Ameriprise Financial

Committee Perspectives

An Ameriprise Global Asset Allocation Committee publication

Fixed Income Research Team
December 15, 2021

2022 Fixed Income Outlook

The Transition From Extraordinary Toward Ordinary

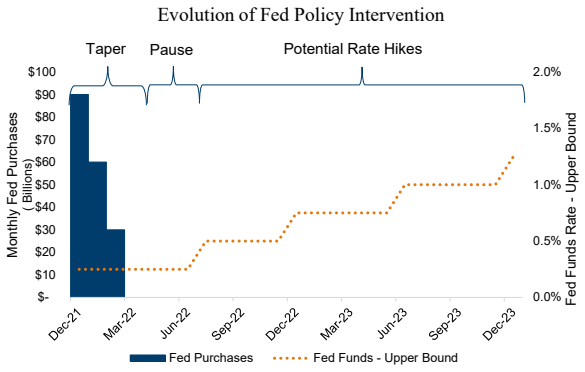
After a less than graceful Fed policy pivot to catch up with sticky inflation at the end of November, we look for Fed policy to transition away from extraordinary accommodation in 2022. The pivot has the Fed and bond markets playing catch-up and should stabilize after messaging of the December 15 policy meeting. We anticipate the Fed's posture to pivot from solely economic downside risks to a greater balance between tail risks in both directions – growth and labor market recovery and inflation implications for price stability.

Fed Policy: We anticipate Fed policy will evolve significantly by the end of 2022. We expect the Fed to reduce purchases from $90 billion per month in December to $60 billion in January at its December policy meeting. At that pace, purchases would end in March, concluding monthly cash infusions the Fed thought necessary through Covid-19 driven business disruptions.

Our Forecasts: Allowing bond markets to adapt to diminished liquidity and progress toward full employment likely fill the Fed's dashboard in the first half of 2022. Our current forecast incorporates a quarter-point hike in July and another in December. As the Fed contemplates potential hikes in the back half of the year, inflation forces may ease given year over year comparisons. With inflation potentially past peak levels, we anticipate the Fed to be more measured with rate hikes than the nearly three quarter-point hikes priced into 2022 fed futures markets as of December 10. We set our year-end 2022 10-year Treasury yield target at 2.00%, up half a percent from where it likely ends 2021. Our target considers both retreating Fed policy interventions and moderate levels of sticky inflation.

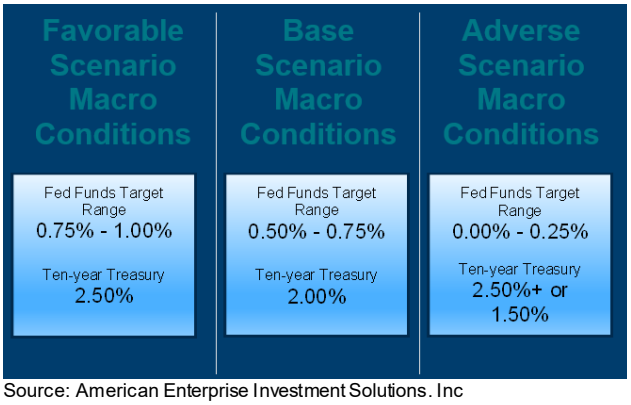
Our adverse scenario encompasses the trail risks facing markets and the Fed. First, slowing growth pace into 2023 and ongoing global geopolitical risk may draw Fed policy back into bond markets sending 10-year yields back to 1.50%. Second, run-away inflation could threaten price stability and force the Fed to hike rates quickly, leading 10-year Treasury

Ameriprise Forecast of Fed Policy 2021-2023



Source: American Enterprise Investment Solutions. Inc

Ameriprise 2022 Year-end Rate Targets



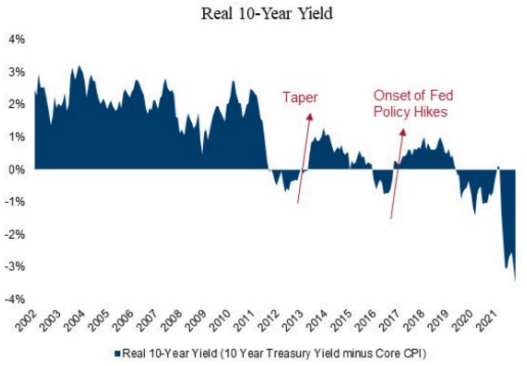
Source: American Enterprise Investment Solutions. Inc

yields significantly above 2.50%. Finally, in our optimistic scenario, we envision a further global reopening lifting 10-year yields to 2.50%, which would still be negative on a real inflation-adjusted basis. We remain far from ordinary but likely headed in that direction through 2022.

Nominal Returns Depressed, Real Returns Depressing

Today, with Treasury yields depressed by massive global central bank response to the Covid-19 pandemic, low coupons offer meager support for total returns. Price returns are likely to come in negative, given the potential for higher short-term and long-term Treasury yields next year. Fixed-income investors will need to be intentional about fixed income selection and strategy.

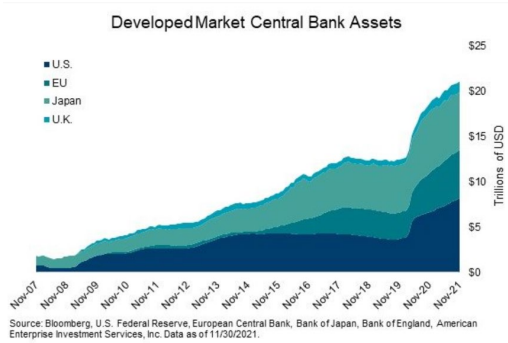
More than 20% of the $63 trillion Bloomberg Global Aggregate Index traded at a negative yield on December 10. In 2022, low coupons offer meager support for total returns, while price returns could be negative given the potential for higher yields. At the end of November, 10-year Treasury yields provided a -3.5% real yield relative to November's core CPI reading of 4.9%. While nominal U.S. yields remain positive, U.S. Treasury investors do not expect their investments to keep up with inflation today. We believe the Fed and its G7 brethren are pot-committed or willing to go all-in to sustain an expansion and avoid a deep contraction. Thus, low yields likely persist.

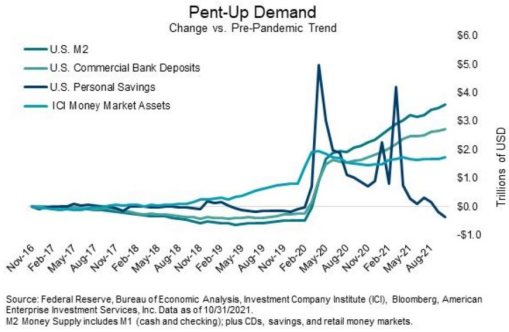


Liquidity Boost Through 2022

We anticipate the Fed will adjust the pace of its bond purchase program, tapering the program to end by March. While purchases may soon end, the impact of past purchases likely persists as a positive impulse in our view. Beyond active bond-buying programs and rate policy, two pillars of liquidity likely persist through next year:

- Central Bank Balance Sheets: G7 central banks hold $21 trillion of assets, including $8.2 trillion at the Fed. Asset purchase programs exchange bondholder debt investments for cash, reflecting trillions of long-term liquidity added since the great financial crisis and $9 trillion added since the beginning of 2020.
- Pent-up Demand: Fiscal and monetary policy flooded the consumer and credit channels with cash, which takes time to navigate the economy. Among the factors supporting markets: $3.7 trillion of above-trend U.S. M2 money supply, $2.7 trillion of above-trend commercial bank deposits, and $1.7 trillion of above-trend assets in money market accounts. See the chart to the right.





We believe liquidity likely remains a force through 2022, supporting risk assets and providing stability through potential dislocations that arise.

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Positioning: Segments and Strategies

Recommended Strategies: We recommend investors consider a buy and hold approach, holding positions until maturity to navigate the challenging return environment. Laddered strategies for individual bonds or target maturity funds use this approach. Alternatively, looking at the total return of a fund investment over a longer period, such as two to three years, takes into account the negative returns of rising rates and the benefits resulting from higher yields on future fund holdings. Finally, mandate flexibility for active fixed income managers, such as an absolute return strategy, could prove helpful at times next year if properly geared with an investor's risk profile.

Government Exposure: We believe U.S. Treasuries continue to offer valuable diversification against event risks that might arise. U.S. Treasuries remain a global safe-haven destination, in our view, and likely benefit from any Fed emergency policy response that may prove necessary. Another form of Treasuries, Treasury Inflation-Protected Securities (TIPS), may outperform fixed-rate Treasuries in scenarios where inflation becomes unanchored and other asset prices, including Treasuries, fall. Following the Fed's policy pivot toward inflation risk at the end of November, breakeven rates suggest TIPS as an attractive diversifier against higher inflation.

Corporate Sectors: We believe credit selection will be key in 2022 and recommend using our Corporate Bond Recommended List or active management with corporate exposure. We see the pandemic benefitting companies in both Technology and Health Care sectors in 2022 and continued opportunities in industries as we transition into mid-cycle investment opportunities. The green technology disruption supports a healthy Energy segment, and steepening Treasury curve sets up potential profit expansion in the financial sector as the Fed retreats. In the Consumer sector, we prefer retailers focused positioned around strong discretionary spending as well as select food and restaurant companies that can more easily pass on higher costs.

Municipals: We expect the relative value of tax-exempt bonds to improve in 2022 as technical imbalances normalize. We expect demand for municipals to ease in 2022 as prospects for higher income taxes fade, and continued risk of elevated inflation and a more hawkish Fed likely dampen fund flows. We would view the 10-year Municipal-to-Treasury ratio in the 80-90% range as an attractive level to add exposure. We believe investors should focus on higher coupon premium-priced bonds as low coupon bonds could underperform in a rising yield environment due to potential tax risk.

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