

# RATE ANGST

The U.S. bond market just exited its worst quarter in years, with Treasuries down 5.6%, corporate bonds down 7.4% and a broad municipal bond index down 6.2%.<sup>1</sup> After shaking off the rise in inflation in 2021, a swing in the outlook for Federal Reserve policy led to a jump in interest rates this year with the 10-year Treasury yield increasing from 1.51% to 2.71% currently. The Fed entered this year only expecting to hike rates three times, leading to a year-end Fed funds rate below 1.00%. The persistence of high inflation has now led the market to price in nearly 10 hikes with a Fed Funds rate over 2% by year-end. Central banks seek to tighten financial conditions to slow growth and therefore hopefully inflation – and as shown below 30-year mortgage rates have jumped from ~3.3% at the start of the year to 5.0% currently. That should likely lead to some eventual cooling in the pace of housing price rises.

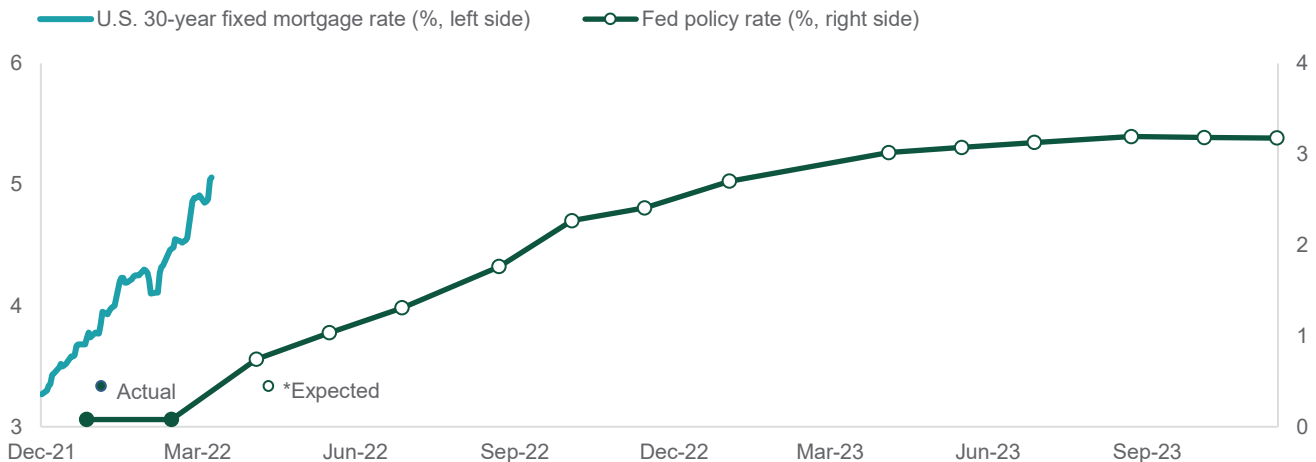
Unfortunately, the war in Ukraine remains a core risk as the humanitarian crisis continues and signs of war atrocities are rising. This is only increasing the resolve of the West, which boosts momentum toward further Russian sanctions. Major supply shocks are in some respects still to unfold, but as shown by the 20% rise in wheat prices since February 23rd markets are reflecting the perceived eventual impacts.<sup>2</sup> Further military escalation remains a

risk case, with the potential for the use of unconventional weapons or further geographic incursions. Our base case scenario envisions a long, drawn-out affair without clear resolution.

In the wake of persistent inflation, the Ukraine war, and lingering COVID problems, global growth is slowing. Europe is at risk of recession, and China is suffering from the effects of COVID-related shutdowns. U.S. growth is holding up relatively better, and nominal growth in the second quarter could hit 10%. A risk case for us is the global slowdown leaking into the U.S., leading to disappointing growth. Nevertheless, U.S. growth looks better insulated than Europe or China and we resultingly favor U.S. equities over developed ex-U.S. and emerging market stocks. We also continue to favor natural resources equities, which have provided significant benefit to portfolios this year as commodities are benefitting from shortages and inflation concerns. Finally, we continue to like high yield bonds due to their attractive yield and strong fundamentals. The sharp tightening of credit spreads over the last month should give some comfort to those worried that an inversion of the yield curve is a certain sign about impending recession.

## LONG RISE, BUT IMMEDIATE IMPACT

While the Fed may take a year to raise rates by 2%, mortgage yields have already made that move.



\*Market implied rate using 30-day Fed funds futures for planned Fed meeting dates from 12/31/2021 through 12/31/2023. Mortgage rate is daily fixed national average from Bankrate.com. Data as of 4/8/2022. <sup>1</sup>Bloomberg, 3/31/2022. <sup>2</sup>Bloomberg, 2/23/2022-4/8/2022.



## Equities

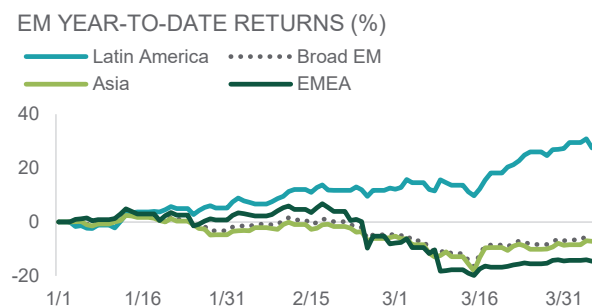
Global equities bounced back from the previous month's war-induced selloff, rising 6.7% for the month.<sup>4</sup> The start of ceasefire negotiations combined with clear signs that Russia's military advance has stalled came as a relief to investors. Europe, which had been most affected by the previous selloff, also recovered the most, rising more than 10%. U.S. equities rose more than 6% while EM lagged with a rise of 1.7%.<sup>4</sup> Within EM the impact of the crisis in Ukraine and the associated worries around energy supply are visible in the underperformance of the EMEA part of the index, whereas the more commodity-sensitive Latin America part of the index did very well (see chart).

However, the much larger Asia part of the index also struggled – and not just because of higher commodity prices. A rise in COVID-19 cases (now spreading into mainland China) dampened investor sentiment. With China still holding onto its zero-COVID policy, the amount of economic disruption from restrictions and regional lockdowns is rising and likely to continue to climb.

Given risk associated with the conflict in Ukraine and China's zero-COVID policy, we maintained underweights across non-U.S. equities in the global policy model. We remain overweight the more insulated U.S. equities.

## DIVERGING EMERGING

Markets closest to Europe and China have struggled.



EM = emerging markets. MSCI EM indexes using data as of 4/5/2022. It is not possible to invest directly in any index.

- The Ukraine war and China COVID issues have hit the EMEA and Asian markets hardest.
- Commodity-sensitive Latin American markets have performed strongly.
- We favor U.S. over non-U.S. equities due to greater confidence in the economic outlook.

## Real Assets

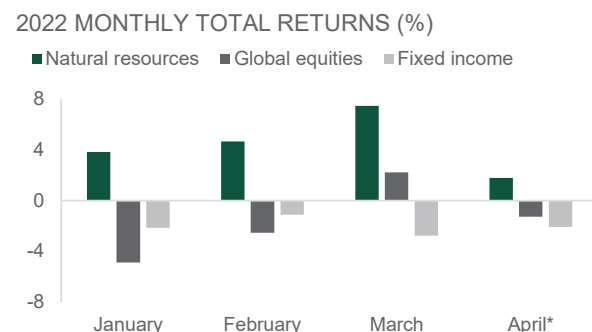
Natural resources (NR) have been a valuable component in a multi-asset portfolio thus far in 2022, providing diversification, returns and income. First on diversification, NR have done what investment grade bonds (IG) have not been able to so far this year – go up when broader equities are going down. As seen in the chart, while global equity returns have been spotty, IG returns have been worse – leaving NR to serve as the ballast to the portfolio. We defended that NR's previous underperformance – driven by low inflation – was allowing the rest of the portfolio (both equity and fixed income) to do well. Now that the shoe is on the other foot (and geopolitical tensions are high), NR is making up for lost time – and lost performance.

That performance has been strong. NR is up over 18%, year to date, versus the -6% return out of global equities and -8% from IG.<sup>5</sup> Less appreciated, NR has provided notable income of late. Given high commodity prices and management's desire to return those cash flows to shareholders, dividend yields – at over 3% – are actually higher than those from "cash flow" assets (real estate/listed infrastructure). So long as commodity prices remain high (seemingly a good bet), NR remains attractive – and we remain tactically overweight in the global policy model.

<sup>4</sup>Bloomberg, 4/4/2022, <sup>5</sup>Bloomberg, 4/8/2022

## THE LONE DIVERSIFIER

Natural resources are providing diversification that not even investment grade bonds have so far this year.



Indexes used: S&P Global Natural Resources (Natural resources); MSCI ACWI (Global equities); Bloomberg U.S. Agg (Fixed income).

\*April returns are through 4/8/2022. 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.

- Natural resources (NR) have been providing the trifecta of diversification, returns and income.
- Continued high commodity prices can mean continued returns and elevated dividend yields.
- We remain tactically overweight NR in the global policy model.

## BASE CASE

### Global Economic Shocks

Russia's invasion of Ukraine risks a major global supply (and some demand) shock. Meanwhile, China's recent COVID surge also represents a global supply/demand shock, particularly given ongoing "zero COVID" policy. The U.S. is more insulated from these shocks than the rest of the world.

### Inflationary Tightrope

Inflation has been pushed higher by a perfect storm of supply bottlenecks and labor shortages (both mostly driven by COVID) along with the aforementioned supply shocks (driven by war). The Fed has a tough job ahead to mute near-term price spirals while preparing for long-term potential disinflationary fallout.

## RISK SCENARIOS

### Economic Degradation

The economic restructuring necessary to address the "newest world order" is greater than what's priced in, causing even lower growth and higher inflation (a key risk for our still-constructive U.S. outlook).

### Military Escalation

Russian President Putin moves further into "unconventional" war tactics or invades the Baltics (or other NATO countries), notably increasing required equity risk premiums and pushing equity markets lower.

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