debt — returned –5.93%. Global bonds, as measured by the FTSE World Government Bond Index, returned –6.46%.

Fed Chair Jerome Powell faces the tough task of creating a soft landing for the economy while keeping inflation in check. In mid-March, the Fed lifted the federal funds rate to a target range of 0.25% to 0.50%. Policymakers also penciled in six more increases by year-end, reduced their U.S. growth estimates for the year, and raised inflation expectations. The Fed's latest dot plot, or median projections, show the policy rate rising to around 2.75% by the end of 2023, the highest since 2008. Meanwhile, the European Central Bank held rates steady but said its remaining asset purchase program will wind down at the end of the third quarter.

The bond markets appear to be conveying a pessimistic view of the economy, inflation, and the Fed. At times, yields on some shorter-term Treasuries edged above those of longer-term Treasuries, creating a flat or inverted yield curve. The slope has flashed warning signs of the probability of a recession. By quarter-end, the yield on the 2-year Treasury note had climbed from 0.73% on December 31, 2021, to 2.34% on March 31, 2022. The yield on the benchmark 10-year Treasury note rose from 1.52% to 2.34% for the same period.

Fed signals aggressive rate hikes

The Fed seems to be having a "whatever it takes" moment to slow inflation. But tighten too quickly, and the Fed could further roil markets and tip the economy into recession. Chair Powell has downplayed the risk of a recession and said the goal of tighter monetary policy is to return the economy to "price stability." Rising prices and interest rates signal more volatility ahead for bond markets, in our view. We believe the Treasury yield curve is a reliable indicator of where we are in the cycle and where we are heading. The slope of the 2-year and 10-year Treasury notes indicates the probability of a recession in 2023 is high and rising. But this will be a slow process, in our view.

The Fed expects growth to slow to 2.8% this year from December's estimate of 4%. Fed officials project core inflation at 4.1% in 2022 before declining to 2.6% next year. Consumer prices rose 8.5% from a year ago in March, the fastest pace in more than 40 years, according to the Labor Department. Against this backdrop, job growth remained robust in March. The jobless rate fell to 3.6%, near its pre-pandemic low, and the labor force participation rate ticked up. The Fed sees the unemployment rate for the year falling to 3.5% this year.

ECB faces inflation and growth risks

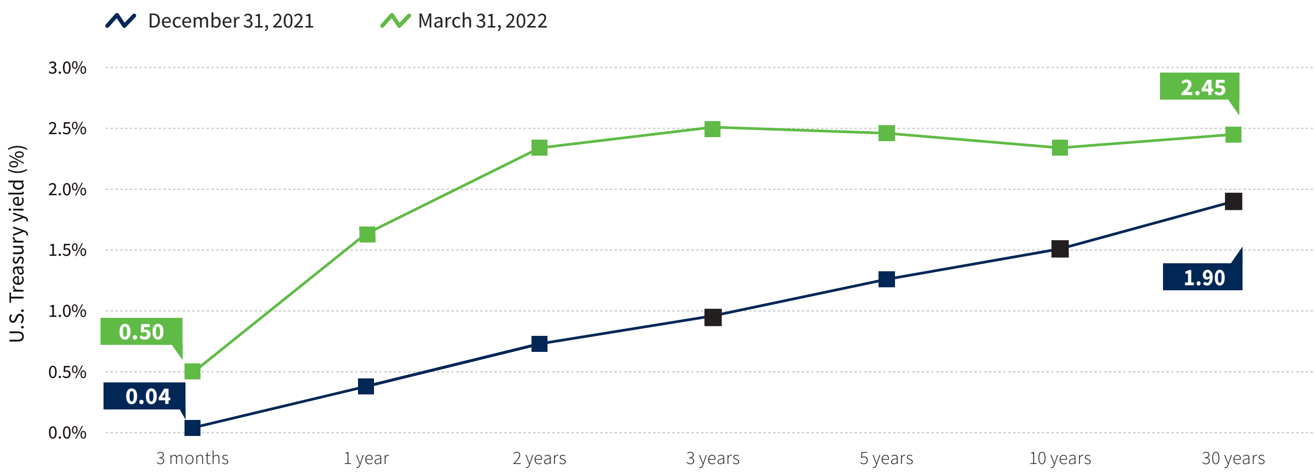
The European Central Bank (ECB) decided to leave interest rates at record lows of 0%, despite rising inflation in the eurozone. The ECB, however, surprised markets in March by mapping out a speedier exit from asset purchases. Policymakers remain divided over how to respond to the economic shock waves from the Russia-Ukraine War. In the medium term, the energy decoupling between Russia and Europe will continue, pressuring energy prices higher and growth trajectory lower for years. The probability of the euro area falling into a recession in the next 12 months is high.

In the United Kingdom, the Bank of England (BoE) raised interest rates to 0.75% from 0.5% in mid-March. Since near-term inflation is high and there are no signs of a deceleration, the BoE will likely hike again in May, before slowing the pace of future rate hikes. Market volatility has pushed bond yields and borrowing costs higher across Europe. Germany's 10-year bond yield, seen as the benchmark for Europe, surged to about 0.82%, its highest level since 2015. The yield on the U.K.'s 10-year notes moved to a six-year high of around 1.90% in April.

China central bank provides 1 trillion-yuan boost

China has introduced lockdowns in Shanghai and other cities amid surging Covid-19 infections. We believe there will be significant economic costs from these disruptions. In early March, Premier Li Keqiang proposed an ambitious growth target of 5.5% for 2022. Special bond issuances from local governments and cash surplus from state-owned entities will provide fiscal funding. The People's Bank of China (PBoC) said it will transfer more than 1 trillion yuan (around US$158 billion) in profits to the government.

The Treasury curve flattened in Q1 as Fed rate hike expectations for 2022 increased



Source: U.S. Treasury Department. Past performance is not indicative of future results.

China also plans to expand credit and lower effective lending rates, pointing to further cuts in the reserve requirement ratio for banks and the policy rate. In our view, the growth target indicates more policy easing in the near term. The central bank in March unexpectedly held its key interest rate for one-year policy loans unchanged. The PBoC probably maintained the rate to support the yuan amid higher capital outflows. China's benchmark sovereign bond yield has seesawed in recent weeks, with the 10-year notes yielding around 2.78% in April.

Sector views

Corporate debt: Investment grade and high yield

The potential effects of inflation and supply chain bottlenecks are considerations for our overall and sectoral positioning. The first quarter correction in bond prices — and yields — generally leaves the investment-grade and high-yield credit markets in a place where the securities have better convexity.

Investment-grade corporate credit was among the poorer performers during the first quarter, given its relatively high interest-rate sensitivity. Still, we have a constructive outlook for investment-grade bonds. We have a positive view of corporate fundamentals, while having a more neutral outlook for the market's supply-and-demand backdrop and valuation level.

In high-yield corporate credit, our view is moderately constructive. We have a positive outlook for high-yield market fundamentals and the overall supply-and-demand backdrop. That said, we anticipate continued bouts of volatility given the conflict in Ukraine, the pace of Fed rate hikes, and potentially negative effects on energy supplies from sanctions on Russia. Our view on valuations is more neutral, given the relative tightness of yield spreads in the market as of quarter-end. Spreads widened during the quarter but remain tight by historical standards.

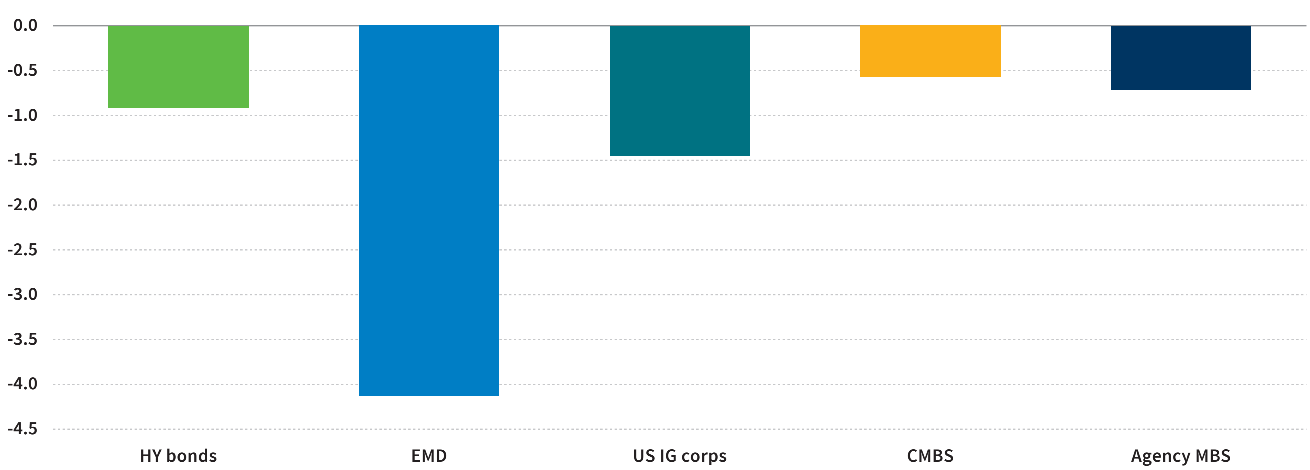
The U.S. high-yield default rate remained very low as of March 31. As for supply/demand dynamics, new issuance of high-yield debt totaled $46.5 billion in the first quarter. This represented a 71% decline from the same period in 2021. Despite tight spreads, we think the market's income potential is attractive in the face of much lower global yields.

Trends in the mortgage markets

In the commercial mortgage-backed securities (CMBS) market, we believe the fundamental environment will continue to improve as workers return to offices, consumer traffic increases at retailers, and hotels welcome back business and leisure travelers. Our emphasis on investment opportunities in the U.S. broadly isolates us from geopolitical risk. With real assets serving as collateral and the potential for rent adjustments, CMBS have historically performed well during periods of rising

Risk assets sold-off amid heightened geopolitical tensions and higher Treasury rates

Excess returns* relative to Treasuries, Q1 2022



Source: Bloomberg, as of 3/31/22. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index. Past performance is not indicative of future results. See page 6 for index definitions.

* Excess returns are calculated relative to comparable maturity U.S. Treasuries for each index. Excess return does not always mean "outperformance."

inflation. CMBS spreads widened during the quarter. The increased liquidity premium enhanced the appeal of select market segments.

In residential mortgage credit, we believe high demand and low inventory of available homes is likely to push prices higher. We are aware that affordability has become a constraint for many prospective buyers as home prices and mortgage rates have risen. Consequently, we think the pace of home price appreciation is likely to moderate in 2022. Wider spreads have created better value among mid-tier and lower-rated securities. We are finding attractive investment opportunities in that area of the market, as well as among higher-rated securities.

The Fed's shift toward tighter monetary policy may likely accelerate its sales of mortgage-backed securities (MBS). A faster pace of MBS tapering may reduce home price inflation, helping to boost the Fed's inflation-fighting mandate. We believe many prepayment-sensitive securities may offer attractive risk-adjusted returns from current price levels and may offer upside potential if mortgage prepayment speeds slow. In our view, prepayment strategies could benefit from an economic slowdown, a shift to supportive fiscal policies, or a sustained increase in mortgage rates.

Currency views

Dollar move hinges on growth and risk sentiment

The Ukraine conflict has taken center stage in global markets, with rising energy prices further bifurcating the reactions from global central banks. The Fed made a hawkish pivot in December, but the war seems to have had very limited impact on the Fed's expected actions in the coming months. Since the March FOMC meeting, hawkish commentary has picked up, making rate hikes of 50 basis points (bps) very likely in May and June. Room for more hawkish expectations relative to the market has declined and is much more symmetric, as the market now prices in a policy mistake with rate hikes this year, followed by rate cuts less than two years from now. From here, the performance of the dollar will depend on prospects for global growth and risk appetite, where there are considerable risks for investor sentiment, as well as idiosyncratic stories driven by the reaction functions from other central banks.

A neutral exposure to the euro

The ECB continued its gradual move in a more hawkish direction, with significant division among the hawks and the doves given the current inflation profile and the ongoing Russia-Ukraine conflict. At its March meeting, the ECB said it plans to end bond buying under its asset purchase program in the third quarter. It further stated rate hikes would be gradual and take place sometime after the end of quantitative easing. If sanctions on oil and gas are avoided, there will be upside risks to the euro. Still, if sanctions are enacted and energy prices surge higher, the single currency could move significantly lower. As such, it is recommended that euro exposure be kept neutral.

Rate hikes and balance sheet normalization likely to lift pound

In terms of the BoE rate hike in March, there were no calls from the nine Monetary Policy Committee members for a 50-basis-point hike, and one member voted to keep rates on hold. In the short term, the Russia-Ukraine War continues to temper any expectations of 50-bp rate hikes. We still expect the BoE to increase interest rates a few more times over the coming months. If the central bank follows its previous guidance, a hike in May would also coincide with the start of active selling of securities and balance sheet normalization. This should be supportive of the currency, especially relative to the euro over the next few months.

Japan yen's valuation likely to be a headwind

The Bank of Japan (BoJ) continues to diverge from other global central banks. Inflation is viewed to be a one-off, wages will remain weak, and overall, a weak yen is considered a positive. These ideas allow the BoJ and Governor Kuroda to suggest it's too early to even discuss an end to ultra-easy monetary policy. So, in the near term, the dollar-yen pair will be driven primarily by external factors. As the Fed starts its rate-hiking cycle, the cost of purchasing longer-dated hedges of U.S. assets has risen. Hedge ratios are likely being adjusted, putting downward pressure on the yen. The yen has broken the range to the weak side. From here, prospects of higher rates to counter inflation by global central banks will likely keep the yen weaker, but valuation is likely to be more of a headwind. The currency will likely stabilize when the Fed's hawkishness has peaked and when the BoJ pivots from its ultra-easy stance.

The Fixed Income Outlook represents the insights of the collaborative process of our 100+ member team and of our senior leadership.

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As of March 31, 2022.

Agency mortgage-backed securities are represented by the Bloomberg U.S. Mortgage Backed Securities Index, which covers agency mortgage-backed pass-through securities (both fixed rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Commercial mortgage-backed securities are represented by the Bloomberg U.S. CMBS Investment Grade Index, which measures the market of commercial mortgage-backed securities with a minimum deal size of $500 million. The two subcomponents of the U.S. CMBS Investment Grade Index are U.S. aggregate-eligible securities and non-eligible securities. To be included in the U.S. Aggregate Index, the securities must meet the guidelines for ERISA eligibility.

Emerging market debt is represented by the Bloomberg EM Hard Currency Aggregate Index, which is a flagship Emerging Markets debt benchmark that includes USD, EUR, and GBP denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The index is broad-based in its coverage by sector and by country, and reflects the evolution of EM benchmarking from traditional sovereign bond indices to Aggregate-style benchmarks that are more representative of the EM investment choice set.

Eurozone government is represented by the Bloomberg European Aggregate Bond Index, which tracks fixed-rate, investment-grade securities issued in the following European currencies: euro, Norwegian krone, Danish krone, Swedish krona, Czech koruna, Hungarian forint, Polish zloty, and Swiss franc.

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FTSE World Government Bond Index (WGBI) measures the performance of fixed-rate, local-currency, investment-grade sovereign bonds.

High-yield bonds are represented by the JPMorgan Developed High Yield Index, an unmanaged index of high-yield fixed income securities issued in developed countries.

Japan government is represented by the Bloomberg Japanese Aggregate Bond Index, a broad-based investment-grade benchmark consisting of fixed-rate Japanese yen-denominated securities.

Tax-exempt high yield is represented by the Bloomberg Municipal Bond High Yield Index, which consists of below-investment-grade or unrated bonds with outstanding par values of at least $3 million and at least one year remaining until their maturity dates.

U.K. government is represented by the Bloomberg Sterling Aggregate Bond Index, which contains fixed-rate, investment-grade, sterling-denominated securities, including gilt and non-gilt bonds.

U.S. floating-rate bank loans are represented by the S&P/LSTA Leveraged Loan Index, an unmanaged index of U.S. leveraged loans.

U.S. government and agency debt is represented by the Bloomberg U.S. Aggregate Bond Index, an unmanaged index of U.S. investment-grade fixed income securities.

U.S. investment-grade corporate debt is represented by the Bloomberg U.S. Corporate Index, a broad-based benchmark that measures the U.S. taxable investment-grade corporate bond market.

U.S. tax exempt is represented by the Bloomberg Municipal Bond Index, an unmanaged index of long-term fixed-rate investment-grade tax-exempt bonds.

Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

The Bloomberg U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed income securities.

The ICE BofA 1-3 year U.S. Corporate Index is an unmanaged index of U.S. investment-grade corporate debt with a remaining term to maturity of less than 3 years.

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