



# Fixed Income 2022: Nowhere to Hide?

**Arif Husain, head of International Fixed Income, discussed a fresh approach to fixed income investing in a year that could be potentially dominated by volatility.**

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## Macro Views on Employment, Growth, and Inflation

- Arif explained that the top-down view is very nuanced. There are many possibilities that he can imagine at the moment, with each leading to very different market outcomes.
- Unemployment is heading downward in the post-coronavirus job shortage environment.
- Growth is expected to slow to some extent, as many government stimulus programs enacted over the past few years will start tapering off.
- Inflation may fall. Arif elaborated that if you measure inflation on a year-over-year basis, it will fall. However, inflation probably doesn't matter as much as the core CPI, which he expects to stay relatively elevated.

## What Is Driving the Markets?

- Generally speaking, while we do need to keep an eye on employment, growth and inflation, the focus moving forward should be on what the Fed is saying and planning to do. In late 2021, the Fed expressed the plan of running off its balance sheet later this year—what we'll call quantitative tightening.
- Going back since the global financial crisis, the dominant factor that's driven fixed income asset returns has been quantitative easing. Through a very simple lens, investors should expect an equal and opposite impact to occur when moving from a quantitative easing environment into one of quantitative tightening.

**February 1, 2022**

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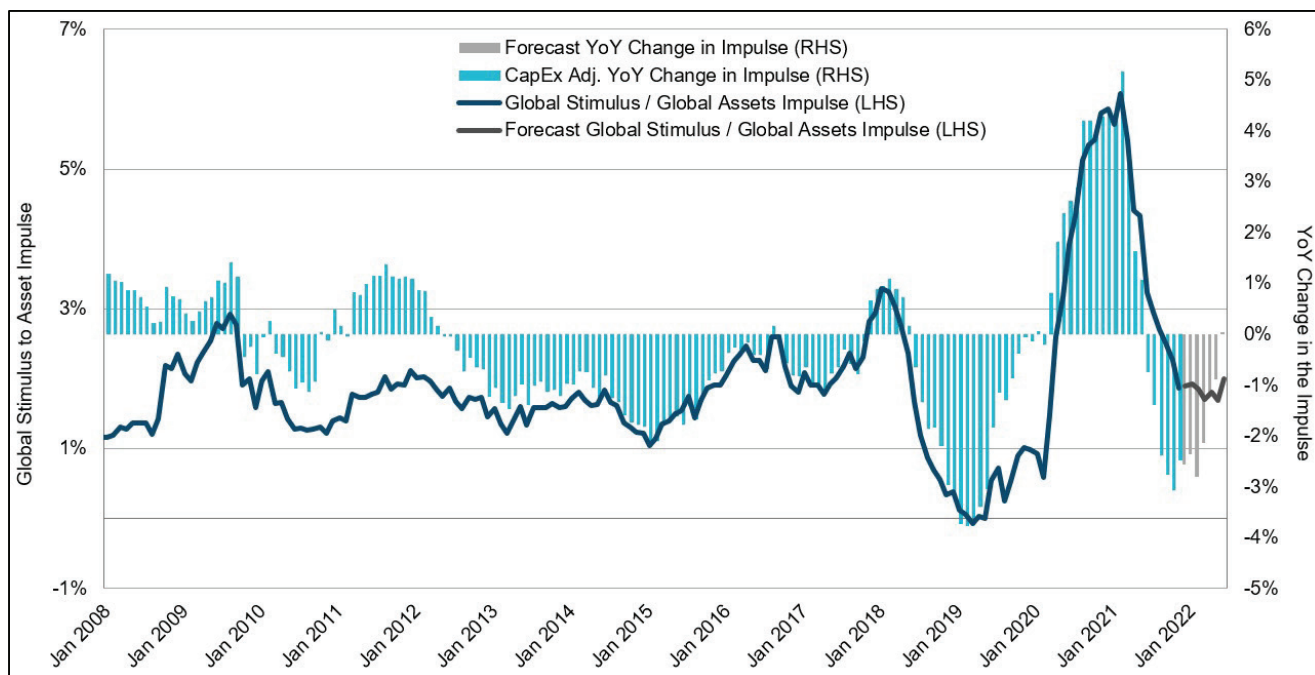
Portfolio Specialist,  
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“  
You can't just rely  
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— **Arif Husain**

*Head of International Fixed Income*

- Arif mentioned that this idea of quantitative tightening is not unique to the US and that investors should expect to see a similar tactic from many central banks worldwide. Globally speaking, the chart below illustrates that stimulus has fallen and will continue to fall into negative territory, which will be key for investing into 2022. As less money is made available via the central banks, the downstream impact will be less investment opportunities in the financial markets.



As of 31 December 2021.

Sources: Bloomberg Finance L.P., analysis done by T. Rowe Price.

There is no guarantee that any forecasts made will come to pass. Actual results may vary.

## Could the Fed Be Making the Same Mistake Twice?

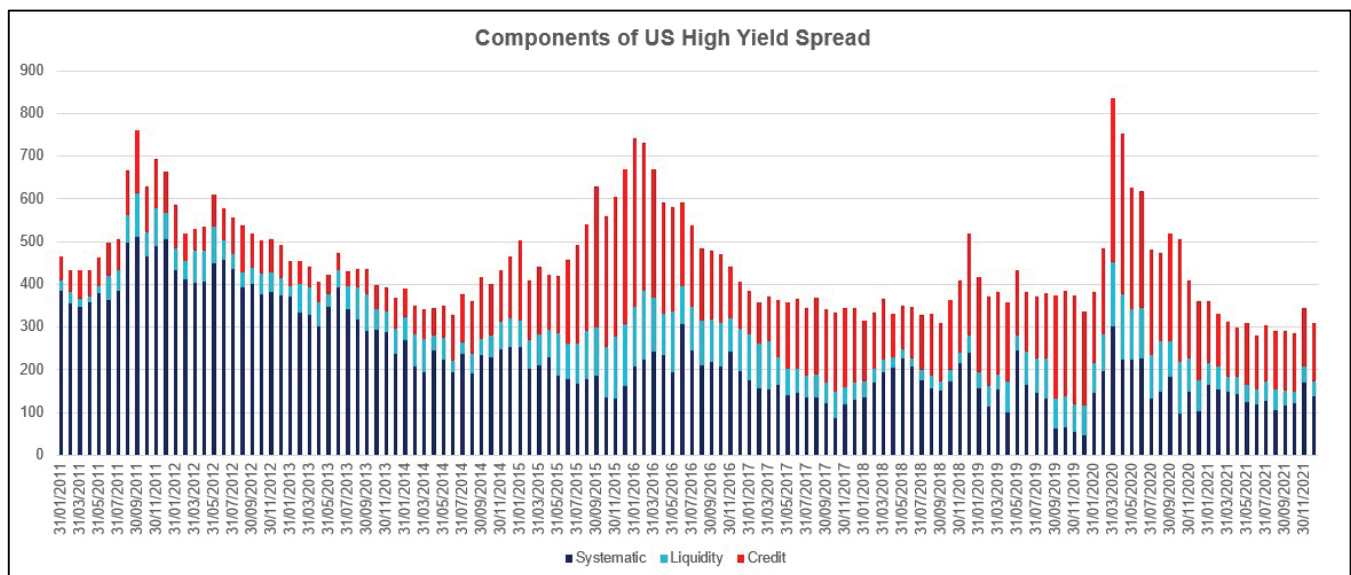
- Admittedly, we're seeing some behavior that is reminiscent of the Taper Tantrum event of 2013 or quantitative tightening efforts around 2018, but Arif believes that the pandemic has changed things. We are essentially in a new environment due to factors such as supply chain problems and changes in human behaviors.
- Historically, whenever the Fed tightens, the yield curve flattens. However, this time, the market dynamics are very different as we're starting at a very low level of short rates. The market has priced in a fair amount of rate increases into next year, but it has priced in almost nothing for 2024 and beyond. So while the market has priced in a shallow, short rate rising cycle, the terminal rate hasn't really changed. Arif believes that yields need to rise a fair bit more to price in the potential for that higher terminal rate.
- Given the current volatility, Arif added that there is a chance we'll see a little bit of re-steepening in the yield curve over the next few months due to the quantitative tightening. He also expected a possibility that the 2s10s curve could severely invert over the course of the year.
- Arif concluded by highlighting the need to be nimble and open-minded. He reiterated that history can be a guide, but not a firm road map, and that it will be imperative to play the field on a day-to-day basis.

“The Fed has a really tricky job to thread the needle...dealing with inflation...without crashing the economy.

— Arif Husain  
Head of International Fixed Income

## Implications for Credit Markets

- Defaults are a key driver of credit returns, and our research team at T. Rowe Price spends a lot of time building our own default forecasts.
- Our outlook for defaults is very close to zero, and what we are seeing from credit rating agencies is an upgrade cycle. So, while the underlying credit fundamentals look great, credit spreads are not just a default premium.
- Credit spreads are made up of three components:
  1. Credit default premium
  2. Liquidity premium
  3. Some form of adjustment for systematic risk
- Overall, although Arif would argue that there isn't enough liquidity premium priced into the markets currently, he'll be watching the credit market carefully and talking with the bottom-up analysts to utilize credit from an opportunistic perspective.



As of 31 December 2021.

Sources: Bloomberg, analysis by T. Rowe Price.

## The Search for Negative Correlation to Other Investments

- Most portfolio construction relies on negative correlation between asset classes. Arif expects that the draining of liquidity is unfortunately going to affect all asset classes similarly.
- Arif's primary piece of advice is that you can't rely on history and previous trends and that slightly different tactics might be needed.
- Arif also sees considerable opportunities, especially via active duration management.
- Instead, focus on:
  1. Liquidity: Do you have enough to be opportunistic when opportunities arise?
  2. Volatility: Is your portfolio balanced to do well within a rising volatility environment?
  3. Realistic Expectations: Expect volatility—don't be surprised and don't panic when it comes.

## Final Thoughts

- Investment managers need to have their eyes wide open.
- It is important for investment professionals to:
  1. Value liquidity
  2. Be nimble enough to take advantage of opportunities
  3. Play defense when necessary

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