Despite experiencing a recession in 2020, the global economy has rapidly recovered. As lockdowns eased, consumer demand soared, and the supply tried to keep pace. It is estimated that the global economy grew 5.5% in 2021 – the fastest in 80 years.¹ Yet this rapid recovery in economies around the world has led to an equally rapid rise in inflation. For over a decade, developed market central banks have been focusing on fiscal and monetary stimulus, accompanied by low to negative interest rates. However, the spectre of rising inflation, that appears less and less transient, is resulting in significant policy changes from central banks, and therefore a more uncertain outlook for credit markets that warrants caution.

**Interest Rate Risk**

In the US, rising inflation has resulted in a more hawkish stance by the US Federal Reserve (Fed) with market expectations ranging from three, four or even six rate hikes in 2022. While it is difficult to predict the number and speed of the rates trajectory, we believe it is unlikely the Fed will forge blindly ahead with a significant number of rate hikes. It needs to create a smooth runway for raising interest rates in a measured way.

An overly hawkish stance at this stage will only act as an impediment further down the line should the Fed need to backtrack. However, we acknowledge that the Fed might face a difficult choice should high inflation persist, and the economy cool.

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**Caution warranted as rate moves and higher inflation cloud the outlook for credit.**

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**Tatjana Greil-Castro**

Co-Head Public Markets

Tatjana is a founding member of the European Leveraged Finance Alliance, a member of the ECB’s Bond Market Contact Group, a regular participant at the UBS Investor Forum and a frequent speaker at investment conferences. Tatjana is a leading advocate for incorporating environmental, social and governance (ESG) practices into credit portfolios. Tatjana joined Muzinich in 2007 from Metlife Investments, where she served as an Associate Director of the Higher Return Unit. Prior to that she worked as a Senior Portfolio Manager in European High Yield for Fortis Investments and as a portfolio manager and credit analyst at Legal & General Investment Management. She has a Ph.D. from the London School of Economics, a Masters from the Kiel Institute of World Economics in Germany and an M.Sc/B.S. in Economics from the University of Vienna.
The European Central Bank (ECB) meanwhile, as has been the case for some time, is more dovish, maintaining its ‘transitory’ view on inflationary pressure. They have been relying solely on their own datasets and forecasts which, in our view, is somewhat dangerous.

The ECB’s data appears to be increasingly at odds with broader market assumptions in terms of the inflationary trajectory.

More recently, we have seen a change in positioning and rhetoric from senior council members who have acknowledged inflation is difficult to forecast and their projections are considered more of a guide.

We welcome this change; the ECB would be in a difficult position and lose credibility if their own projections proved incorrect and the market ended up dictating the direction of rates.

Despite a significant move in interest rates so far this year, there could be more. For credit investors, an allocation into shorter duration instruments with less exposure to interest rate risk could be an attractive option against a backdrop of rates uncertainty.

Credit Risk

Over the past few months, credit markets have experienced an increasing amount of volatility, with significant spread widening in November and January on the back of fears of an increasingly hawkish Fed. Yet there are also uncertainties weighing on the outlook for credit.

Until now, corporate fundamentals have held up remarkably well, given pressures such as supply-chain disruptions and rising energy costs.

Yet as we move into fourth quarter earnings season, the backdrop appears to be changing. While top-line growth has been relatively good, profitability has declined on the back of rising consumer and producer prices.

Producer prices have gone up much more than consumer prices - on average 25% for PPI and around 5% for CPI (year on year). 3 This is eating into margins and could lead to sustained price increases as companies try to recoup some of those margins.

Meanwhile we believe supply side bottlenecks, which arose during the pandemic, are unlikely to be purely pandemic related. We are witnessing a global sea change and believe inflation is a longer-term issue driven by fundamental alterations in the global economic operating model, likely to impact corporates for some time.

China’s stance towards international trade has altered as it becomes more focused on domestic consumption. Climate change and the move to net zero is having a notable impact on how companies operate, including their energy supply, which is affecting prices.

Companies also appear under increasing scrutiny in terms of the sustainability and source of their supplies, which is also likely to affect the availability and price of goods. Climate change is impacting weather patterns and therefore food prices. Ongoing geopolitical risks provide further uncertainty.

For some time, central banks have been accommodative with low rates and quantitative easing. With longer-term inflationary trends likely to persist, central banks must walk a fine line between controlling inflation and quantitative tightening, without dampening growth.

The recent equity market volatility and spread widening in credit is, in our view, due to the market’s concerns around this fresh challenge. With ongoing volatility likely in the months ahead, we believe a more cautious approach to portfolio management is warranted in credit portfolios. As a result, we have reduced interest rate and credit risk whilst keeping carry attractive, which allows us to pursue a patient stance.

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