

FEBRUARY 15, 2022

ON THE RADAR

FAQs on the Markets and Economy

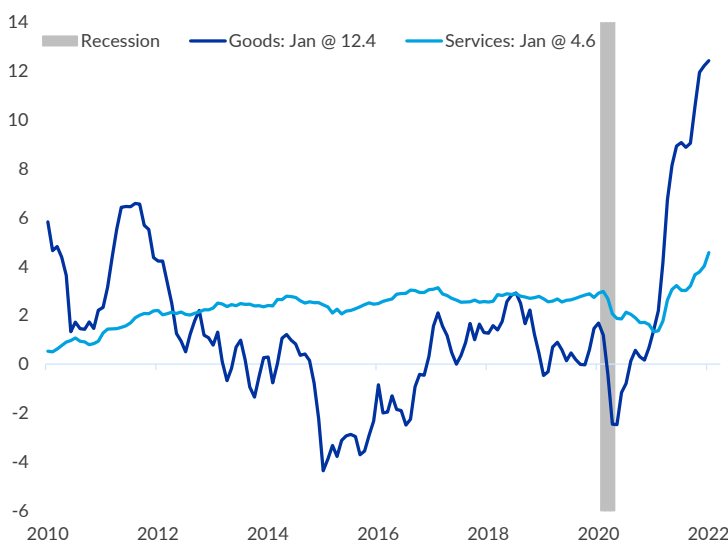
When Will Inflation Start to Decline?

Inflation is high. The consumer price index in January hit a 40-year high of 7.5%. A large part of the higher prices is a mismatch between supply and demand. We think it is about to peak.

Prices for goods continue to drive much of the inflationary surge (see chart). It is fueled by pandemic-related supply-and-demand imbalances. Some prices continue to have extremely high prices: used-car prices are up 40.5% in the past year, energy prices have gained 27.0%, and food prices are up 7.0%, the sharpest rise since 1981.

CPI: Goods and Services

% change, year-over-year, seasonally adjusted



Source: Bureau of Labor Statistics, as of January 2022.



KEY QUESTIONS

What is the Fed's plan for reducing monetary stimulus this year?

How is earnings season going?

Why do variable rate bonds make sense?

There is a need for significant price declines in the goods sector for overall inflation to decrease. That should happen this year as supply chain problems get worked out and there is a shift away from goods purchases and back toward services. Goods purchases skyrocketed during the pandemic since that was "the only game in town" as consumers pulled away from service spending, like at restaurants and travel. The decline of COVID cases should help this.

What Is the Fed’s Plan for Reducing Monetary Stimulus This Year?

We know from its December meeting the Fed plans to have three increases of 25 basis points this year. Since that meeting, we have heard from some of the Fed policymakers of their view of even more rate increases and the plan to reduce the size of its bond holdings.

Pressure on the Fed continues to mount as the yearly change in inflation continues to rise. In January, the consumer price index reported a 7.5% increase from a year ago. That is a 40-year high. This has pushed up market expectations for six or seven rate hikes this year (see chart below).

Although there is a great deal of press about the Fed needing to raise the interest rate by 50 bps at its March meeting, this is not our view. The Fed is not in the position to shock and awe

the markets, which causes unneeded volatility. Its job is to be methodical and tactical. Its goal is the long-term growth of the economy. If it believes more tightening is needed, a more attractive option should be even-keeled. The Fed may raise the funds rate 25 bps at each of the March, May and June meetings. If inflation has not started to wane, it still has four more meetings this year to raise the rates and be more aggressive in reducing the size of its bond portfolio.

Fed Funds Futures - December 2022 Contract
implied number of 25 bps hikes in the funds rate



Source: Bloomberg, as of February 2022.

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How Is Earnings Season Going?

Q4 2021 earnings season is now well underway. With about 72% of S&P 500 companies having reported, earnings growth is once again running above expectations, rising at a very strong 30.3% versus a forecasted 21.3% at the start of the quarter. However, despite some notable expectations, markets have not rewarded these stocks in a meaningful way with investors focused more on potential Fed actions and continued high inflation readings.

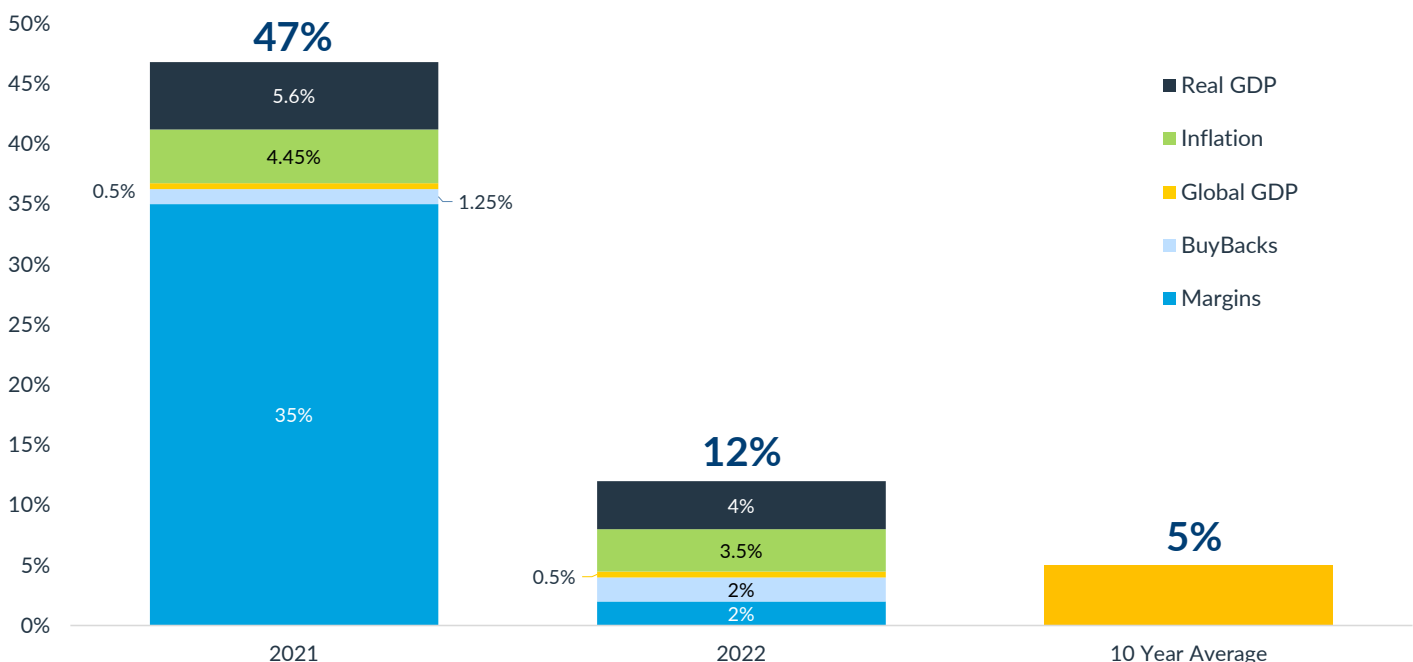
We still believe that over the next year, fundamentals and earnings performance will return as a key driver for higher equity prices. Even though yields are on the rise, they remain low, and as long as corporate profits rise at a solid pace, the relative valuation gap with bonds can be sustained.

Encouragingly, while S&P 500 earnings are expected to moderate over the year, estimates are still robust and well above the prior 10-year average. Companies appear to be successfully passing along price increases to consumers, which has helped profitability stay resilient in spite of higher input costs. Pricing power is a key reason why equities have proved to be a

successful hedge to inflation over time.

Though equity markets in general should be able to absorb higher bond yields, some stocks will likely do better than others, making prudent sector and security selection through active management more critical than in recent memory. Speculative and growth-oriented equities, for example, may be more vulnerable to valuation pressures from interest rate increases, and we recommended focusing on high-quality companies, selling at reasonable valuations, with the ability to generate earnings despite headwinds from tighter Fed policy and moderating economic growth.

CNR S&P 500 Earnings Per Share (EPS) Estimates



Source: CNR Research.

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Why Do Variable Rate Bonds Make Sense?

Throughout the history of markets, new security structures have been a hallmark of the modernization of financial assets, allowing for enhanced diversification and targeted risk levels.

One such structure is the leveraged loan, with a market size that has grown from \$5.2B in 1997 to \$1.35T today. These investments have several distinct features. First, they are the primary means of financing private equity transactions, which often support small and medium-sized companies. Second, they occupy the senior most portion of the capital structure and are fully secured. Third, and the most important feature today, income tied to loans adjusts with changes in floating rate benchmarks. This combination of features has made the loan market one of the most efficient and stable credit-based investments.

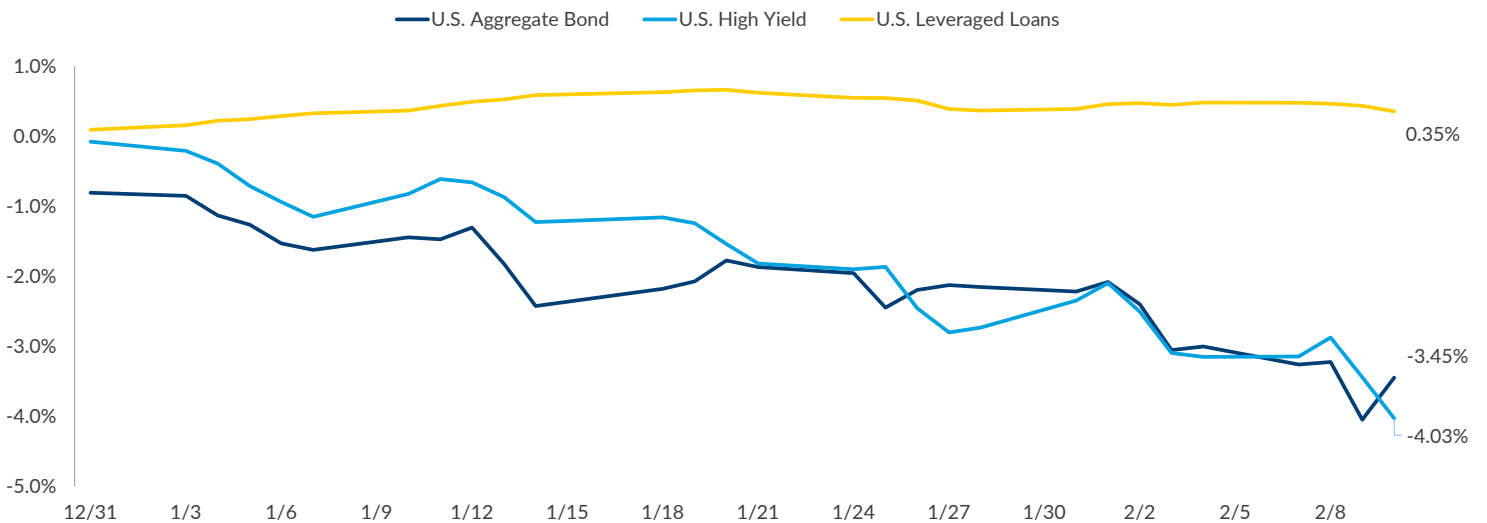
As a result of these features, leveraged loans have low interest rate exposure and, instead, move in tandem with economic growth rates and corporate profitability. As inflation continues

to climb and the Federal Reserve is anticipating raising rates in the midst of a healthy corporate environment and above trend growth, leveraged loans are positioned to outperform other credit investments, especially those with fixed rate yields.

Over January, flows into U.S. Leveraged Loan Funds set records with two of the top five weeks of fund inflows in the history of the market totaling over \$4B, eclipsing records set in 2013 during the taper tantrum. Further, as the fixed rate U.S. High Yield Corporate is down over 4% YTD 2022¹, the loan market has been resilient, turning in a positive performance of 0.4%². When searching for investments in a low yield world, we believe exposure to leveraged loans and other variable rate assets is the place to be in 2022.

Leveraged Loans vs. Investment Grade and High Yield Bonds Returns

Year-to-Date 2022



Footnotes:

¹ Bloomberg.

² S&P LSTA.

Sources: S&P LSTA, Lipper, Bloomberg (U.S. High Yield), S&P LSTA (Leveraged Loans).

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INDEX DEFINITIONS

S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market cap because there are other criteria that the index includes.

Muni Bond: A municipal bond is a debt security issued by a state, municipality, or county to finance its capital expenditures, including the construction of highways, bridges, or schools. These bonds can be thought of as loans that investors make to local governments.

Bloomberg Barclays U.S. Corporate High Yield Bond Index: measures the USD denominated, high yield, fixed rate corporate bond market.

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