CION INVESTMENTS

Fed + Inflation = Volatility

April saw bond yields rising dramatically in response to the Fed's messaging that it would be more aggressive in fighting inflation. The Fed has two levers to tighten monetary policy. The first is to increase the key Fed funds rate and the second is to reduce its own balance sheet, which removes price support for some assets and pushes up yields.

The Fed's path to increasing short-term rates was positioned as becoming much steeper than previously announced, with a series of likely 50-basis point hikes beginning at the May meeting and persisting through year-end. Balance sheet reductions, or quantitative tightening (QT) will begin soon, with up to $95 billion in reductions each month.

The consumer price index (CPI) of 8.5% in March was the highest level in 41 years. This bolstered the Fed's more hawkish posture. In anticipation of at least a 50-basis point hike at the upcoming May FOMC meeting, ten-year Treasury yields hit 2.94% by April's end, up 60 basis points. Two-year yields rose 38 basis points, which pushed the yield curve back into a normal, or positive, slope.

Mortgage rates shot up, with the 30-year fixed rate hitting above 5% by month end, the highest it has been since 2009. This raised fears that the housing boom would turn out to be a bubble, and promptly pop. The prospect of the Fed overshooting and instead of engineering a "soft landing" for the economy, slowing growth to the extent that it causes a recession, gained credibility. The release of the advance first quarter GDP number by the Bureau of Economic Analysis (BEA) showed that for the first time since the second quarter of 2020, GDP shrank. The annual rate was -1.4%. Recessions are usually defined as two consecutive quarters of negative GDP.

The data from the first two weeks of May has not been reassuring. April employment numbers from the BEA of 428,000 non-farm jobs remain solid, but the household survey indicated that labor force participation may be slowing down. While the annualized April CPI number was lower than March at 8.3%, it missed expectations that inflation would moderate to 8.1% as food prices increased dramatically.

What Does All This Data Mean for Bond Markets?

If you were a bond investor back in the 1980s, the debacle that ensued in bond markets may be familiar to you. But that's essentially the only parallel, because interest rates have been declining for decades, which has provided support for bond prices (bond prices move inversely to their yields.). How bad is it now? The Bloomberg U.S. Aggregate Index had the worst start to the year since the data began in 1976. It's down 9.5% year-to-date.

As rates continue to increase, and the Fed reduces its balance sheet, prices will likely continue to suffer.

Equity Market Volatility Is Increasing. Aren't Bonds Supposed to Provide Ballast in a Portfolio?

The usual risk on/risk off trade has investors moving out of equities when volatility increases, into the relative safety of bonds. This increases bond prices. So far this year, it's not working. Traditional fixed income is down across sectors, and outflows year-to-date from investment grade funds total $47 billion. The positive correlation between equities and bonds means that the core proposition of the traditional 60/40 portfolio, that it will allow for growth while cushioning downturns, can be a recipe for disaster.

A Closer Look: Diversification Can Be Elusive

Bonds usually benefit from equity market declines and higher volatility as investors seek out lower-volatility assets. Bonds have suffered historically bad returns so far in 2022, and the equity markets are also struggling. This has disrupted the largely negative correlation of these two asset classes over the last several decades.

Bonds and equities are now moving in tandem, and from the perspective of investors, they are both going the wrong direction. What options are there for those seeking to balance an equity position? Assets that are not traded on public exchanges may have lower correlations to equities, as they are somewhat insulated from the movements of the public markets.

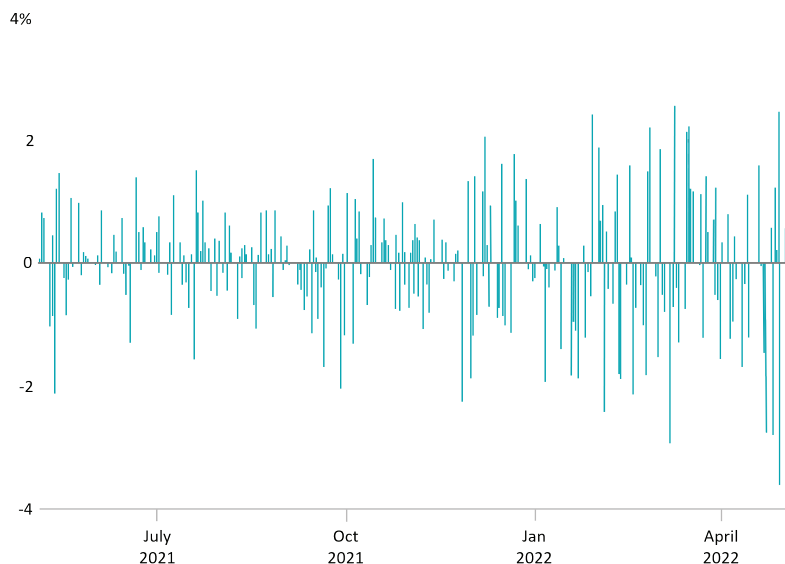
Performance Among Credit Indices

	MTD (3/31/2022 - 4/29/2022)	YTD (as of 4/29/2022)	TRAILING 1 YEAR (4/29/2021 - 4/29/2022)
Credit Suisse Leveraged Loan Total Return Index (CSLLLTOT)	0.17%	0.07%	2.87%
Bloomberg US Corporate High Yield Total Return Index (LF98TRUU)	-3.56%	-8.22%	-5.22%
Bloomberg US Aggregate Total Return Index (LBUSTRUU)	-3.79%	-9.50%	-8.51%
Bloomberg Municipal Bond Index (LMBITR)	-2.77%	-8.82%	-7.88%
Palmer Square CLO Debt Index (CLODI)	-0.31%	-0.71%	1.43%

Source: Bloomberg as of 5/4/2022

Chart Spotlight: Volatility is Increasing

As the Fed attempts to control inflation through more hawkish monetary policy, equity markets (as represented by the S&P 500) are experiencing much wider swings in price.



Source: Baidi Wang/Axios using data from FactSet

Credit Asset Classes

Private Credit	Structured Credit	High Yield
In 2021, private credit funds amassed about $190 billion, the largest fundraising year since 2017 when managers raised nearly $202 billion, according to PitchBook Data Inc. The full year 2021 performance of the Cliffwater Direct Lending Index, an asset-weighted index of over 8,000 directly originated middle market loans totaling $191 billion as of December 31, 2021, was 12.78%. Fitch Ratings reports that companies in business services, technology and healthcare have served as a large source of issuance in direct lending. Relative to issuers in other sectors, exposure to increased labor and raw material costs might be low for these companies. Large lenders are also willing to put more capital at risk in individual deals as the private debt market matures and attracts more capital, which could result in larger companies tapping the direct lending market. There were 17 unitranche deals exceeding $1 billion in size in 2021, compared with six $1 billion-plus deals in 2020.	The S&P LSTA Leveraged Loan Index saw BB-rated loans on top of the leaderboard for a second consecutive month with a return of 0.42%. Single-Bs were slightly behind the Broad Index at 0.19% for the period, while CCCs lagged notably, at -0.50%, and have been in the negative territory for every month since January. In April, total issuance was $35.5 billion, more than doubling March's tally of just $17.3 billion and well ahead of February's $23.9 billion. New CLO formation increased to $13.6 billion in April and has now eclipsed $44.3 billion on a YTD basis. There were no defaults in the Index during the month, as the Index continues to be default-free in 2022.	High yield bond performance, as measured by the ICE BofA US High Yield Constrained Index, was negative in April. The index returned -3.63%. Year-to-date performance at month end stood at -7.96%. Yields rose sharply as prices declined, ending the month 102 basis points higher at 7.06%. High yield spreads widened by 54 bps, rising to 398 bps. The negative performance was broad-based across ratings categories. BBs returned -3.66%, Bs were at -3.37% and CCCs were down the most at -4.02%. The Gaming, Leisure, Steel, and Transportation sectors fell less than the market, while Cable, Healthcare, and Building Materials underperformed.

Other Related Asset Classes

Treasuries	Investment Grade Corporates	Municipals
The benchmark ten-year U.S. Treasury bond yield closed at 2.94% up from last month's 2.34%. This marked the biggest monthly gain in ten years. The ten-year yield has jumped 143 basis points in the last two months. The 30-year U.S. Treasury Bond closed at 3.00%, up from last month's 2.45%.	The increase in Treasury rates spilled over into the corporate bond market, contributing to a a return of -2.72% for the ICE BofA/ Merrill Lynch 1–10 Year US Corporate Index. This marks four consecutive months of negative returns. Widening credit spreads also contribute to the negative performance, as well as significant market outflows.	Municipal bonds as represented by the Bloomberg Municipal Index returned -2.76% in April. April municipal bond issuance of $34 billion marked a 7.5 percent drop compared to April 2021 and 22 percent lower than March 2022, per The Bond Buyer. Asset outflows continued from municipal bond funds, topping $13 billion, per Lipper, about twice the prior month's level.

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