1. **What’s your outlook on Fed action and raising of rates?**
   The Fed recently began its long-awaited tapering of the $120 billion per month of Treasuries and mortgage-backed securities it has been buying since March of last year. The cessation of this quantitative easing has been anticipated and well telegraphed, and therefore should have a muted, short-term impact on bond prices. If the Fed holds this pace steady, we believe that quantitative easing will be concluded by July of next year. It is important to note that tapering by itself is not restrictive, and if the Fed holds to tapering bond purchases by $15 billion per month, the Fed’s balance sheet will still increase by over $400 billion through mid next year.

   We think the next move for the Fed after tapering is concluded will be to tap on the brakes, or to start increasing the federal funds rate and the discount rate. Chairman Powell had stated that the Fed would not increase rates until well after quantitative easing had concluded. The recent surge in inflation has thrown that assertion into some doubt, and the market is currently pricing in two rate increases next year. We think that may be overly aggressive.

   The sharp surge in demand that has pushed U.S. inflation to 30-year highs has fueled concerns that “temporary” pandemic-related inflationary pressures could prove more persistent, and has raised the fear that the Fed could act more aggressively to combat rising prices.

   First, we do believe that the surge in inflation is transitory and will show some evidence of slowing as 2022 progresses. Keep in mind that the year-over-year comparison for prices will get increasingly easier, which should slow the rate of change. As the law of supply and demand dictates, rising prices should result in more supply, which will put a lid on future price increases. As the old saying goes, the best cure for rising prices is rising prices.

   Secondly, vacancies on the Federal Reserve Board are likely to be filled with dovish members as the administration desires to keep the liquidity spigot turned on to support economic growth and further their agenda. Therefore, the Fed may act more slowly to rein in inflation and economic growth.

2. **What expectations do you have for the bond market in 2022 and beyond?**
   We expect modest returns (low single digits) for investment grade corporate bonds and municipal bonds. We believe that non-investment grade, or high yield bonds, should do somewhat better. We also believe that Treasuries are likely to struggle. In the last 10 periods when the yield on the 10-year Treasury increased by more than 100 basis points, Treasuries declined in every single period while high yield bonds had positive returns. High yield bonds also outperformed the Bloomberg Barclays Aggregate Bond Index in the 2004-2006 and 2015-2018 rate hike cycles.

   Providing support to the bond market in 2022 is the expected decline in the new supply of bonds across the credit curve. Treasury issuance is expected to drop as COVID-related fiscal policies wind down. In addition, after two exceptionally elevated years of corporate credit issuance, we expect a return to a more normalized pattern for new debt in 2022. Investment grade and high yield debt new issuance are expected to decline by about 13% and 25%, respectively in 2022 from 2021 full year levels.

3. **What are the factors you're watching to evaluate shifts in the bond market?**
   There are really two main drivers of fixed income returns: the expectations for future rates and the risk of default. If rates are moving higher because of economic strength, then the risk of defaults should go down and credit spreads should tighten. This means that corporate bonds and municipal bonds should outperform Treasuries.

   On the flip side is the potential for sustained (not transitory) inflation, which would push longer-term rates higher. A weakening economy would have the opposite effect, with longer-term rates falling. Given that the common variable in these key elements for the bond market is the economy, a close watch on economic data and trends is vital. Fed actions are an important driver of future economic growth, so monetary policy is another key factor we will be watching closely.

4. **How do you balance the triple challenge of interest rates, duration and credit quality?**
   Active management! Interest rates and the slope of the yield curve are constantly in flux. The slope of the yield curve itself gives clues as to future economic growth. A positively sloped curve is usually associated with the potential for economic growth in the future. This leads to a position that favors shorter duration and lower credit quality in fixed income portfolios.

   Conversely, a flat or inverted yield curve suggests the economy will be slowing, which would favor longer durations and higher credit quality. The conclusion is that the three elements—interest rates, duration and credit quality, are intertwined and must be considered simultaneously. We believe that active management is the best way to navigate this complex relationship.

5. **Given all the headwinds facing fixed income (rising rate, inflation, etc.), how should investors think about the risk management piece of their portfolio that has traditionally been the role of bonds? Are there different strategies or asset classes, like currencies, that should be considered to help with risk management?**
   The role bonds play in a portfolio has not changed. An investor should own bonds for stable cash flow and to offset the volatility of stocks. The expected return arguably is lower today than we have seen historically, but bonds should still generate modest positive returns and should continue to be significantly less volatile than stocks. It is also important to recognize that not all bonds are the same.

   As mentioned in the second question, Treasuries do not do well in periods of rising rates. Conversely, high yield bonds have performed better in years that interest rates have increased than they have in years when rates have fallen. This very unique characteristic in the fixed income world certainly leads to the conclusion that a thoughtful allocation to credit in bond portfolios makes an abundance of sense in the current and forecasted environment.

   We also believe that active management is critical in periods of time during which the Fed is raising rates. Historically, the yield curve has flattened (and sometimes inverted), with short-term rates rising significantly and long-term rates remaining fairly flat. This makes sense as the Fed directly controls overnight rates (very short term), and the risk of future inflation decreases as it raises rates. The changing shape and slope of the yield curve makes active management desirable and puts bond ladders at a disadvantage.

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