

FIXED INCOME MARKET UPDATE

Fourth Quarter 2021

MONTH IN REVIEW

Inflation, The Fed and Omicron

Fourth quarter returns were generally positive in fixed income, even as the market dealt with increasingly worse inflation news and evolving responses from the Federal Reserve (Fed). At the beginning of the quarter, the Consumer Price Index (CPI), a year-over-year measure of inflation, was at 5.4%. By the end of October, it had risen to 6.2%, prompting the Fed to announce plans to taper asset purchases. By November 30, CPI clocked in at 6.8% and Fed Chairman Jerome Powell acknowledged that it may be time to retire the word “transitory” in describing inflationary pressures. On December 15, the Fed announced it would double the pace of its tapering plans and stop new purchases by March 2022. Investors have long expected the Fed to start raising interest rates in 2022, and the expected timing of the first hike continues to move earlier in the year. A new COVID strain appeared (the Omicron variant), but the Fed did not waver in its plans, and risk assets outperformed Treasuries in December after digesting the news. Looking back at the full year, the Bloomberg U.S. Aggregate Bond Index (the Agg) dropped nearly 3.5% in the first quarter, then recovered gradually throughout the rest of 2021 before ending with an approximate 1.5% loss. This marks just the fourth negative-return year since the index’s inception in 1970. Treasury yields showed some volatility throughout the year and ended higher across most of the curve, while credit spreads were quite stable amid mostly benign credit conditions. High yield bonds benefited from the strong fundamental corporate backdrop and were one of the top fixed income categories for the full year. See below for further analysis of the fourth quarter and full year 2021.

MARKET SUMMARY

Returns were positive in the fourth quarter for the major fixed income categories. Treasuries and investment grade (IG) corporate returns were negative for the full year while high yield (HY) was the top performer.

YIELDS & RETURNS (%)¹

	Duration (years)	Yield	Q4 Return	YTD Return
Treasuries	7.10	1.23	0.18	-2.32
Investment Grade Corporates	8.70	2.33	0.23	-1.04
High Yield Corporates	3.90	4.21	0.71	5.28
Municipal Bonds	4.82	1.11	0.72	1.52

U.S. TREASURY MARKET

In the fourth quarter the Treasury curve flattened, moving higher on the short end and lower on the long end. Outside of short T-bills, Treasury yields ended 2021 higher than where they began.

TREASURY YIELDS (%)¹

	Q4 Change	Year-to-Date Change	12/31/2021	11/30/2021	10/31/2021	9/30/2021
90-Day T-Bills	0.01	-0.03	0.05	0.05	0.05	0.04
2-year Treasury	0.44	0.61	0.73	0.55	0.49	0.29
5-year Treasury	0.28	0.90	1.26	1.15	1.19	0.98
10-year Treasury	-0.02	0.58	1.50	1.44	1.56	1.52
30-year Treasury	-0.19	0.25	1.89	1.79	1.93	2.08

Fourth quarter returns on Treasuries were mixed, with the largest (positive) results coming at the long end. With inflation a major theme of 2021, TIPS returned nearly 6% for the year.

TREASURY RETURNS (%)¹

	Duration (years)	Q4 Return	YTD Return
90-Day T-Bills	0.24	0.01	0.04
2-year Treasury	1.99	-0.53	-0.57
5-year Treasury	4.86	-0.90	-2.80
10-year Treasury	9.24	0.67	-3.60
30-year Treasury	22.94	4.70	-4.62
U.S. Treasury TIPS	7.59	2.36	5.96

BROAD INVESTMENT GRADE

The Agg was flat in Q4, cementing its first negative full-year return since 2013. Every component of the Agg was negative in 2021, while all but mortgage-backed securities (MBS) outperformed Treasuries.

INVESTMENT GRADE INDEX & SECTOR RETURNS (%)¹

	Duration (years)	Yield	Q4 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
U.S. Aggregate	6.84	1.75	0.01	-0.15	-1.54	0.32
Treasuries	7.10	1.23	0.18		-2.32	
Agencies	4.18	1.15	-0.58	-0.24	-1.32	0.00
Mortgage-Backed Securities	5.03	1.98	-0.37	-0.26	-1.04	-0.68
Asset-Backed Securities	2.33	1.13	-0.57	-0.12	-0.34	0.31
Intermediate Corporates	4.47	1.82	-0.56	-0.06	-1.00	0.88
Long Corporates	15.17	3.10	1.47	-0.64	-1.13	2.88

Investment grade corporate spreads widened in the quarter and ended the year having traded in a relatively narrow range. MBS spreads were slightly more volatile and ended the quarter and full year wider.

INVESTMENT GRADE SPREADS (basis points)¹

	Q4 Change	Year-to-Date Change	12/31/2021	11/30/2021	10/31/2021	9/30/2021
Intermediate Corporates	8	0	68	76	64	60
Long Corporates	8	-10	130	135	123	122
MBS Current Coupon Spread	12	14	57	56	44	45

Across the IG ratings spectrum, corporate bonds showed positive absolute returns in the fourth quarter while underperforming Treasuries. Incidentally, it was announced in December that Apple Inc. joined the short list of AAA rated corporate issuers.

INVESTMENT GRADE CORPORATE CREDIT QUALITY RETURNS (%)¹

	Duration (years)	Yield	Q4 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
AAA	12.96	2.09	1.12	-0.48	-2.26	0.81
AA	10.30	2.02	0.59	-0.34	-1.46	1.08
A	8.39	2.11	0.13	-0.33	-1.93	0.73
BBB	8.60	2.55	0.23	-0.24	-0.22	2.43

Spreads widened across every IG sector in the fourth quarter. Full-year spread moves were mixed, with limited volatility; 7 of the 10 sectors finished the year less 10 basis points away from where it began.

INVESTMENT GRADE CORPORATE BOND SPREADS BY SECTOR (basis points)¹

	Q4 Change	YTD Change	12/31/2021	11/30/2021	10/31/2021	9/30/2021
Consumer Non-Cyclical	6	-2	88	95	83	82
Technology	9	6	81	88	77	72
Energy	11	-21	116	126	106	105
Consumer Cyclical	5	-4	78	86	75	73
Transportation	5	-17	98	104	92	93
Basic Industry	6	-6	115	124	112	109
Communications	9	-2	118	127	114	109
Capital Goods	6	-12	86	92	80	80
Utilities	11	1	107	108	96	96
Financials	8	0	83	90	79	75

HIGH YIELD

High yield corporates posted positive returns for every quarter in 2021. CCCs lagged in the fourth quarter but finished the year as the top-performing HY ratings category.

HIGH YIELD SECTOR RETURNS (%)¹

	Duration (years)	Yield	Q4 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
High Yield Corporates	3.90	4.21	0.71	1.06	5.28	6.63
BB	4.58	3.30	0.75	1.03	4.61	6.24
B	3.20	4.57	0.84	1.27	4.85	5.92
CCC	2.91	6.82	0.54	0.98	8.59	9.52

HIGH YIELD OPTION-ADJUSTED SPREADS (OAS) (basis points)¹

	Q4 Change	YTD Change	12/31/2021	11/30/2021	10/31/2021	9/30/2021
High Yield OAS	-6	-77	283	337	287	289
BB OAS	-9	-70	194	241	202	203
B OAS	-14	-66	313	374	322	327
CCC OAS	25	-109	549	612	529	524

Spreads tightened in the fourth quarter across all HY sectors other than Communications (telecoms, advertisers, etc.) and Technology. Year-to-date, spreads tightened across the board, led by the Transportation (mainly airlines) and Energy (largely oil-related) sectors.

HIGH YIELD CORPORATE BOND SPREADS (OAS) BY SECTOR (basis points)¹

	Q4 Change	YTD Change	12/31/2021	11/30/2021	10/31/2021	9/30/2021
Consumer Non-Cyclical	-11	-37	250	307	259	261
Technology	10	-69	244	301	245	234
Energy	-16	-210	327	402	331	343
Consumer Cyclical	-13	-73	269	323	280	282
Transportation	-22	-324	309	370	305	331
Basic Industry	-15	-84	288	338	295	303
Communications	18	-8	317	361	305	299
Capital Goods	-6	-75	276	323	281	282
Utilities	-18	-25	249	303	271	267
Financials	-5	-59	265	310	267	270

The number of HY issuers in default dropped significantly in the quarter, continuing the steady improvement seen throughout the year.

HIGH YIELD DEFAULT RATES²

	Q4 Change	YTD Change	12/31/21	11/30/21	10/31/21	9/30/21
Number of Issuers in Default	-12	-56	11	12	18	23
Issuer Default Rate	-1.8%	-8.0%	1.5%	1.7%	2.5%	3.3%
Number of Issuers in Default (ex commodities)	-3	-24	7	7	9	10
Issuer Default Rate (ex commodities)	-0.6%	-4.1%	1.1%	1.1%	1.5%	1.7%

MUNICIPALS & OTHER

Short-duration munis were essentially flat in the quarter while longer duration categories were positive. For the full year, munis posted positive absolute returns while offering additional potential tax benefits to holders.

MAJOR MUNICIPAL BOND INDEX RETURNS (%)¹

	YTW	Duration (years)	Q4 Return	YTD Return
Short Duration (1-5 Years)	0.56	2.74	-0.03	0.35
Intermediate (1-15 Years)	0.87	4.20	0.38	0.86
Long Duration (22+ Years)	1.74	6.54	1.58	3.17

MUNICIPAL YIELDS BY RATING CATEGORY AND DURATION (%)¹

	AAA	AA	A	BBB
1 Year	0.17	0.28	0.41	1.02
5 Year	0.57	0.71	0.83	1.49
10 Year	1.04	1.17	1.31	2.01
30 Year	1.48	1.71	1.91	2.59

AA MUNICIPALS – HYPOTHETICAL AFTER-TAX YIELDS BY EFFECTIVE TAX RATE (%)³

	<u>20%</u>	<u>25%</u>	<u>30%</u>	<u>35%</u>
1 Year	0.35	0.37	0.40	0.43
5 Year	0.89	0.95	1.02	1.10
10 Year	1.46	1.56	1.67	1.80
30 Year	2.13	2.27	2.44	2.62

Non-US bonds were negative in the quarter and the full year. Leveraged loans enjoyed a strong year, aided by strong credit fundamentals and floating coupons. Convertible bonds were also positive in another strong year for equities.

OTHER SECTOR RETURNS (%)^{1,4}

	Duration (years)	Yield	Q4 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
Emerging Markets	5.69	7.08	-2.24	-2.06	-3.07	-1.02
Global Investment Grade Treasuries (Unhedged)	8.54	0.94	-0.99	-0.16	-6.60	-1.54
S&P/LSTA Leveraged Loan 100	–	3.88	0.75	–	5.20	–
U.S. Convertibles	1.85	0.99	-0.93	–	4.32	–

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¹Source: Bloomberg.

²Source: Bank of America Merrill Lynch.

³Hypothetical yields are calculated as the AA municipal yield divided by (1-tax rate). Actual tax-adjusted yields will depend on individual tax circumstances.

⁴Source: Standard & Poor's.