CITY NATIONAL ROCHDALE®

AN RBC/CITY NATIONAL COMPANY

DECEMBER 16, 2021

# On the Radar

FAQS ON THE MARKETS AND ECONOMY

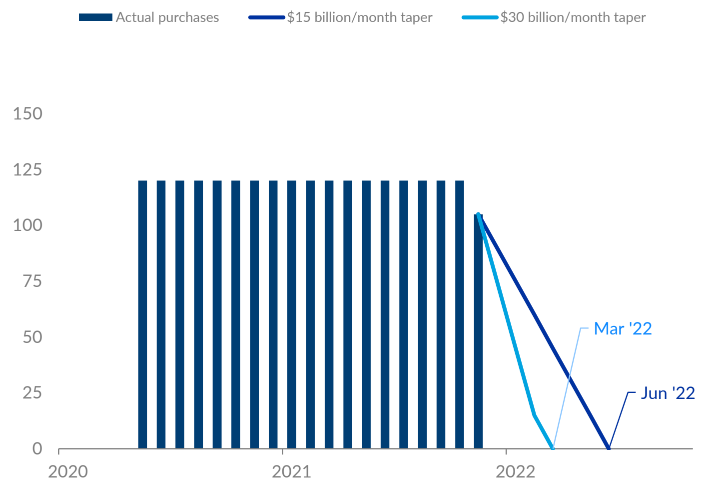
## Why is the Fed planning on speeding up its tapering of bond purchases?

Fed Chair Jerome Powell took a surprising change in his tone by turning more hawkish. The Fed is becoming more concerned with inflation, and Powell is joining a chorus of other Fed officials considering increasing the pace of the tapering of its bond purchases.

The pace of tapering, which the Fed approved at its November 3 meeting, reduces bond purchases by $15 billion per month, which would have ended its bond-buying program in June 2022. But, a new pace approved at their December 15th meeting sets a faster pace of $30 billion per month would end the program in March. The Fed will not begin to raise interest rates until it is done with its bond-buying program. This move allows the Fed to begin raising interest rates sooner than previously thought. The median number of interest rate hikes the Fed policymakers plan for 2022 is now three, just three months ago it was zero.

**The Fed Bond Buying Program**

*$, billions, purchases per month*




Source: Federal Reserve, CNR Research, as of November 2020 .

**KEY QUESTIONS**

Inflation is at a 39-year high; will it ever drop?

What's behind recent market volatility?

How did COVID-19 impact corporate bond defaults?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# Inflation is at a 39-year high; will it ever drop?

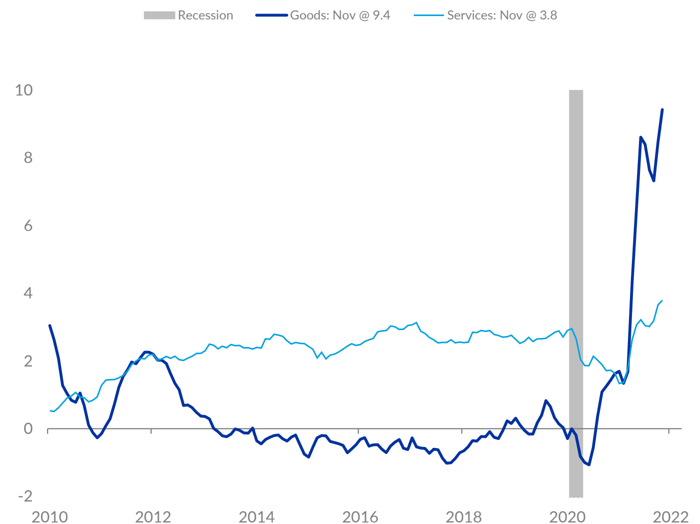
Strong consumer demand continues to collide with limited supply due to pandemic-related constraints, pushing prices upward.

The consumer price index stands at 6.8% y-o-y, and now marks six consecutive months above 5.0%. Price pressures continue to be focused on goods rather than services (chart). A limited amount of goods are available, due heavily to COVID-19-related reduction in manufacturing and transportation. At the same time, demand for many of those items has picked up due to generous actions by the Federal Reserve Bank and the current and past administrations. The inflation rate of services has been more stable, due mainly to the excess capacity.

We expect the annual inflation rate to increase in the coming months as low monthly inflation numbers drop off the yearly calculation and will be replaced by more moderate gains. After that, the yearly change in inflation should begin to subside next year, as the supply/demand imbalance comes back into balance.

**CPI: Goods and Services**

*% change, year-over-year, seasonally adjusted*




Source: Bureau of Labor Statistics, as of November 2021

# What's behind recent market volatility?

Renewed concerns over COVID-19, as well as the Fed's path of tapering, have brought volatility back to the market with the S&P 500 recently seeing its worst two-day performance in over a year and the VIX above 30 for the first time since February. Nevertheless, the pullback has been short-lived with stocks again trading near record highs.

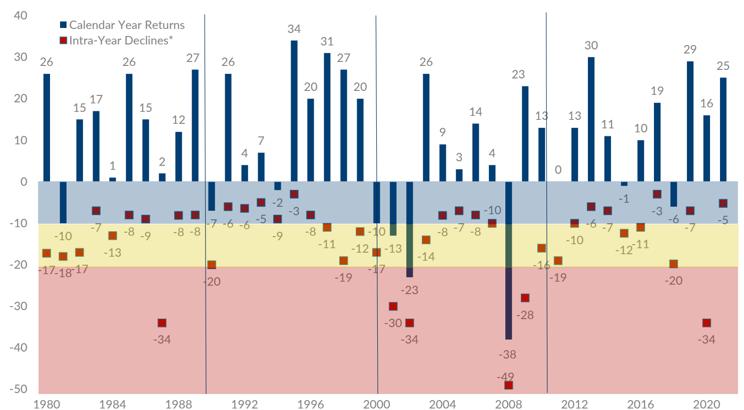
While uncertainty around the path and virulence of Omicron remains, early data seems to indicate the variant is less severe than originally expected. Moreover, medical advances and vaccination progress have better prepared the health system to deal with another virus wave, and we would expect any disruptions to economic activity to be less severe going forward.

Markets are also closely watching actions by policymakers, with the Fed expected to announce the acceleration of balance-sheet tapering. Nonetheless, we continue to believe the Fed still has room to be patient and deliberate when it comes to rate hikes, the true measure of economic tightening. Equities historically have held up well during tapering and the start of Fed rate hikes.

Currently, investors have more questions than answers, and a more balanced landscape of risks raises the prospect of further volatility in the coming months and even a potential market correction. However, investors should also remember that short-term volatility is normal. Market declines do occur each year, but more often than not annual returns are positive. Indeed, despite recent volatility, the S&P 500 is up 25% YTD.

We also believe this bull market still has room to run and that the combination of sustained economic expansion, robust earnings growth and low interest rates will ultimately remain a tailwind for stock prices through 2022. Given this, investors may want to use any weakness ahead as an opportunity to add to core positions.

**S&P 500 Return (%)**




Source: FactSet, as of December 2021.

# How did COVID-19 impact corporate bond defaults?

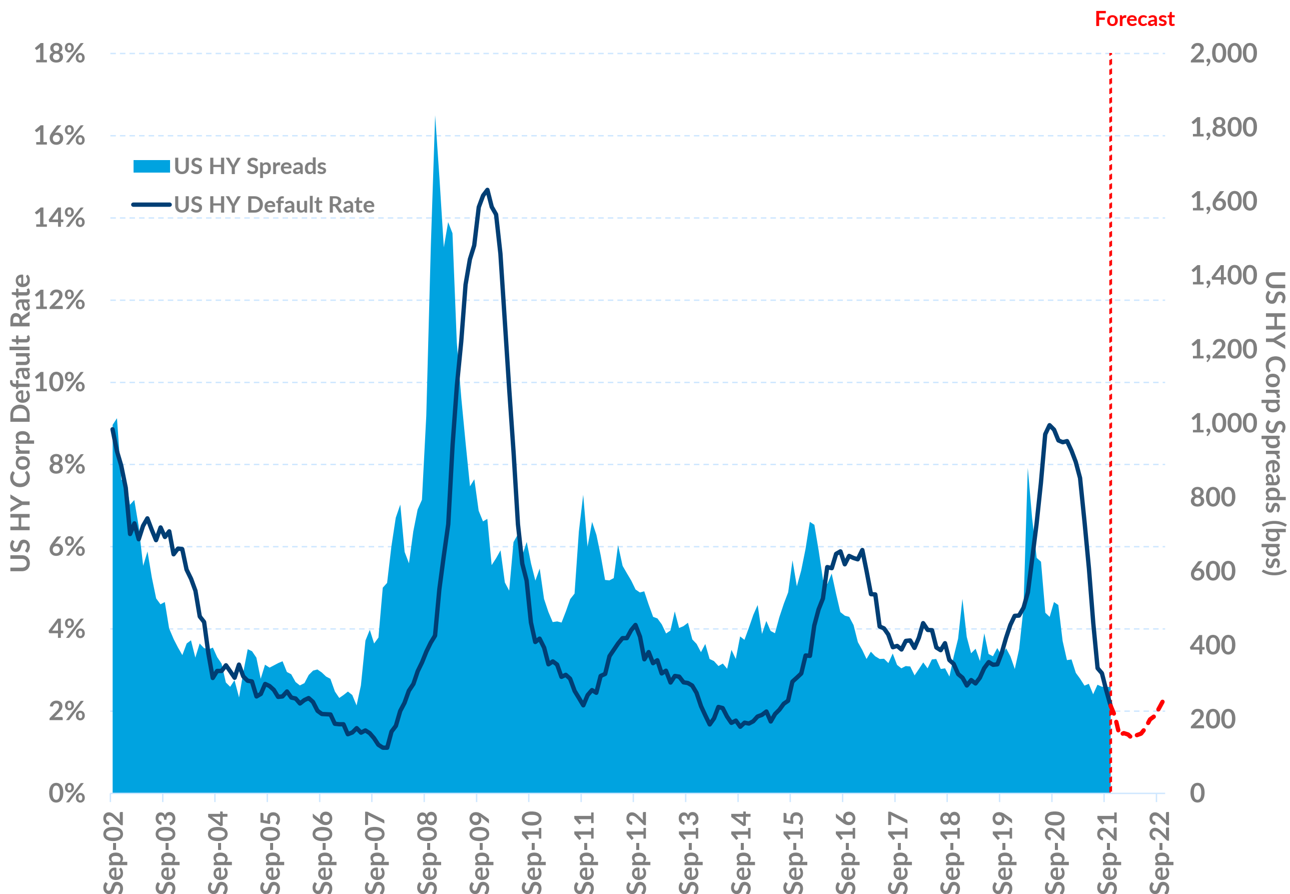
The pace of US high yield defaults has slowed significantly compared to a year ago, falling from nearly 9% in August 2020 to a six-year low of 2.1% in October 2021. The recovery has been driven by waning COVID-19 shocks and improving macroeconomic conditions, as well as funding conditions that remain accommodative despite the Federal Reserve's increasingly hawkish tone.

On the corporate level, numerous borrowers refinanced outstanding debt during the pandemic, reducing their interest burden and extending maturities. This has provided significant breathing room for issuers despite recent supply chain disruptions, labor shortages, nagging inflationary pressures and lingering pandemic-driven headwinds.

Looking ahead, many on the street expect credit conditions to continue to improve, driven by easing supply constraints and labor shortages, further vaccine distribution and a gradual normalization in monetary policy. Both Moody's and S&P expect US high yield default rates to bottom near 1.5% before increasing to roughly 2.5% in the second half of the year, which is still well below pre-pandemic levels of +/-4%.

High yield corporate bond yields have compressed more than 420 basis points as credit conditions improved, driving significant outperformance YTD against duration-matched Treasury (+6.4%) and investment-grade corporate (+5.8%) benchmarks. There is little discussion around the consistent underperformance of passive high yield strategies vs. active fund peers. Turnover costs are high in the high yield market, and we estimate that costs passive funds an additional 1% per year. Over 10 years, HYG* has underperformed its benchmark by almost 10%. We believe deploying high yield in a separately managed account, targeting specific bonds, is the best way to gain exposure.

**U.S. High Yield Corporate Bond Default Rate vs. Spreads**




Source: Moody's Bloomberg

* HYG is the most popular high yield corporate bond ETF and represents the iShares iBoxx High Yield Corporate Bond ETF.

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