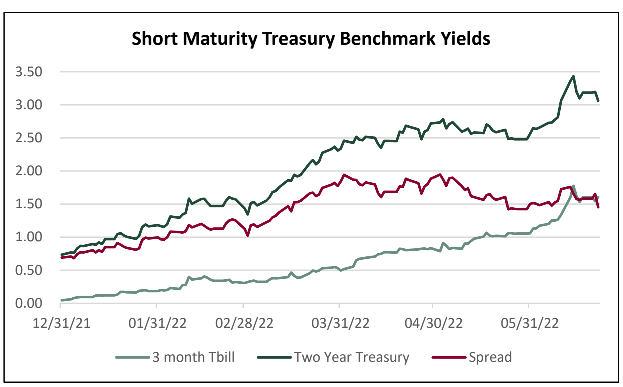
Tightening Monetary Policy and Risk Management Considerations

Interest rates have increased significantly, and risk assets including equities and corporate bonds have materially underperformed on a year-to-date basis, as the market narrative regarding moderating inflation metrics in the second half of 2022 is challenged. Contributing factors to the underperformance of risk assets include escalating geopolitical conflicts as well as lingering COVID restrictions in China, exacerbating supply chain issues which have been in place since the onset of the pandemic. A theme for the Chandler team at the beginning of 2022 was markets were at an *inflection* point with policy accommodation poised to pivot via tightening monetary policy and the impact of prior fiscal stimulus waning. At the outset of 2022, expectations for monetary policy tightening were modest, however, as inflation metrics remained elevated the Federal Reserve turned more hawkish, with the Fed Funds rate increasing by 1.50% thus far in 2022, including 25 basis points in March, 50 basis points in May, and 75 basis points in June.

Additional rate increases are forecasted for later in the year as policy accommodation is removed to counteract elevated inflation metrics. Market participants have “priced in” a material amount of policy tightening; the graph below exhibits the year-to-date change in the 3-month Treasury Bill, closely linked to the actual Federal Fund rate, compared to the Two-Year Treasury note, which takes into consideration market expectations of future changes in the Fed Funds rate.



Source: Bloomberg

The year-to-date performance of U.S. fixed income benchmarks has been dismal and correlated with the negative performance of equity assets in 2022, a bit of a market anomaly. Historically, equity assets can absorb increases in the Fed Funds rate until the rate is above the ‘neutral rate’ and financial conditions become restrictive. In the current cycle, the market reaction has been condensed to the detriment of total returns across asset classes, and we believe will influence the future trajectory of monetary policy tightening.

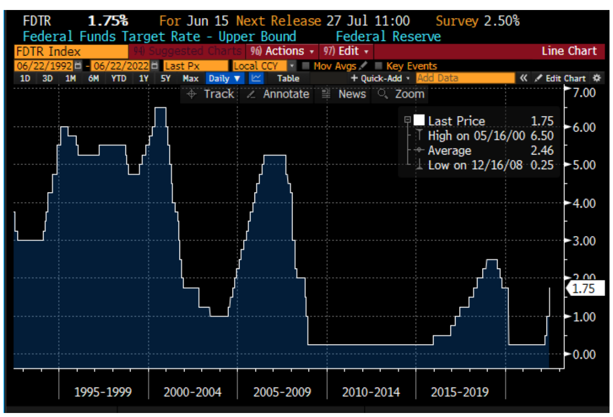
As interest rates move higher, fixed income portfolios can generate negative total returns over short time horizons due to the lower market value on legacy positions from the impact of higher interest rates, with longer maturity strategies generating incrementally lower total returns. In prior tightening cycles fixed income portfolios absorbed increases in interest rates over intermediate time horizons partially linked to reinvesting sold and maturing positions into higher yielding investments. However, in the current cycle, fixed income portfolios are under considerably more total return ‘stress’ due to the starting point in valuations with overall yield levels extremely low since the onset of the pandemic.

	US Treasury and Agency Index YTD Returns			
	1-3 Year	1-5 Year	1-10 Year	1-30 Year
YTD 5/31/22	-2.27%	-3.39%	-4.93%	-8.46%
2018	1.60%	1.53%	1.44%	0.83%
2017	0.44%	0.66%	1.08%	2.42%
2016	0.89%	1.09%	1.14%	1.15%
2007	7.14%	7.88%	8.55%	8.76%
2006	4.14%	4.04%	3.86%	3.48%
2005	1.70%	1.45%	1.63%	2.66%

Source: ICE BofA Indices

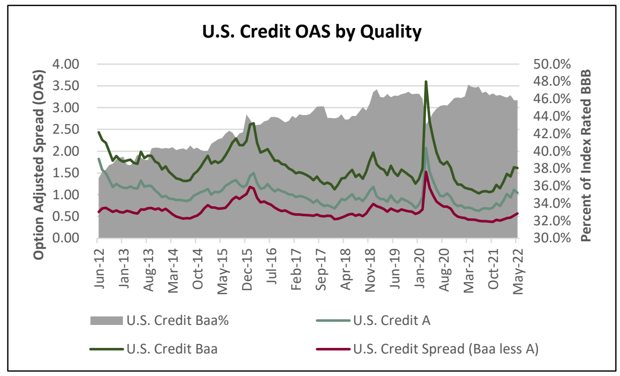
Notably, in prior periods of monetary policy tightening, annualized returns were positive for high quality fixed income benchmarks across the maturity spectrum. Given the overall adjustment thus far in 2022 to yield levels and valuations, the outlook for fixed income assets generating a positive total return over the coming 12-month time horizon has increased. The swift adjustment thus far in the Fed Funds rate and the subsequent greater adjustment in yields should lead to an improved total return experience for fixed income investors in the second half of 2022.

A key question for investors going forward is how high will the Fed Funds rate go and the subsequent impact to broad fixed income asset valuations? Along with increasing the Fed Funds rate, the Federal Reserve is also removing policy accommodation via the process of shrinking the Federal Reserve's balance sheet. The balance sheet has ballooned in size to just under $9 trillion, further fueling accommodative financial conditions during the pandemic. Beginning in June 2022, the Fed's balance sheet is set to contract by $47 billion per month, increasing to $95 billion in September 2022, to an annualized run rate in excess of $1 trillion per year. The policy change is transitioning the Federal Reserve policy from Quantitative Easing (QE) to Quantitative Tightening (QT). The Chandler team believes the market implications of QT of this magnitude are underappreciated by market participants and QT will influence how high the Fed Funds rate will ultimately rise to counteract the current elevated inflation readings.



Source: Federal Reserve / Bloomberg

Considering both the increase in the Fed Funds rate and QT, the Chandler team believes additional dislocations in various segments of the market are likely as liquidity conditions tighten and investors become more discerning in the overall level of risk in fixed income portfolios. One very visible segment of the market for all investors to monitor is the investment grade corporate market. We believe investors will demand a higher risk premium to own asset classes that are both increasing in size relative to the market and have risk premiums that may not reflect the extent of tighter financial conditions. The team is monitoring closely the general level of credit spreads and valuations of investment grade corporate securities, in particular the BBB segment. Partly attributable to the growth of the lower quality (BBB) segment of the investment grade market, relative valuations are likely to become more attractive (cheaper) as investors incorporate a more restrictive financial backdrop into their financial decision-making process.



Source: Bloomberg Indices

The Chandler team believes the economic backdrop in the second half of 2022 is going to be more challenging for consumers due to the adjustment in market valuations since the start of the year. Tighter financial conditions, via both rate increases and QT, will exert downward pressure on inflation metrics. Given the adjustment thus far in valuations across the capital markets, and the likely implications to the growth outlook for the economy, additional allocations to fixed income portfolios is a reasonable risk/return trade off in Chandler's judgment.

The team recommends positioning portfolios conservatively from an asset allocation perspective to be in the position to add risk as spreads valuations potentially become more attractive. It is also advised to bifurcate your overall asset allocation between monies available to withstand the market volatility and generate higher returns over an intermediate time horizon versus short-term liquidity needs, which should be invested very conservatively. The current level of interest rates is supportive of taking duration risk, as current valuations are discounting additional increases to the Fed Funds rate and the outlook for above trend growth and strong consumer behavior in the second half of 2022 is circumspect.

William Dennehy II, CFA
Co-Chief Investment Officer

Questions?

Please contact Chandler at info@chandlerasset.com, or toll free at 800-317-4747 with any questions or to learn about investment management solutions for public entity investment programs.