Allspring

Crossroads: Politics, Inflation, & Bonds

GEORGE BORY, CFA

+ Fixed Income Strategy/ Portfolio Strategist

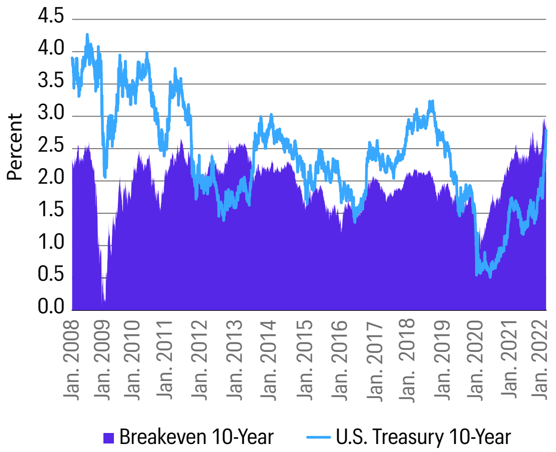
At the crossroads of politics and inflation sit all investments, including bonds. Earlier this year, fixed income investors were jolted out of their slumber as the Federal Reserve (Fed) took a much more hawkish stance to combat inflation. Just a few weeks later, Russia invaded Ukraine, which presented a whole new set of challenges that only reinforced the need for the Fed to act. It's hard to overstate the magnitude of these two developments, especially since they occurred in such a short time frame and came on the heels of a global pandemic just two years prior. It's fair to suggest the combination presents a seismic shock that will have repercussions in political capitals and capital markets for years to come.

With markets at a crossroads, there is a lot at stake for bond investors. In this note, we discuss the context and present views that will guide our strategy in the months ahead:

- **Move to neutral duration**
- **Real yield opportunities are improving**
- **Be judicious in credit**
- **Municipals look attractive**
- **Emerging markets may benefit**

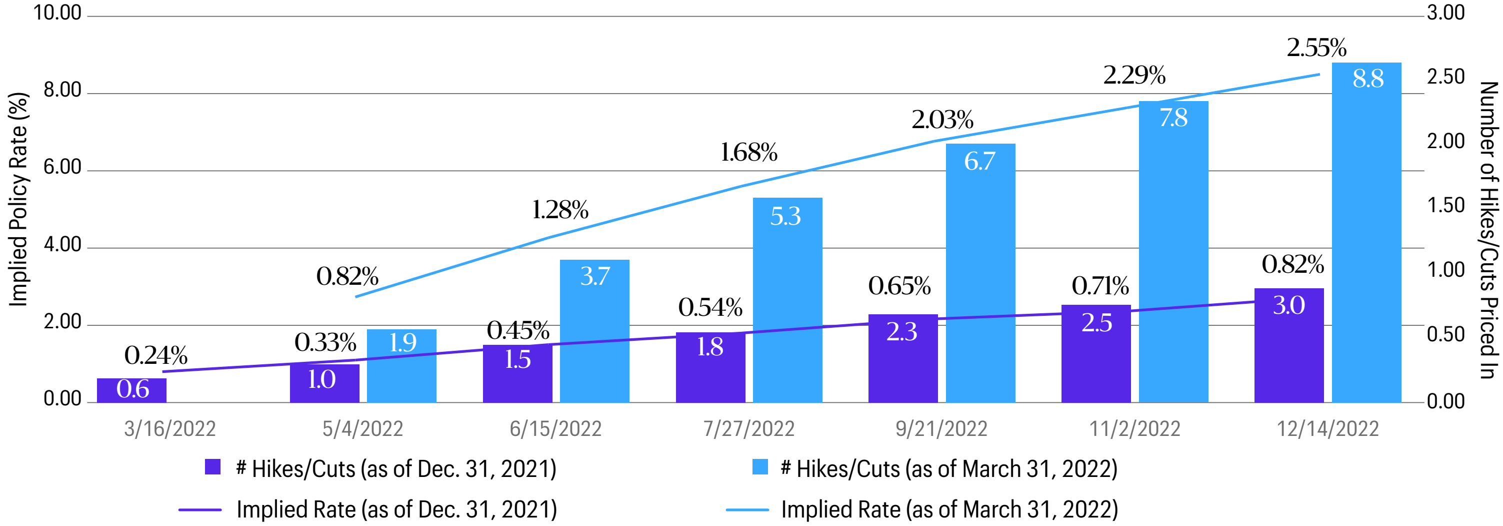
Both Ukraine and Russia are suffering significant direct consequences of the war. In Ukraine, thousands have been killed and millions have been displaced, all but assuring that Ukraine's economy should grind to a halt. Ordinary Russians are also bearing the full force of international sanctions. For the rest of the world, the fallout is no less consequential—longstanding alliances are under unprecedented strain and new ones are being forged. Moreover, shortages and supply chain disruptions have extended across the energy complex, grains, metals, and chemicals, pushing global commodity prices meaningfully higher and restricting the availability of critical parts, goods, and supplies for manufacturers and consumers. Many economists expect the resulting spike in prices to detract at least 1% from global growth this year, with the brunt of negative growth being borne by Eastern and Western Europe.

FIGURE 1: INFLATION & BOND YIELDS



Sources: Bloomberg L.P. and Allspring Global Investments
*Breakeven is the U.S. Treasury 10-year yield minus the U.S. Treasury Inflation-Protected Securities 10-year yield.

FIGURE 2: IMPLIED OVERNIGHT RATE & NUMBER OF HIKES/CUTS



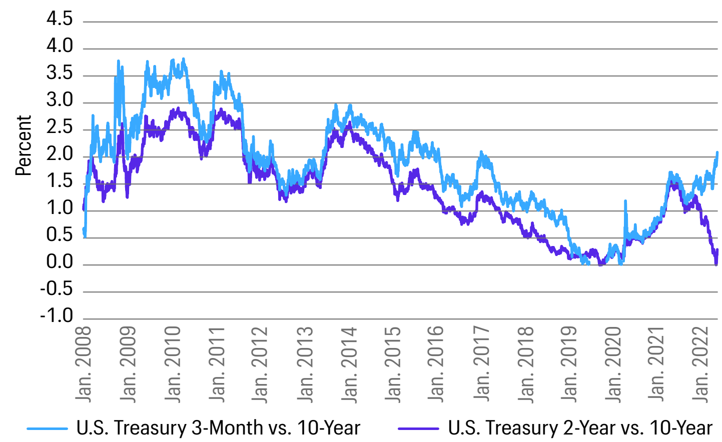
Sources: Bloomberg L.P. and Allspring Global Investments

The Fed's reaction to the economic fallout from the conflict and its shift to a much more hawkish stance have the most important consequences for financial markets. It seems the Fed views inflation as a clear and present danger and it is staking its credibility on its ability to restore price stability to the U.S. economy. To no great surprise, markets have responded aggressively.

Goods inflation was already running hot coming into the year. The invasion has further inflamed concerns among the world's central banks. The Bank of England implemented its first rate hike on December 16, 2021, and was joined by Canada on March 2, 2022, but it was the Fed that really changed its stance and dramatically shifted market expectations. In mid-January, the Fed ratcheted up its hawkish bias and signaled to the market its intent to start tightening monetary policy over the remainder of 2022 and into next year. At first, the message was measured and persistent, but following Russia's invasion of Ukraine, the Fed's rhetoric strengthened significantly, culminating with its first rate hike on March 16, 2022. Today, the federal funds market is now pricing in 250 basis points (bps; 100 bps equal 1.00%) of rate increases over the next 12 months.

FIGURE 3: TERM SPREADS

FED STILL BEHIND THE CURVE



Sources: Bloomberg L.P. and Allspring Global Investments

Unsurprisingly, the entire fixed income market has undergone a massive duration rebalancing, reflecting higher inflation and a more hawkish Fed. Further out on the curve, yields have risen and the coupon curve has flattened, while yields at the very front end remain attached to the actual federal funds rate. Yields in the overall U.S. Treasury market are about 130 bps higher so far this year, which has resulted in a year-to-date, mark-to-market loss of more than 7%—the worst start to a year on record for fixed income. Importantly, the 10-year U.S. Treasury bond recently breached its long-term support level of 2.6%, which is a long way from the 0.5% it recorded as recently as August 2020. Its recent move higher has pushed yields into no man's land with little technical support until yields reach the mid-3% level.

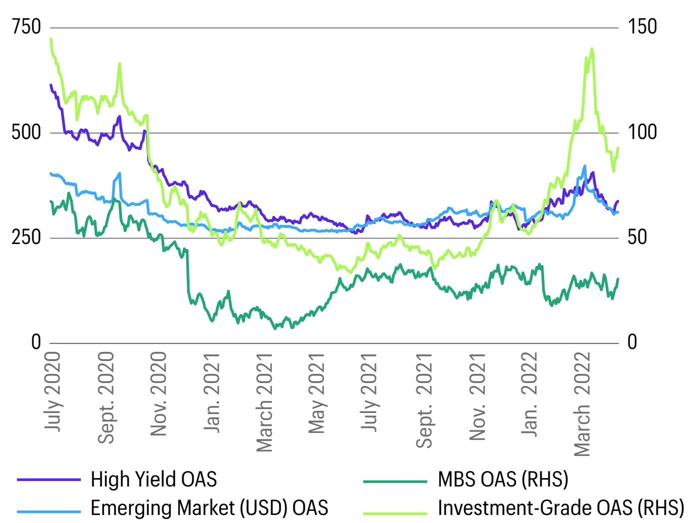
Beyond U.S. Treasuries, credit spreads in everything from government-guaranteed mortgage-backed securities (MBS) to the lowest-rated high-yield debt have widened as well. But, to be fair, spread widening has been fairly modest given the extreme volatility in the rates market.

Recalibrating the bond market

While painful, much of the repricing in fixed income was necessary in recognition that the extraordinary monetary policies implemented in 2020 in reaction to COVID-19 were not sustainable. Moreover, following the dramatic shift in the geopolitical landscape, supply chains will need to be reworked and the globalization trend of the past two decades should slow further. As a result, it is likely inflation will be higher, growth will be slower, and monetary policy will be tighter going forward. However, that does not mean a recession is imminent.

Today's higher yields, wider spreads, and relatively flat yield curve better reflect the current economic backdrop and should allow credit to flow through the system in a more economically judicious and efficient manner. In the aggregate, this suggests to us that interest rates will likely continue to head higher in the coming months, but at a much slower pace than seen in the first quarter.

FIGURE 4: MID-CYCLE CREDIT SPREADS (BPS)



Sources: Bloomberg L.P. and Allspring Global Investments; OAS = option-adjusted spread

Credit spreads remain a wild card. Much of this year's repricing appears to reflect the need to shed duration in the face of high inflation and a less accommodative Fed. Current credit valuations are more consistent with mid-cycle growth than fears of a hard landing. We have sympathy for this view, but we are uncertain about the pace at which tighter financial conditions will affect the real economy and borrowers.

From defense to offense

Pockets of value have emerged in parts of the market, and we have started to enact a more debt-friendly stance in our fixed income portfolios. In implementation, it is important that bond investors carefully calibrate 1. their investment horizon—don't get too far out ahead of the trends, 2. diversify—multiple sources of income are your best way to protect against a surging macro backdrop, and 3. keep your cool—it's important to maintain an unbiased approach and not get tethered to one position or view. Our clients should consider the following:

- **Duration.** We started the year quite defensively positioned with respect to duration, but the recent sell-off—and its pace—allowed us to move back to neutral. We don't think bond revaluations have fully run their course, but the pace should moderate. Current values have started to create some interesting value propositions for different types of bond investors. As we like to say, value is in the eye of the bond holder!
- **Real yield.** We like positive real yields. Late last year, they were almost impossible to find. Today, the picture is much different. As investors shed duration earlier this year, bond yields moved higher across different segments of the market, some of which now offer positive real yields. This includes short-duration high yield, long-duration municipal bonds, emerging markets, and intermediate investment-grade credit (just barely).
- **Credit.** Credit spreads are currently trading in the middle of this year's range and trending marginally tighter. A macroeconomic backdrop of high nominal growth certainly supports credit quality in theory. But, we are cautious about the outlook. Our bias is to use the strength in the market to move up in quality and/or structure to capture yield. We also prefer to take more interest rate/duration risk as yields rise rather than go down in credit quality. To be fair, this trade requires patience but is one we plan to stick with as the year unfolds.
- **Municipals.** Municipal bonds got hit particularly hard in the first quarter due to very long durations and a heavy concentration of individual investors. However, with municipal-to-Treasury yield ratios now close to and sometimes above 100%, the value proposition looks compelling. This is particularly true for lower-rated municipal debt. Credit quality is still improving and funding requirements are limited.

- **Emerging markets.** The world has certainly changed when developed markets find themselves "behind the curve" in the fight against inflation while emerging markets take it in stride. Countries such as Brazil started tightening policy about a year ago and are much closer to the end of their tightening cycles than the beginning. Furthermore, several emerging economies stand to benefit economically (particularly Brazil, Peru, and Chile) as global supply chains are re-tooled away from Russia.

The short of it

To summarize, we think a massive shift in the global order is underway. Political shifts, policy shifts, supply chain shifts, pricing power, the balance between developed and emerging markets … they're all in play, and bond investors have only begun to react. Our five-pronged strategy is intended to help bond investors protect capital, capture yield, and maximize total return in today's rapidly changing market.

Distribution in the United Kingdom (UK), European Economic Area (EEA) and Switzerland: Allspring Global Investments™ (Allspring) is the trade name for certain investment management companies owned by Allspring Global Investments Holdings, LLC, including, but not limited to, Allspring Global Investments (UK) Limited (Allspring UK), an investment management company authorised and regulated by the UK Financial Conduct Authority (FCA), and Allspring Global Investments Luxembourg S.A. (Allspring Luxembourg), authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF). Allspring Luxembourg has branches in Frankfurt and Paris and is allowed to provide services on a cross-border basis in the EEA. This material has been approved for distribution in the UK by Allspring UK for the purposes of Section 21 of the Financial Services and Markets Act 2000 (FSMA). Allspring UK does not provide services to retail clients, the FSMA rules for retail clients will not apply and the United Kingdom Financial Services Compensation Scheme is not available. Unless otherwise stated, information does not contain investment advice, an investment recommendation or investment research as defined under UK FCA regulations or the Markets in Financial Instruments Directive (Directive 2014/65/EU (MiFID II) and therefore does not comply with the requirements for the provision of such services. For professional investors only. Recipients who do not wish to be treated as professional should notify their Allspring contact immediately.

Distribution in the United Arab Emirates (excluding Dubai International Financial Centre and Abu Dhabi Global Market): Allspring Global Investments™ (Allspring) is the trade name for certain investment management companies owned by Allspring Global Investments Holdings, LLC, including, but not limited to, Allspring Global Investments (UK) Limited (Allspring UK), an investment management company authorised and regulated by the UK Financial Conduct Authority (FCA); Allspring Global Investments Luxembourg S.A. (Allspring Luxembourg), authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF); and Allspring Global Investments, LLC. This material is intended for professional clients (defined by DFSA). This material, and the information contained herein, does not (intend to) constitute a public offer in the United Arab Emirates (UAE) and should not be construed as such. It is offered to a limited number of exempt investors in the UAE who fall under one of the following categories of non-natural qualified investors: 1. an investor that is able to manage its investments on its own, namely the federal government, local governments, government entities and authorities or companies wholly owned by any such entities; international entities and organisations; or a person licensed to carry out a commercial activity in the UAE, provided that investment is one of the objects of such person, or 2. an investor who is represented by an investment manager licensed by the Securities and Commodities Authority (SCA), each a non-natural qualified investor. The materials have not been approved by or licensed or registered with the UAE Central Bank, the SCA, the DFSA, the Financial Services Regulatory Authority or any other relevant licensing authorities or governmental agencies in the UAE (the authorities). The authorities assume no liability for any investment that the named addressee makes as a non-natural qualified investor.

Distribution in Australia: Allspring Global Investments, LLC, is exempt from the requirements to hold an Australian financial services license in respect of the financial services it provides to wholesale clients in Australia. Allspring Global Investments is regulated under US laws, which differ from Australian laws. Any offer or documentation provided to Australian recipients by Allspring Global Investments in the course of providing financial services will be prepared in accordance with the laws of the United States and not Australian laws.

Distribution in New Zealand: this material and the information contained in or accompanying this material are not, and are under no circumstances to be construed as, an offer of financial products for issue requiring disclosure to an investor under Part 3 of the Financial Markets Conduct Act 2013 (N.Z.) (the Financial Markets Conduct Act (N.Z.)). This material and the information contained in or accompanying this material have not been registered, filed with or approved by any New Zealand regulatory authority or under or in accordance with the Financial Markets Conduct Act (N.Z.). This material and the information contained in or accompanying this material is not a disclosure document under New Zealand law and does not contain all the information that a disclosure document is required to contain under New Zealand law. Any offer or sale of any interests described in these materials in New Zealand will be made only: (a) to a person who is an "investment business" within the meaning of clause 37 of Schedule 1 of the Financial Markets Conduct Act (N.Z.), (b) to a person who meets the investment activity criteria specified in clause 38 of Schedule 1 of the Financial Markets Conduct Act (N.Z.), (c) to a person who is "large" within the meaning of clause 39 of Schedule 1 of the Financial Markets Conduct Act (N.Z.), (d) to a person who is a "government agency" within the meaning of clause 40 of Schedule 1 of the Financial Markets Conduct Act (N.Z.), (e) to a person who is an "eligible investor" within the meaning of clause 41 of Schedule 1 of the Financial Markets Conduct Act (N.Z) or (f) in other circumstances where there is no contravention of the Financial Markets Conduct Act (N.Z.) (or any statutory modification or re-enactment of, or statutory substitution for, the Financial Markets Conduct Act (N.Z.)). In subscribing for interests, each investor represents and agrees that it is not acquiring those interests with a view to dealing with them (or any of them) other than where an exclusion under Part 1 of Schedule 1 of the Financial Markets Conduct Act (N.Z.) applies to such dealing and, accordingly: (a) it has not offered or sold, and will not offer or sell, directly or indirectly, any interests and (b) it has not distributed and will not distribute, directly or indirectly, any offering materials or advertisement in relation to any offer of interests, in each case in New Zealand within 12 months after the issue of interests to that investor other than to persons who meet the criteria set out in (a) to (d) above.

Distribution in South Korea: this document is distributed in the Republic of Korea by Allspring Global Investments, LLC, which is registered with the Financial Services Commission pursuant to the Financial Investment Services and Capital Markets Act (the Act) to conduct investment advisory and discretionary investment business with qualified professional investors (as defined in the Act). This document is not intended for, and should not be relied on by, any person other than qualified professional investors.

Distribution in Japan: this material and the information contained herein does not constitute and is not intended to constitute investment advice or an offer of securities and accordingly should not be construed as such. Any products or services referenced in this material may not be licensed or registered in all jurisdictions and, unless otherwise indicated, no regulator or government authority has reviewed this material or the merits of the products and services referenced herein. This material and the information contained herein have been made available in accordance with the restrictions and/or limitations implemented by any applicable laws and regulations. This material is directed at and intended for "professional" or "institutional" investors (as such term is defined under the laws of each applicable jurisdiction). This material is provided on a confidential basis for informational purposes only and may not be reproduced in any form. Allspring does not provide tax, legal or accounting advice, and this material does not take an investor's personal investment objectives or financial situation into account. Before acting on any information in this material, prospective investors should inform themselves of and observe all applicable laws, rules and regulations of any relevant jurisdictions and obtain independent advice if required. This material is for the use of the named addressee only and should not be given, forwarded or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

Distribution in Canada: Allspring Global Investments™ (Allspring) is not registered as an investment advisor in any of the Canadian provinces, is only authorised to provide investment advisory services in Canada pursuant to an exemption available to foreign investment advisors under Canada's National Instrument 31-103 (NI 31-103) and can provide such services only to "permitted clients" as defined under NI 31-103. Allspring is registered as an investment advisor with the United States Securities & Exchange Commission. Its head office is located at 525 Market Street, 12th Floor, San Francisco, California, 94105, and, thus, substantially all of its assets are situated outside of Canada. As a result, there may be difficulty enforcing legal rights against Allspring because of the above, and investors are directed to Blakes Vancouver Services, Inc., Allspring's agent for service of process, in the event of any disputes at the following address, phone number and email address: Blakes Vancouver Services, Inc., 595 Burrard Street, Suite 2600, Three Bentall Centre, Vancouver, BC, V7X 1L3; phone: +604-631-3300; email: lisa.marchese@blakes.com.

U.S./EMEA: PAR-0422-00463
APAC: PAR-0222-00464
Canada: PAR-0422-00465