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Weekly perspective on current market sentiment May 11, 2022

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Last week's S&P 500 Index: -0.2%

Fixed income expectations

Key takeaways

- We believe the Federal Reserve (Fed) will aggressively raise the Fed funds target rate to the 2.5% to 3% range by the end of this year.
- Our overall portfolio posture has moved toward a more defensive stance over the last 2½ months.

Consumer price inflation is hitting 40-year highs. The Fed is no longer buying U.S. Treasury securities and mortgage-backed securities. In addition, on June 1, the Fed is allowing maturing securities it has purchased to "roll off" its swollen balance sheet and will not be reinvesting the proceeds. Given this decline in demand for these securities, investors have pushed interest rates higher (bond prices lower) after an extended period of extremely low rates going back to the period after the Great Financial Crisis.

The yield on the 10-year Treasury note has moved from approximately 1.5% at the beginning of this year to a recent high of just over 3.1% in short order. Our outlook calls for the 10-year yield to end this year in the 3% to 3.5% range. We know that the Fed is in the midst of an aggressive series of interest rate hikes that we believe will likely take the fed funds target rate into our projected 2.5% to 2.75% range by year end. Note that the target rate was near zero coming into 2022 and the Fed has already raised it by 75 basis points (100 basis points equals 1%) since March. Given the easing pandemic and surging inflation, it makes sense that the Fed's emergency monetary policies needed to change.

As a result of the Fed's aggressive tightening efforts and a slowing economy as we move through 2023, we do not expect the yield on the 10-year Treasury note to continue to move higher next year. In fact, we see the yield moving down and falling into the 2.5% to 3% range by the end of 2023, reflecting a slower growth and more moderate inflationary environment.

We have been playing defense in fixed income for some time as we have been looking for interest rates to increase. Our rating on long-term fixed income continues to be most unfavorable given this segment's high sensitivity to rising interest rates. But we are most favorable on intermediate-maturity and favorable on short-term maturity segments of the bond market. The returns in these segments tend to be less sensitive to rising interest rates. We also carry a favorable rating on the municipal and commercial mortgage-backed securities sectors of the bond market.

Our recent efforts to reduce portfolio risk have involved shifting some allocations from more cyclical equity asset classes like emerging markets and U.S. small caps into our favored fixed-income asset classes. In terms of equity sectors, we have also taken on a more defensive, less economically sensitive stance and moved those funds into fixed income as well as the Health Care and Consumer Staples sectors.

For the time being, given current uncertainties and our economic outlook, we prefer this more cautionary approach.

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