Markets Hold Their Own Through First Quarter's Inflation, Rising Rates, War

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From my perspective, there were two main forces driving financial markets in the first quarter — inflation (and the reaction of the U.S. Federal Reserve) and Russia's invasion of Ukraine.

Broadly speaking, for almost the whole quarter, inflation – both actual and expected — was higher than expected. The Fed was more hawkish than expected, raising rates by 25 basis points (bps) in March for the first time this cycle, and began quantitative tightening (QT) to shrink its balance sheet. Markets started pricing in multiple 50-bps hikes by the Fed.

Rates rose across the curve, but especially at the front end, resulting in a flatter curve — the 2-10 year Treasury curve actually inverted, mildly and temporarily on April 1. The two-year Treasury tacked on 97 bps in March, rising to 2.28% by the end of the quarter, its highest level since May 2019. The 10-year Treasury gained 60 bps in March to hit 2.32% — again, the highest level in three years.

While Russia's invasion of Ukraine at the end of February was first and foremost a humanitarian disaster, it is also in many ways an unprecedented geopolitical event, with a major "risk off" shock for the markets. The shock first hit Russian and Ukrainian assets and then spread to Eastern Europe, other emerging markets and the broader global risk markets.

Quick Credit Rebound

But by a week after the invasion, the safe-haven buying that had temporarily pushed down Treasury rates gave way to continuing inflation pressure. Rates continued their march higher, as investors perceived the big supply shock to be inflationary. Oil and commodities surged higher, as Russia and Ukraine are both major food producers, and Russia is a dominant oil exporter.

Even with rising rates and the war – and the subsequent choppy performance of risk assets – by the end of the quarter credit spreads still managed to tighten compared with February 28 levels, right after the invasion started.

For example, on March 31 the spread on the ICE BofA U.S. High Yield Index stood at 343 bps — 34 bps tighter than a month prior. The Bloomberg U.S. Corporate Investment Grade Index also tightened, by 6 bps to 116 bps. While these levels are wider than at the start of the year, here's another perspective: Spreads on both the high-yield and investment-grade indexes are still tighter than their 15-year median marks.

The quarter was also notable for the rare hawkish unanimity achieved by the Fed, the European Central Bank (ECB), the Bank of England, and other central banks in both developed and developing countries. The inflation fight is truly a global one.

Bottom line: The rest of the year will likely give us more clues about the durability of the expansion as rates continue to rise. And, hopefully, it will bring a quick and just peace for the besieged people of Ukraine.

The impact of the coronavirus on global markets could last for an extended period and could adversely affect a strategy's performance.

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Value Opportunities Grow as Spreads Widen in 1Q22

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Corporate	Investment Grade (IG)			✓			Improved value in investment grade, as IG underperformed HY beta adjusted over Q1. IG spreads pricing in a much larger growth slowdown than HY. All-in forward returns improved on spread widening and higher rates.
	Floating-Rate Loans			✓			Low expected defaults/credit losses; expect liquidity premiums to increase as policy becomes less accommodative. Large portion of the market is fully floating, as Libor and Sofr are above their floor levels, which should keep investors engaged but increase debt service costs over time. As cycle matures, watch out for highly levered LBOs.
	U.S. High Yield		✓				Low expected defaults/credit losses; expect liquidity premiums to increase as policy becomes less accommodative. Convexity profile has improved as rates have backed up. Focus on reducing exposure to cyclical sectors and focus on high quality.
Municipal	High-Quality Investment Grade			✓			The muni market generated its worst first-quarter return since 1980 (-6.23%). With absolute yields significantly higher than they were to start the year, we are beginning to see some value, especially in the front end of the curve.
	High Yield			✓			The muni high-yield index declined -6.53% in the first quarter. Despite the downturn, high-yield muni spreads remain historically tight, as credit quality is strong.
Securitized	Agency MBS				✓		Moving to overweight from neutral; nominal spreads above 100bps already wider than 2018 quantitative tightening.
	ABS		✓				Spreads are too tight, but short weighted average lives (WALs) make them tempting hiding spot.
	CMBS		✓				Pockets of opportunity but significant fundamental property valuation questions remain unanswered.
	Nonagency MBS				✓		Moving to overweight from max underweight; risk profile has certainly shifted, with bonds extending and future home price appreciation limited by high mortgage rates, but spreads 200+bps wider in safer tranches are too cheap.
	CLOs				✓		We have seen spread widening across the capital stack, with most noticeable widening at the AAA level. Spread widening is a result of increased risk awareness caused by the Ukranian crisis and related adverse economic effects. However, given the floating-rate nature as a natural hedge against rising rates, we expect spread levels to remain flat to potentially tighter given the relative value compared to other risk assets. Reduced new-issue CLO supply should also provide some technical support for spreads. We believe spread levels are attractive barring exogenous shocks to the markets.
Emerging Markets	Sovereign – Local Currency				✓		Higher U.S. rates will be a headwind for EM local assets, but EM central banks are generally way further along the curve in normalizing monetary policy, which will support rates and FX valuations.
	Sovereign – U.S. Dollar				✓		Spreads have widened and are starting to look interesting.
	Corporate				✓		Outside of China property and Russia-Ukriane, fundamentals remain strong on the back of strong earnings and debt reduction, yet valuations are wide versus similarly rated developed-market peers. The asset class remains exposed to a risk-off event, however, given the large participation of crossover investors.
Other	Duration		✓				The inflationary environment is still bearish for yields, and the Fed has shifted to be much more hawkish. Still worth being underweight, but yields have sold off a lot already.
	Cash/Liquidity				✓		Real yield on cash is now significantly negative, but liquidity is worth keeping. The Fed needs to tighten financial conditions, which is another way of saying asset valuations need to weaken.
	Inflation Breakeven				✓		The war in Ukraine pours fuel onto the global inflationary fire. Long-end breakevens don't have enough risk premium built in to account for the chance inflation is slow to come down.

Source: Morgan Stanley Investment Management, as of 4/1/22.

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