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Fixed Income Perspectives

April 2022

Quarterly macro and market insights

from Capital Group's fixed income team

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The statements expressed represent perspectives from Capital Fixed Income Investors, as at 31 March 2022. The views of individual portfolio managers and analysts may differ. Data as at 31 March 2022, and attributed to Capital Group / Bloomberg Index Services Ltd, unless otherwise stated.

Global growth outlook dims, as uncertainty pressures risk assets

- US growth may moderate as the war in Ukraine, persistent inflation and tightening US Federal Reserve (Fed) policy take their toll
- COVID-19 loosened its grip in the US and unemployment dropped, with wages now higher than pre-pandemic levels
- Risk assets may remain volatile as the market digests upcoming Fed balance sheet tapering

Global economic optimism declined in the first quarter of 2022. War in Europe added to already stiff inflationary headwinds from continued supply-chain disruptions. A more hawkish tone from the Fed and other major central banks fuelled concerns of slowing global economic growth. We expect US growth to moderate over the coming quarters.

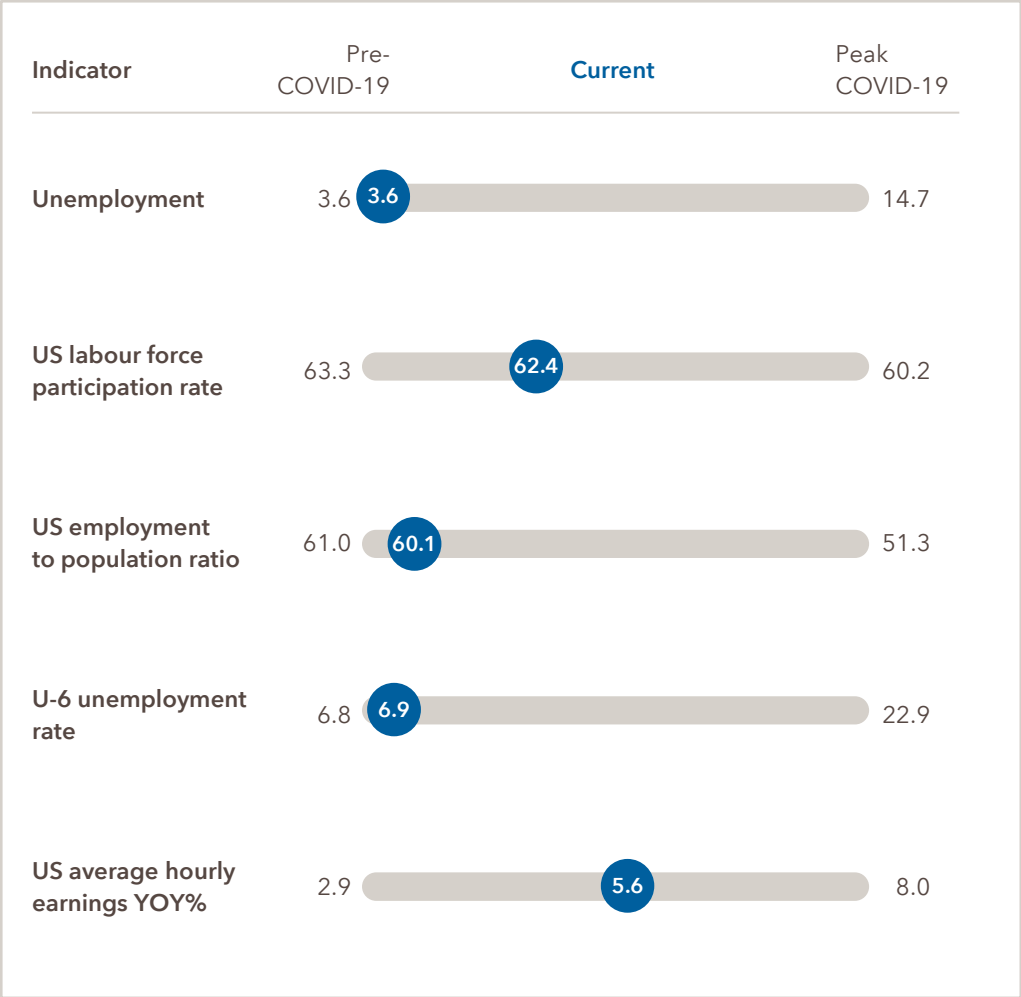
Market volatility and risk to the downside increased in February as Russian President Vladimir Putin ordered the invasion of Ukraine. Supply disruption intensified worldwide, and commodity prices soared.

The fallout from the war is far from obvious given uncertainty around ceasefire negotiations and how waves of escalating sanctions will play out. Global relations with Russia and China are in flux.

Economic activity appears to have peaked worldwide but remains positive. The US printed a high composite Purchasing Manager's Index (PMI) in March, signalling continued expansion. The eurozone's figure eased slightly, while China's PMI fell.[1] US economic activity could continue to outpace Europe as the region will likely bear the brunt of the war's impact.

US economic activity returned to pre-COVID levels as Omicron cases declined. The unemployment rate fell to 3.6% in March.[2] That has helped boost wages beyond pre-pandemic levels, though not enough to account for high inflation.

Labour market indicators show workers are in demand



Data as at 31 March 2022. Source: US Department of Labor

1. Source: Markit Economics
2. Source: US Bureau of Labor Statistics

Consumer fundamentals, labour market dynamics and inflation impulses remain strong – setting the stage for tighter Fed policy this year. The US Consumer Price Index (CPI) rose 7.9% year-over-year in February.[3] There were broadening price pressures across major categories of the CPI basket including shelter, where prices increased at the fastest pace since May 1991.

Supply issues are likely to remain, with upside risks to food and energy prices due to demand and the war in Ukraine. Investors are pricing rising inflation risk premium into bonds. The five-year breakeven rate on Treasury Inflation-Protected Securities (TIPS) jumped 60 basis points (bps) to 3.6% this year, a record high.[4]

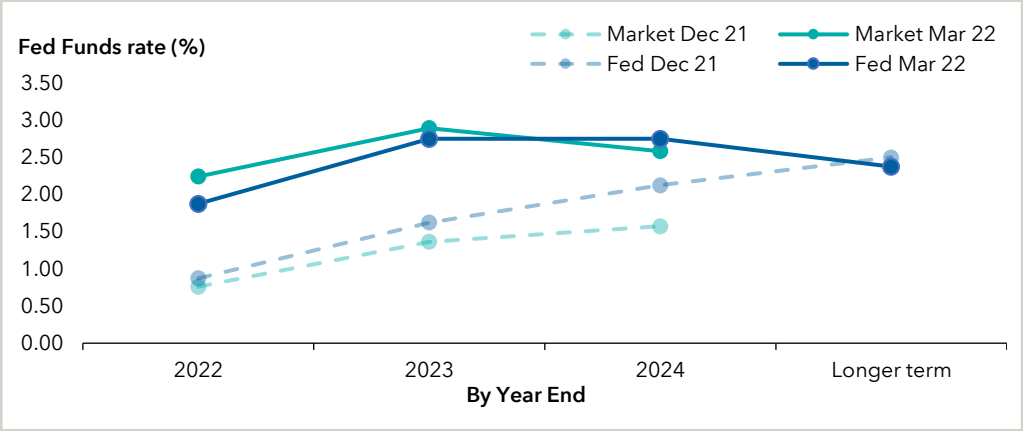
At their March meeting, Fed officials confirmed plans to shrink the balance sheet. Members also leaned into a more aggressive pace of interest rate hikes and the Fed's dot plot shifted higher. We expect a series of 25-50 bps rate hikes, for a total of 225 bps for the year.

The European Central Bank (ECB) and the Bank of England (BoE) both made hawkish pivots over the quarter. The ECB President, Christine Lagarde, flagged "unanimous concern" about inflation but played down the chances of a rate hike in 2022. Meanwhile, in February, the BoE delivered its third 25 bps rate hike in as many meetings.

China stepped up investments in infrastructure to boost anemic growth, with a budget that appears to be mildly stimulative. We forecast growth between 0-2% this year based on the government's budget allocation and continued low credit growth. The country's zero-COVID policy could add to economic pain.

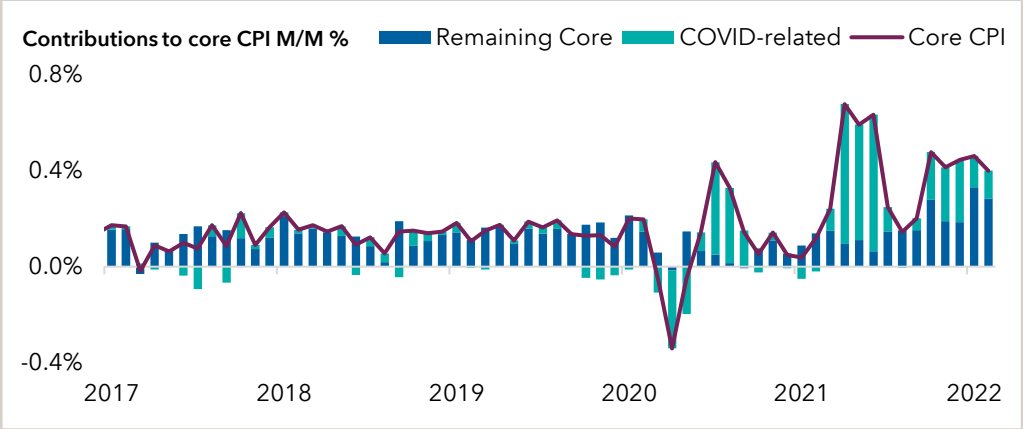
Spreads across risk assets widened over the quarter as headwinds to global growth and climbing input costs, reset pricing. With final details on the Fed's balance sheet tapering not expected until sometime in the second quarter, risk assets could remain volatile.

Fed policy rate: Fed dots vs. market



Data as at 31 March 2022. Source: Bloomberg

Inflation has hit almost every sector of the economy



Month-end data through 28 February 2022. Source: Bloomberg

Forecasts shown for illustrative purposes only.

3. Source: US Bureau of Labor Statistics
4. Source: Federal Reserve Bank of St. Louis

Aggressive policy tightening unlikely to impact near-term inflation

The Fed is likely to aggressively raise its policy rate and shrink its balance sheet this year given persistent inflation and a hot labour market. Barring a major fundamental shock, the Fed will likely hike rates by increments of 25-50 bps for the rest of 2022, with 200 bps of additional tightening this year.

Hikes are expected to be front-loaded in the coming months as the Fed wants to get its policy rate to neutral as quickly as possible before moving into restrictive territory to slow economic growth if needed.

The Fed plans to shrink its balance sheet nearly twice as fast as the last time it undertook quantitative tightening. Coupled with rate hikes, this represents the most rapid tightening policy in decades.

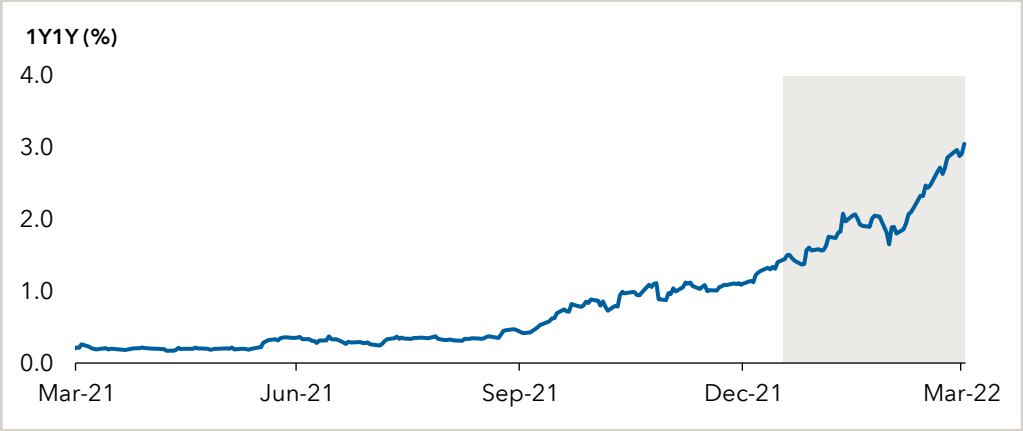
We expect the yield curve to continue to bear flatten as Fed policy catches up with high inflation. Although the curve is already extremely flat, particularly for the beginning of a hiking cycle, it's likely we'll see greater and more lasting yield curve inversion this cycle.

An inverted yield curve is an important signal but does not necessarily indicate a recession is imminent. We do not get the sense that the Fed is concerned about the slope of the yield curve, or that the Fed is likely to use alternate methods of policy tightening to attempt to steepen it.

Economic and labour market indicators suggest the current expansion, and the rate hiking cycle, have further room to run. The greatest risk to the bear flattening position is a pause in rate hikes – potentially the result of an exogenous shock – given the aggressive path expected by the market.

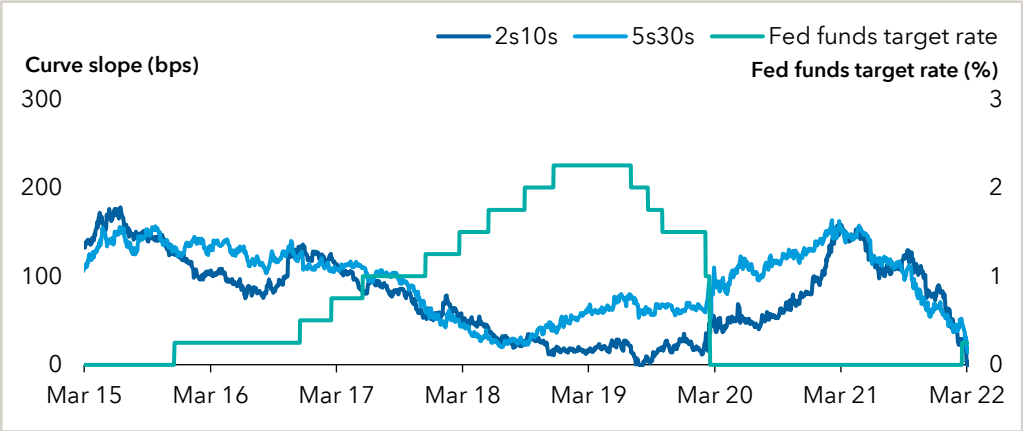
The Fed's hawkish pivot will likely have little impact on the near-term trajectory for the Consumer Price Index. As such, we continue to favour short maturity TIPS to protect portfolios against elevated, near-term inflation. As inflation becomes more entrenched, there is also potential for inflation expectations to rise further.

Fed rate hikes have been pulled forward



Data as at 31 March 2022. 1Y1Y is the expected one-year interest rate in one year's time. Source: Bloomberg

The yield curve has flattened as Fed hikes interest rates



Data through 31 March 2022. The 2s10s slope shows the yield gap between 10-year US Treasuries and two-year Treasuries (and, likewise for the 5s30s). Source: Bloomberg

Forecasts shown for illustrative purposes only.

Inflation risks rise amid energy supply shock

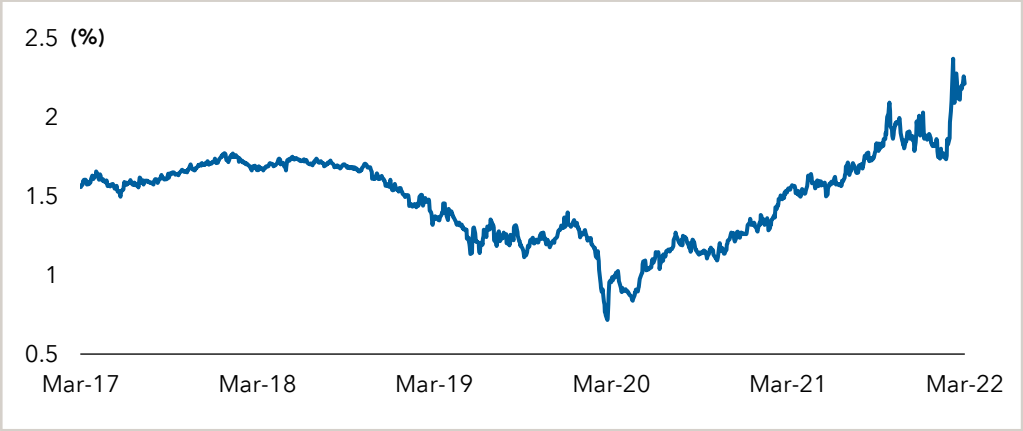
The conflict between Russia and Ukraine poses a significant threat to the European economy. Given Europe's dependency on Russian oil and gas, the sharp increase in energy prices represents a substantial negative supply shock, which may boost inflation and depress gross domestic product (GDP) growth. Energy supply disruption would likely be a serious threat to the economic recovery, especially in Germany and Italy as well as many countries in central and eastern Europe.

Eurozone inflationary pressures are widespread and appear to be intensifying. In March, eurozone CPI inflation jumped to 7.4% and core inflation increased to 2.9%[1], well above the ECB's 2% target. There is uncertainty about the extent of inflationary pressures, but producer and import prices are rising strongly, companies are expecting to raise their prices significantly, and labour costs have jumped as economies re-open. Market expectations on inflation also have increased rapidly, reaching levels not seen over the last 10 years (chart 1).

Reflecting the increase in inflation-upside risk, the ECB turned more hawkish at its March meeting. The policy changes are heavily skewed towards the hawkish side. Policy guidance is no longer 'forward guidance' but 'data dependent' – a significant change for the ECB. The market is pricing around a 60 bps increase in rates in 2022 (chart 2) with rates turning positive in Europe by year-end. Fiscal policy will probably have to do the heavy lifting, and the EU might decide on 'Recovery Fund 2.0' to promote a more rapid energy transition.

We remain cautious on European fixed income markets. We are underweight duration in European government bonds, mainly in France and Italy, as the termination of the ECB's asset-purchase programme will likely be negative for peripheral spreads. We continue to see opportunities in Danish covered bonds (attractive valuations and strong fundamentals), and have become more constructive on select high-quality corporate bonds, particularly in the banking sector where spreads on senior debt have become more attractive.

Euro inflation market expectations



Data as at 31 March 2022. Based on 5-year, 5-year Euro inflation swap rate. Source Bloomberg

Market-implied ECB policy rate

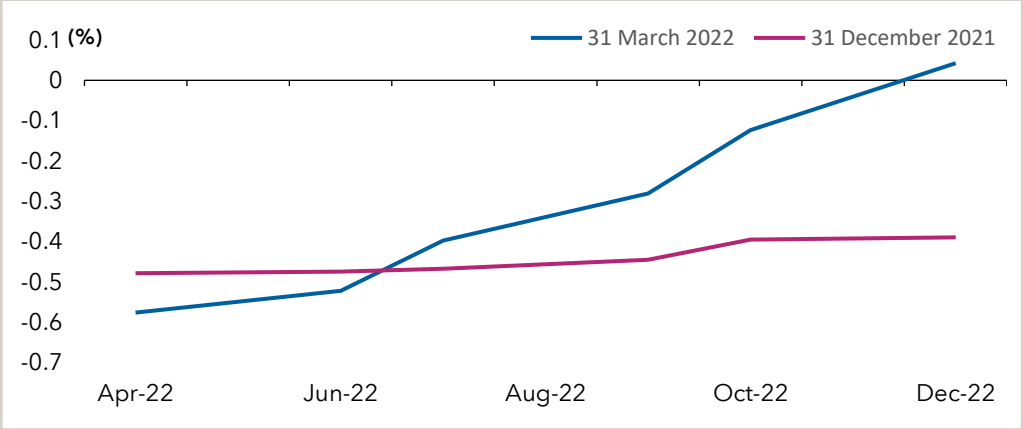


Chart shows the market-implied policy rate for the ECB as at 31 December 2021 and 31 March 2022. Source: Bloomberg

Forecasts shown for illustrative purposes only.

1. Source: Eurostat

Despite being a volatility hedge, JGBs and the yen are being pressured

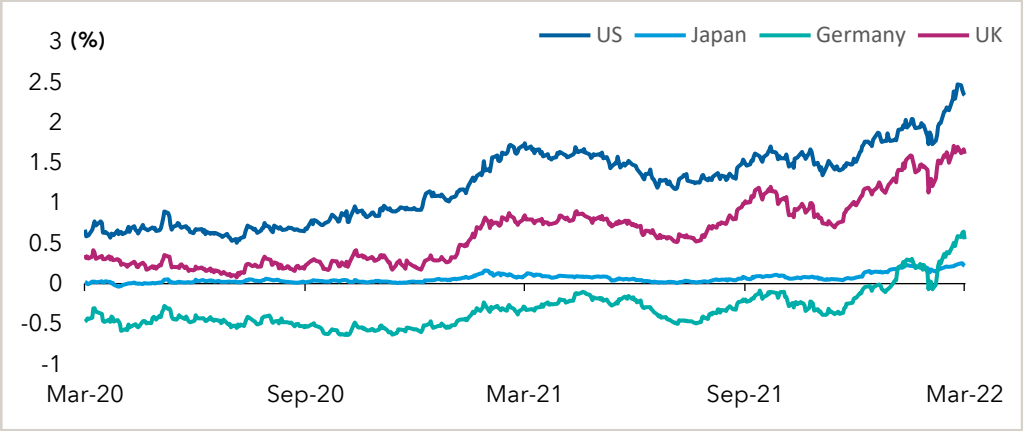
External factors rather than domestic developments have driven Japanese government bonds (JGBs). Following the lead of other developed market bonds, the 10-year JGB yield backed up to a level not seen since 2016, touching the Bank of Japan's (BoJ) upper bound of 0.25%. As inflation worries grew, especially given the ongoing war in Ukraine, there were concerns that the BoJ might change its ultra-easy monetary policy at its March meeting. However, no such changes were made, with the BoJ later defending its bond-yield cap by offering to buy an unlimited amount of 10-year JGBs at 0.25%.

Higher US Treasury yields have provided a greater incentive to invest in the US dollar. With JGB rates pegged by the BoJ, the dollar appreciated against the yen, with the USD/JPY rate briefly trading above 124, a level last seen in 2015 when the Fed started its previous hiking cycle. Despite its status as a safe-haven asset, the Japanese yen has continued to depreciate even given the backdrop of the war in Ukraine.

Inflation in Japan has recovered from an extremely low level but has, so far, lagged other developed economies. Going forward, higher commodity prices are a headwind, but the return of economic activity to normal levels following the lifting of COVID-19 restrictions could help support growth. While input prices are experiencing upward pressure, demand-side price pressure has stayed weak. Wages continue to show very little response.

The BoJ's yield curve control is expected to remain in place and may help to limit volatility. However, if headline inflation continues to rise, the upward pressure on rates may show up in other parts of the yield curve, especially in the longer end. The Japanese yen remains cheap from a valuation perspective. While it will likely continue to serve as a hedge to market volatility, interest rate differentials may influence short-term currency movements. That said, the trend may change quickly if the BoJ becomes more reactive to inflationary pressures or the Fed's hawkishness shifts.

JGB backed up but lagged behind other developed market rates



Data as at 31 March 2022. Chart shows the 10-year government bond yield across different markets. Source: Bloomberg

The Japanese yen continued to depreciate despite market volatilities

Data as at 31 March 2022. Source: Bloomberg

The impact on growth and inflation will be central to assessing relative value in 2022

Persistently high inflation strengthened expectations for central bank tightening and Russia's invasion of Ukraine further weighed on market sentiment. Elevated geopolitical tensions and the war's impact on commodities brought an additional inflationary impulse while also restricting growth.

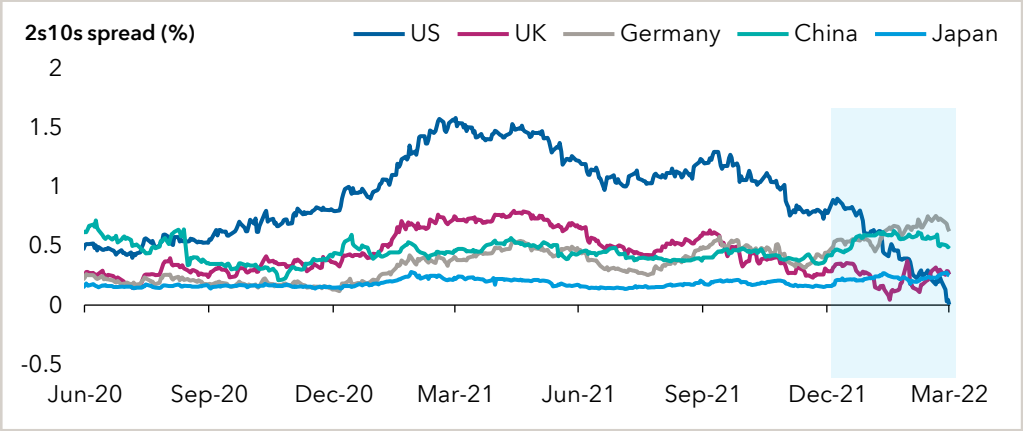
Yields moved steadily higher through the quarter. In the US, the 10-year yield rose from 1.51% at the end of December last year to reach a peak of 2.48% on 25 March. The US yield curve (2s10s) briefly inverted, although the German Bund curve steepened slightly. The Fed began hiking rates in March and the market now expects more than 200 bps of further hikes in 2022, with an implied federal funds rate of 2.4% at year end. The BoE raised rates twice during the quarter, and we now expect the ECB to begin hiking in the second half of 2022 with an implied 60 bps of hikes by year end.

Inflation is likely to remain elevated into 2023 amid persistent supply pressures given the impact of the Russia-Ukraine conflict, ongoing lockdowns in China and strong labour markets. While the Fed may need to tighten further than the six rate hikes it indicated in March, market pricing suggests rate cuts may be necessary as soon as 2024 in response to slowing growth.

We favour US duration for its defensive qualities in the uncertain environment – also the hiking cycle is largely priced in. We see limited value in Europe; there is a risk that the ECB remains behind the curve in addressing inflation, and Europe is likely to be most affected by the growth and inflationary impacts of the war. Chinese duration is less attractive now that core yields have moved higher and geopolitical risk has increased.

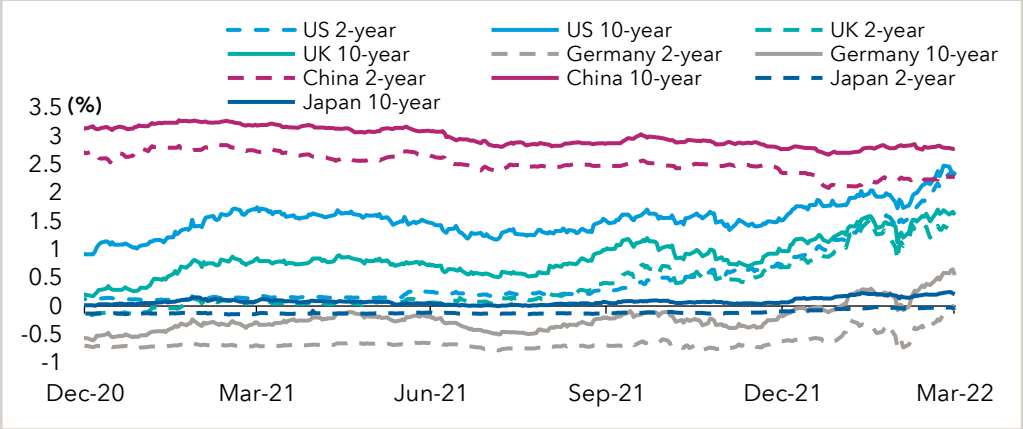
Further US dollar strength is likely in the short-to-medium term given an environment of ongoing volatility, weaker global growth and the potential for US real yields to move higher relative to other markets.

The US yield curve saw significant curve flattening in Q1 2022



Data as at 31 March 2022. 2s10s is the yield differential between the 10-year Treasury rate and the 2-year Treasury rate. Source: Bloomberg

The yield increase has been most acute in the front end of the US curve



Data as at 31 March 2022. Chart shows 2-year and 10-year yields for major markets. Source: Bloomberg

Past results are not a guarantee of future results. Forecasts shown for illustrative purposes only.

Selectivity is key as spreads may widen further given heightened uncertainty

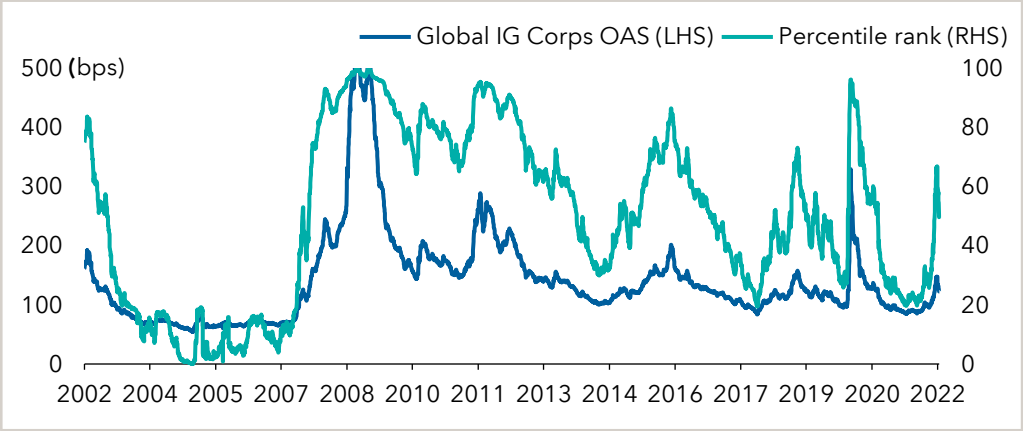
It was a difficult quarter for global investment-grade corporates as yields increased sharply on the back of heightened global inflationary pressures and a more challenging risk environment. With inflation remaining sticky, investors adjusted their interest rate expectations. The Fed is now expected to hike rates by 200 bps through 2022, while the ECB is expected to raise its deposit rate to zero by October. Russia's invasion of Ukraine has also caused commodity prices to rise sharply and increased uncertainty for global growth.

The Bloomberg Global Aggregate Corporate Index (USD unhedged) returned -7.44%. The option-adjusted spread widened from 97 bps at the beginning of the year to a high of 149 bps before compressing again to end the quarter at 124 bps. On a regional basis, spreads of euro corporates widened more than US dollar corporates (from 95 to 129 bps vs. 92 to 116 bps), but total US dollar corporate returns (-7.7%) were worse than euro corporates (-5.0%) given the longer duration of the market.[1] In this environment, the financials industry group held up better than either industrials or utilities.

We remain cautious in our assessment of investment-grade corporates relative to some other fixed income sectors. Slightly wider credit spreads and relatively stable corporate fundamentals should be balanced against heightened macro risks. Major central banks' monetary policy normalisation could lead to tighter financial conditions, the Russia/Ukraine conflict could further weaken already slowing growth momentum, and inflation could prove stickier than expected.

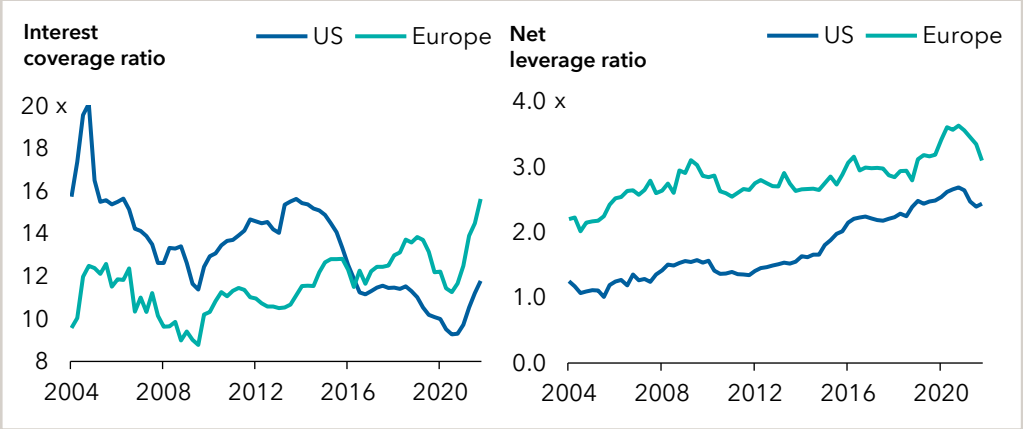
Spreads may widen further from current levels. While they have widened about 30 bps from their cyclical lows last year, this is less than the 60-100 bps of spread widening seen during the four non-recessionary periods of tightening of financial conditions since 2000. Heightened spread volatility means it is a period to be selective in names and sectors. An overall slightly defensive-to-neutral credit risk stance seems prudent. The investment team continues to find its highest conviction ideas in energy, utilities and autos.

Global investment-grade option-adjusted spread and percentile rank



Data as at 31 March 2022. Index is the Bloomberg Global Aggregate Corporate Index. Index inception date is 29 September 2000, spread data is available from 17 September 2002. IG: investment grade, OAS: option adjusted spread, bps: basis points. Source: Bloomberg

Interest coverage and net leverage levels across US and Europe



Data as at 31 December 2021. Source: Morgan Stanley

Past results are not a guarantee of future results.

1. Based on the Bloomberg US Corporate index and Blomberg Euro Aggregate Corporate index

Corporate earnings may ease from record highs as inflation bites

The Bloomberg US Corporate Investment Grade Index lost 7.7% in the first quarter as investors fled in anticipation of a string of rate increases by the Fed. The asset class fared worse than US Treasuries of similar duration.

The sell-off drove yields on investment-grade corporate bonds to 3.6%, or 127 bps wider than the start of the quarter. Spreads widened by as much as 53 bps in mid-March before closing the quarter 23 bps wider.

Corporate fundamentals remain positive, though price increases for labour and materials are beginning to pinch earnings. With breakneck earnings growth in 2021, corporate profits are now well above pre-COVID levels. That said, inflation is unevenly impacting consumer-oriented sectors, while commodity-related companies have benefited. We expect continued healthy cash flow and profits, though the pace of growth could slow.

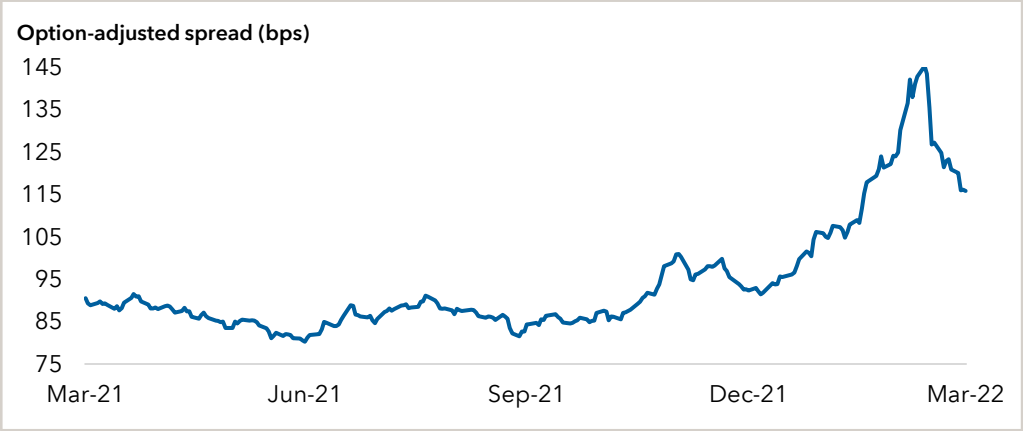
Corporate bond markets experienced significant outflows over the quarter. Investors instead sought shorter duration sectors, potentially sacrificing credit quality. While flows were a headwind, US$461 billion of issuance occurred over the quarter – slightly above last year's issuance and outpacing the five-year average.[1]

Overseas demand for investment-grade credit may wane as the Fed hikes rates. The cost of hedging increases as rates rise, which may erase the benefits for foreign investors buying US dollar-denominated corporate debt on a hedged basis.

Double-barrelled Fed tightening represents the biggest headwind for corporate bonds in 2022. Continued economic growth, albeit at a slower pace, and solid corporate fundamentals could provide a decent backdrop of earnings.

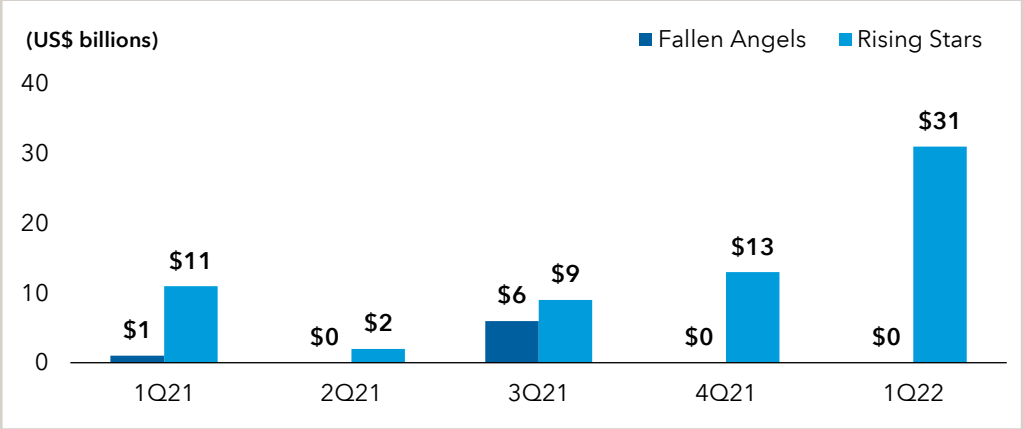
Risk tied to mergers and acquisitions (M&A) has increased, as have our expectations for shareholder-friendly activity. We expect M&A and its related debt issuance to remain elevated, though deals are highly idiosyncratic across industries.

US investment-grade corporate spreads have widened



As at 31 March 2022. Source: Bloomberg

Ratings upgrades to investment grade picked up meaningfully



As at 31 March 2022. Source: JPMorgan

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1. Sources: Dealogic, JPMorgan

Strong fundamentals could keep defaults near historic lows

The Bloomberg US Corporate High Yield Index fell 4.8% during the quarter as rising interest rates and global instability led to significant losses across all bond markets. The figure outpaced most higher quality and longer duration asset classes.

Spreads widened following Russia's invasion of Ukraine but have since retraced some losses. Specifically, spreads gapped out 128 bps to 412 bps, before tightening to close the quarter at 326 bps. Yield-to-worst stood at 6.0%, in line with the 10-year average for the market, and 248 bps wide of last year's low of 3.54%.

High yield fundamentals remain healthy, despite a backdrop of rapid inflation and slowing growth. Spreads have widened because investors are repricing risks from higher interest rates and slower growth patterns, rather than a deterioration of fundamentals. We expect defaults to remain low.

Investors sold high yield bonds as expectations mounted that the Fed would aggressively tighten policy to control prices. High yield bond funds posted US$25 billion of outflows during the quarter, following last year's figure of –US$13 billion. The combined figure accounts for 86% of 2020's record inflows. The backup in rates and widening of spreads weighed on new issuance, with volume down 70%.[1]

We expect inflation to subside in the back half of the year, and for economic growth to slow but remain positive. Inflationary concerns are issuer and sector specific. Certain industries such as pharmaceutical, construction, rental and lodging can keep profit margins intact and pass increased costs to consumers. Automotive, retail and consumer products have less pricing power.

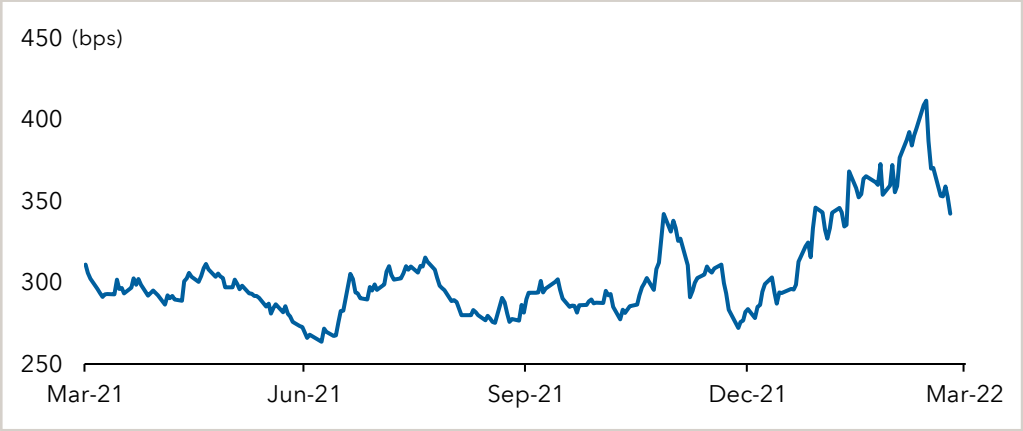
Investors could benefit from holding high yield bonds as the market prices in the Fed's quantitative tightening plan. Fundamentals remain strong, with issuance likely to stay measured given higher rates.

Positive GDP growth and the sector's short duration position could also support high yield debt. However, risks to the downside include continued geopolitical uncertainty in Europe and other Fed action.

Past results are not a guarantee of future results. Forecasts shown for illustrative purposes only.

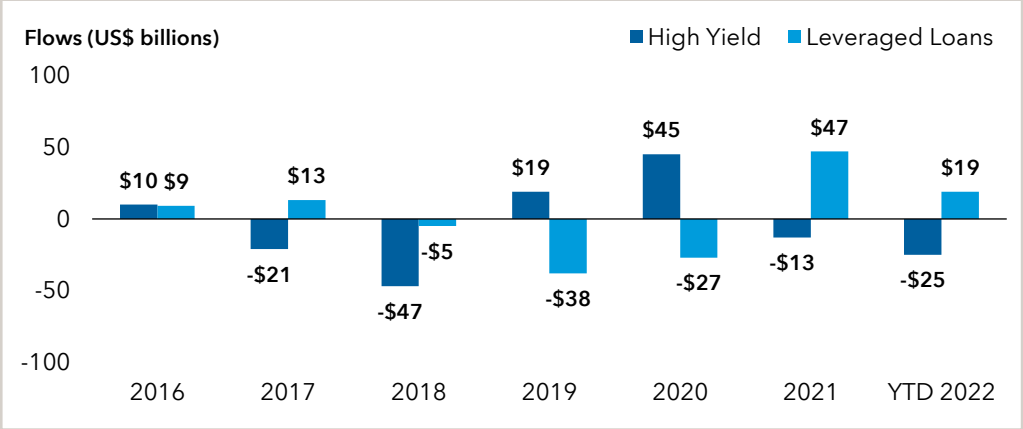
1. Source: JPMorgan

High yield bond spreads ended the quarter wider



Data as at 31 March 2022. Source: Bloomberg

Investors have piled into loans over high yield bonds



Data as at 31 March 2022. Sources: JPMorgan, Lipper

Ukraine war adds new economic stresses, select opportunities surface

The war in Ukraine weighed heavily on emerging markets (EM) debt. The JPMorgan EMBI Global Diversified fell over 10%, the fourth largest quarterly decline since the index was created. Russian, Ukrainian and Belarusian debt collapsed into distressed territory and the Russian ruble fell 8.9% against the US dollar over the quarter.

Debt of countries geographically close to the war including Hungry, Poland, and Romania declined. Those that rely heavily on imports from Russia and Ukraine, such as Egypt, also fell.

The US and its allies coalesced around wide-ranging sanctions on Russia. Countersanction measures by Russia froze trading and price discovery in the country's debt and equity markets. Russian bonds were removed from numerous widely tracked indexes.

Inflation is a key near-term concern, and the economic and financial market implications of the war may be far-reaching. EM may feel inflation more acutely than developed markets given their dependence on global growth and generally higher weighting of food and energy in the consumer price baskets.

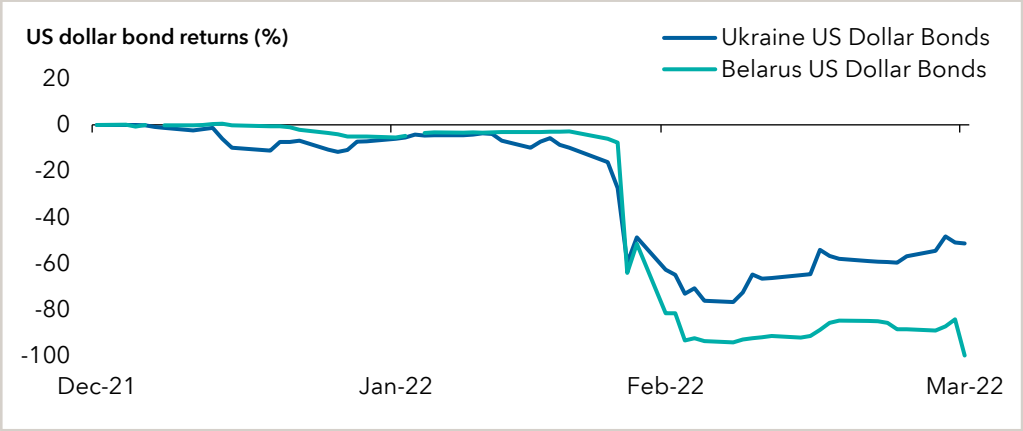
Commodity exporters may benefit from the run-up in prices, which can help correct external and fiscal imbalances and mitigate the effects of weaker global growth. The appreciation in many Latin American currencies year-to-date reflects this potential.

Fundamentals across several emerging countries appear stable. Valuations have broadly corrected to the downside and yields have risen, indicating that investors may have partially priced in negative outcomes for EM. Given the likelihood of ongoing elevated volatility, we favour a balanced and diversified portfolio.

Select local rates markets appear attractive, particularly where central banks have aggressively raised interest rates to combat inflation.

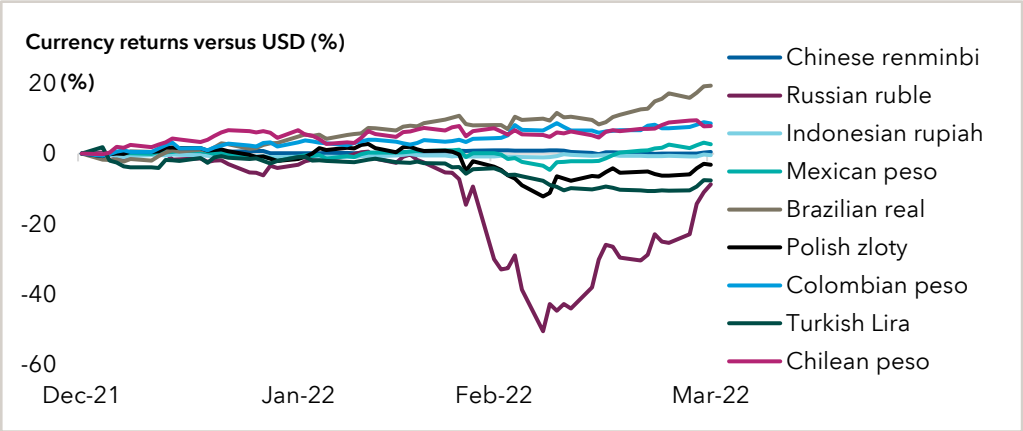
Though currency valuations are broadly cheap, we remain cautious given the Fed's bias towards tightening and the potential near-term support that may provide to the US dollar. Select sovereign and corporate hard currency issuers also appear to offer reasonable longer term value.

Ukraine and Belarus US dollar bonds dive



Data through 31 March 2022. Sources: JPMorgan, Refinitiv

Russian ruble regained some value after falling



Calendar-year currency returns for select components of the JPMorgan GBI-EM Global Diversified Index through 31 March 2022. Source: JPMorgan

Past results are not a guarantee of future results.

Higher quality muni bonds, yield curve positioning offer value

Municipal bond returns were negative in the first quarter. Concerns over inflation and the pace of policy normalisation by the Fed resulted in the Bloomberg Municipal Index and the Bloomberg High Yield Municipal Bond Index declining 6.2% and 6.5%, respectively.

The investment-grade curve for munis flattened. The 2s10s and 10s30s portions of the curve flattened by 35 bps and 12 bps, respectively. Ratios trended higher, and, in historical terms, munis were relatively inexpensive compared to US Treasuries (ratios express pretax AAA-rated municipal bond yields as a percentage of Treasury yields).

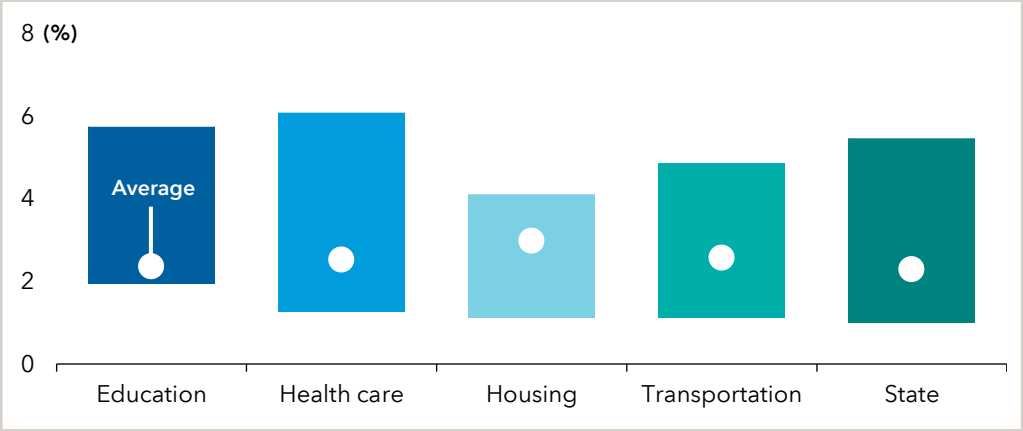
The start of 2022 saw the beginnings of an outflow cycle, with over US$20 billion sold out of muni mutual funds. This outflow cycle is on track to be the third worst over the past 30 years, only behind the global financial crisis and the onset of the COVID-19 pandemic.

We anticipate a more volatile return environment through 2022. Yields will have a bias to move higher amid monetary policy normalisation and inflation concerns, while spreads are expected to remain tight relative to historical averages. The impact of over US$1 trillion in pandemic-era stimulus continues to be felt and solid economic growth may leave fundamentals on firm ground for the medium term.

Selectivity is becoming more important for uncovering value given the tight spread conditions. Rich credit fundamentals warrant seeking opportunities of a higher quality as spreads may not materially compress any further. Many sectors still offer opportunities for value as the post-pandemic period of economic normalisation continues and closes gaps in dispersion of valuations.

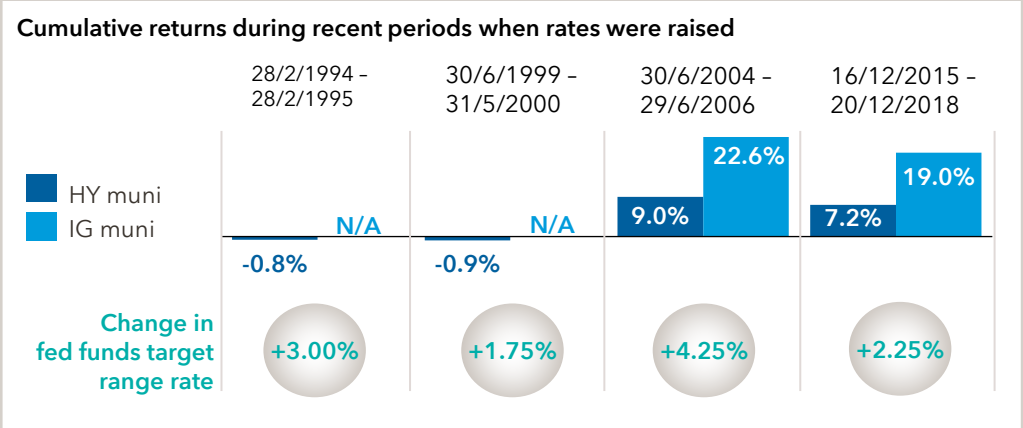
Despite market setbacks, municipal bond investors can invest in bonds offering higher tax-exempt yields. Moderating long-term growth prospects support a flatter curve as muni yields at shorter maturities climb more swiftly. In coming months, active management of duration and curve could offer a meaningful source of potential returns.

Varied yields in pandemic-disrupted sectors offer opportunities



As at 31 March 2022. Yield ranges and averages based on respective index sectors within the Bloomberg Municipal Bond Index. Source: Bloomberg Index Services, Ltd

Muni bonds and past Fed hikes: gains, as well as modest declines



Proxies: Bloomberg Municipal Bond Index (IG muni) and Bloomberg Municipal High Yield Index (HY muni). Daily returns unavailable prior to 2006; results for then calculated using nearest month-ends to the first and final hikes. HY muni results unavailable pre-2003. Returns in USD. Source: Bloomberg Index Services, Ltd

Past results are not a guarantee of future results.

Price-sensitive buyers fill void, likely to dictate wider spreads

Mortgage-backed securities (MBS) valuations remain rich amid high inflation and a shifting supply and demand dynamic in the sector. With heightened volatility, it is important to focus on option-adjusted spreads metrics. We continue to have a cautious medium-term outlook on mortgages given stacked risks within the sector.

The start of a new phase in the Fed's tightening campaign could further weigh on MBS valuations. After pumping trillions into the financial system during the pandemic, central banks may soon reduce their footprint in the mortgage market. The Fed already halted its pandemic-era asset purchase programme in March and is likely to employ quantitative tightening (QT) in the coming months.

The roadmap for exactly how the Fed will reduce its balance sheet remains uncertain. Of particular interest is whether, and when, it will engage in outright asset sales. The Fed previously emphasised its intention to let the balance sheet run down at a predictable pace. More recently, officials said they would consider MBS asset sales well after balance sheet runoff was under way.

Bank demand for MBS is declining since banks are less incentivised to invest in securities with extension risk amid a rising rate environment. Deposit betas are showing weakness relative to prior periods of rising rates and banks will earn more yield on excess reserves as rates rise. There has also been a pick-up in loan growth.

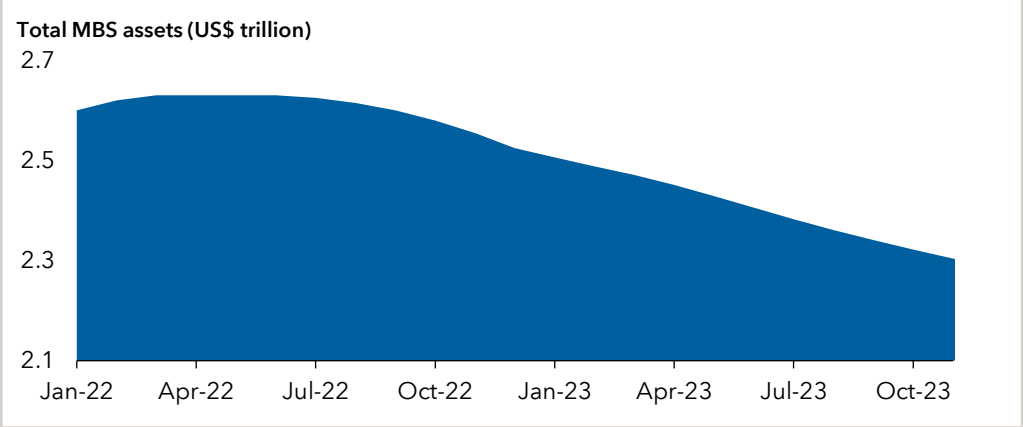
The supply outlook remains robust, boosted in the near term by higher home sales during the summer. As the Fed and banks take a step back from the MBS market, price-sensitive buyers will be left to absorb record supply and will likely demand cheaper valuations. Money managers will need to absorb a significant US$400 billion in supply, with downside risks to that number given higher mortgage rates.

Interest rate volatility has weighed on mortgages year to date. Mortgage volatility has followed the macroeconomic environment and been exacerbated recently by uncertainty around the Fed's QT path. Ongoing geopolitical tensions pose upside risks for volatility. A less than benchmark allocation to mortgages is a way to express a long volatility view.

Interest rate volatility highest since 2013 taper tantrum

As at 31 March 2022. Chart illustrates volatility in the expected movement in interest rates (in bps) over the next year as implied by at-the-money 1y10y swaption data. Source: Bloomberg

Fed poised to reduce MBS on its balance sheet



Projections as at 31 March 2022. Source: Capital Group

Forecasts shown for illustrative purposes only.

Important information

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Privately held

Over US$2.5 trillion in assets under management*

* Assets under management as at 31 March 2022. All values in USD.

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