2021 Year in Review & 2022 Outlook

December 2021

Year in Review

As we approach the end of the year and look forward to the coming holidays with family and friends, it's a good time for reflection and to briefly share our investment outlook for 2022. The main themes for 2021 were the re-opening of the economy and the debate over transitory versus persistent inflation. Through November, the Bloomberg U.S. Treasuries Index as well as the Bloomberg U.S. Aggregate Index are on pace to deliver their first negative performance since the taper-tantrum of 2013, albeit, after two back-to-back years of solid, high single digit returns in fixed income. Investment grade convertible bonds through November are likely on pace to deliver high single digit returns, while U.S. equity indices continued to set records this year and appear poised to deliver total returns of around 20% for the year-barring a dramatic worsening of market conditions due to the Omicron strain of Covid-19.

2022 Outlook

A battle against persistent inflation driven by supply chains, labor scarcity and regulatory policy will be the dominant macro-economic theme in 2022, while improved corporate balance sheets, an ability to pass on increasing costs to consumers and robust consumer demand should temper the economic effects of tighter monetary policy.

By continuing expansionary monetary policy in conjunction with massive fiscal stimulus despite rising inflation and a rebounding economy, the Federal Reserve has now put itself in the unenviable position of needing to tighten monetary policy late in the economic cycle, just as economic growth is expected to slow. The Federal Open Market Committee ("FOMC") will need to thread the needle to engineer a soft landing.

Inflation has proven much more persistent than the Federal Reserve had previously expected, and consumer and business behavior is changing in response. Supply chains are being on-shored or near-shored for reliability in a move away from "just-in-time", which will require quarters or years to complete, and may drive up inventory costs. Labor scarcity is contributing to delays and pushing wages higher, while firms are demonstrating pricing power as Fed-Ex, UPS, airlines, restaurants, furniture companies, etc., pass increasing costs along to consumers. This comes as no surprise to us given that aggregate demand is currently exceeding aggregate supply in a wide variety of goods and services which leads to rising prices. Acknowledging persistent inflation, Federal Reserve Chairman Jay Powell recently retired the "transitory" description of inflation and indicated in Congressional testimony the need to hasten the wind-down of quantitative easing, perhaps ending it as early as spring '22. While we expect core inflation will ease somewhat through the year, we believe it will still be averaging between 2.75% - 3.25% by the end of 2022, causing the Federal Reserve to raise short term interest rates to 1% before having to possibly reverse course in 2023. Of course, with the recent announced departures of two hawks from the Fed (Rosengren and Kaplan), President Biden will nominate three new Federal Reserve Governors. We expect the Biden Administration will come under heavy pressure from progressives to re-shape the Federal Reserve Board, further pushing the Fed's "mission-creep" into objectives, such as inequality and climate change, increasing the risk of policy error.

Looking at the positives, corporate fundamentals have been improving and default rates are expected to remain low. Companies have shown resiliency through the pandemic as profitability has expanded amidst rising costs. Revenue and EBITDA have quickly recovered above pre-COVID levels, and leverage is trending lower from its peak in 2020. This should result in positive ratings momentum, reversing much of the negative momentum experienced during the onset of the pandemic. We remain vigilant in our credit allocation with a tilt toward sectors aligned with the economic reopening such as leisure and transportation as well as sectors with attractive risk-reward profiles, such as energy and banking.

We expect 2022 will be a volatile year of modestly positive to slightly negative returns in fixed income indices as the Federal Reserve moves short term rates to near 1% in response to persistent core inflation, and the yield curve flattens significantly. Our forecast indicates that yield spreads between corporate bonds and U.S. Treasuries should trade in a range of 100-130 basis points as quantitative easing ends, while the U.S. Dollar strengthens in response. For convertible bonds, rising rates could pressure rate sensitive sectors, such as financials and utilities. A neutral delta position and well diversified portfolio should help realize both upside participation should stocks rise while providing downside support should it be needed. We expect convertible bonds and equity indices will likely deliver more modest, mid-single digit positive returns to slightly negative returns for the year in the event of a policy error. A stronger dollar, combined with slowing growth later in the year, should cause declines in commodity prices. However, the lack of investment in "old-economy" energy and mining, as well as a punitive regulatory and legislative environment (which is making a hurried push to go green) may lead to shortages or inefficiencies, contributing to continued upside inflationary pressure. Unlike 2020-21 where long beta generally paid off, careful credit selection and stock picking should matter and be rewarded as the economic and credit cycles appear to be moving much faster than that of the previous decade.

Finally, thank you for being an INCORE Capital Management client. We sincerely appreciate your business, and the confidence you have in our team. We wish you and your families the happiest of holidays and look forward to working with you in 2022.