How Inflation and the Economic Environment are Impacting Fixed Income

After the first half of the year included steep declines in stock and bond prices, inflation hitting its highest levels in decades, and aggressive rate hikes, can the Fed usher in a soft landing? Weitz Investments portfolio managers Tom Carney, CFA, and Nolan Anderson share their views on the current economic environment, the bond market, where they're finding opportunities, and their outlook for forward returns.

Jenna Dagenhart:

The wild ride in the fixed income marketplace continues. Both stock and bond prices faced steep declines during the first half of the year. Inflation and the Fed's ensuing fight against it have led to increased market volatility, and now investors are bracing for the possibility of a recession. Joining us today from Weitz Investment Management to share their take on the current environment are portfolio managers Tom Carney and Nolan Anderson. Thank you both for being here.

Nolan Anderson:

Hi, Jenna. Great seeing you.

Tom Carney:

Pleasure to be on Asset TV again, Jenna. Thank you.

Jenna:

Well, great to have you both back with us. Tom kicking us off, what are your thoughts on inflation and whether the Fed can usher in a soft landing as they obviously hope to do?

Tom:

Well, on inflation, it's kind of an easy answer. It's terrible. And it's particularly terrible for that part of America that have the least ability to withstand increased food, increased energy, increased rent, so many costs that are rising that impact their budget on a day-to-day basis that really aren't being matched, even though incomes are rising, but certainly not enough to offset CPI – last reading of over 9% and many consumer baskets that are much higher than that. Ronald Reagan arguably said it best about inflation when he said inflation is as violent as a mugger, as frightening as an armed robber, and as deadly as a hit man. And we've certainly seen inflation be a problem, certainly in the market broadly, in the economy. And the Fed is certainly trying now, aggressively, to offset the rise in inflation and the impact that it's having on the economy broadly.

The key will be, though, just to add one thing as to – what does inflation look like as we go forward from here? Using analogies, I think of mountains, and Mount Thor in Canada has a claim of being one of the steepest vertical drops in the world. Very, very sharp peak of 40,000 plus drop, actually a 105-degree angle. So if inflation can come down as fast as a person falls off that mountain, then the economy might be fine. But it might more look like North Table Rock Mountain in Colorado, which has a plateau that seems a mile long. So if inflation just is persistently stuck high, the Fed has lots and lots of work to do as we go forward.

And as to whether or not they can usher in a soft landing as they hope to do, this marks the 13th time since 1954 that the Federal Reserve Board's policymaking Open Market Committee began ratcheting up interest rates gradually, and this year very sharply, on bank reserves in a series of steps. Eventually, however, all of those rate increases stopped, and the FOMC began bringing the Fed Funds rate back down. Of those times, it's been 12 times since 1954, only four have resulted in a soft landing. So, a batting average of 33% might get you in the Baseball Hall of Fame, but it's going to get you an F non-passing if you were to, for example, be taking the CFA exam. So that's really the challenge the Fed faces, and even most recently Neel Kashkari, Federal Reserve of Minnesota, even admitted the Fed has a poor history of accomplishing a soft landing. So, time will tell as to whether or not the Fed is actually able to both bring down inflation and do so in a way that accomplishes some version of a soft landing. But it really reminds me of songs by Aerosmith actually, too, that like, I like songs, and I think in many ways they might be "Dreamin' On." So we'll find out how that ends up.

Jenna:

Certainly a tough road ahead for the Fed. And sticking with you, Tom, how is the current economic environment impacting the bond market?

Tom:

Well, much like the stock market, it's in a word, volatility, and lots of it. But the volatility has generally resulted in dramatically lower prices, lower bond prices, higher yields, as both the Treasury curve has lifted higher, flattened, so short to long term rates are much closer than they were a year ago together. And then also, credit spreads have widened pretty meaningfully if not dramatically. Certainly in the high yield market, the high yield market had its worst six months in '22 ever in terms of decline, price decline, total return basis.

And just maybe for some added perspective, the U.S. investment grade market as of the end of June, beginning of July, there's been a pretty meaningful recovery since the U.S. investment grade market was trading at a dollar price of approximately $93, which is a… haven't seen that low of a level from a dollar price perspective since the Great Financial Crisis of '08 and '09. And it's a full 13 points lower than the long-term median, which is north of par, approximately 106, which even includes elevated periods of inflation in 1994 through 2008.

High yield, even worse. There's been dramatic spread widening in the high yield market, has left dollar prices in high yield much lower. So, high yield bonds were trading in the mid-eighties at the beginning of July, certainly higher today, but it's certainly lower than the long-term median and even lower than the post-Great Financial Crisis median as well.

Jenna:

Turning to, Nolan, where are you finding opportunities today for the Short Duration Income and Core Plus Income Funds? And what's your outlook for the rest of 2022?

Nolan:

Yeah, thank you, Jenna. While the broader opportunity set has clearly improved, as Tom alluded to, currently we're finding very solid opportunities in higher-quality, short-duration asset backed securities with the 2-year, 1- to 3-year, part of the Treasury curve, now the highest part of the curve, at about 3%. You don't have to take a lot of risk to earn a very reasonable return. And as credit spreads have widened, as Tom also alluded to, the investment opportunities today are just far superior than they've been in the last several years.

On this slide that you see, we lay out eight investments that we've made in both strategies over the last couple of quarters. And you can see in the dark blue bar, these are the yields that are… that we've received on our new investments today versus what was available in 2021. And you can see both the spread component and the base rate component has led to yields in the 4 to 5 and a half percent range on average versus about 1% last year. So big step function increase in yields. And again, these are these are 1-to-2-year average life know high-quality investments.

And also in some cases, we also have the credit ratings on the slide here. And in some cases that has led to an increase in the credit rating. So not only are we earning multiples of what we were last year for similar investments, we believe the risk component of the risk return framework is actually working in our advantage.

Credit rating agencies have also, we've noticed some normalization in the credit for the consumer. Tom talked earlier about, in particular, the lower end of the consumer spectrum. But really across the curve, we have seen a normalization in credit trends. But overall, the credit portfolios within these investments remain very strong. But rating agencies are trying to be forward looking. And then I'd also point out, too, that, you know, these lenders that we do business with, some of which are identified on the screen, they're seeing these credit trends, too. So they're making adjustments in real time. They're tightening their lending standards. So unlike a manufacturer who has long lead times for raw materials, sourcing, it's a long process. Lenders can truly make real-time changes in their in their underwriting. And we're seeing that. So it's actually a positive, we think, going forward that not only has our cost of capital increased, which has required them to think differently about their returns, they're making the right decisions long term for their franchises in terms of tightening up credit today.

Jenna:

And last question to you, Tom. What's your overarching message to investors and fund shareholders today?

Tom:

Well, you turn on the news, a lot of times you get a lot of dour commentary potentially. But as Nolan certainly highlighted, there is a silver lining in what's happened to interest rates broadly, credit spreads broadly, because that has improved the prospect for forward returns materially. In previous commentary, we lamented ourselves about an environment of return-free risk. Credit spreads were historically low and Treasury rates were equally so, especially on the front end.

And it was kind of a double whammy of low returns. And so, that changed materially in the first six months of ‘22. And certainly, it's a result of what the Fed is doing. Certainly inflation. Worry about recession. Confusion about forward progress on the macro environment. All these things present opportunities for the fundamental investors… so meaningfully improved from a year ago. We spent nine years post the 2008, actually April of ‘08, nine years approximately at zero interest rates on the front end. And we only spent six months of that timeframe above 2%. And now, as of the Fed's action as of this past monetary policy action, we're above two again.

This will be the seventh time in ten years where short-term investors, at least, have seen much better forward return prospects. And overall, we see an environment that is not this attractive since the first and second quarters of 2020, when there was dramatically more concern about the economy and its prospects, post the reaction, economic reaction the nation in the world took in response to the to the virus.

So in many ways, this is a very interesting time. Forward returns are very good. Certainly the key is to do bottom-up, fundamental in investing with an overlay of at least a sense of where the macro is. And although we certainly don't try to predict where forward interest rates or stock market prices are going to be, it's like equity, it’s one stock, one company bond investing. It's one security at a time, seeking out those opportunities where we can best find them with a flexible mandate that allows us to cast out into various areas of the marketplace that are either misunderstood, disliked, and take advantage of that by deploying capital on behalf of ourselves and our investors.

Jenna:

Well, Tom Nolan, thank you both so much for being with us today and great to have you.

Tom:

Jenna, always a pleasure. Thank you.

Nolan:

Thank you, Jenna.

Jenna:

And thank you so much for watching. Once again, that was Weitz Investment Management fixed income portfolio managers Tom Carney and Nolan Anderson. And I’m Jenna Dagenhart with Asset TV.

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