Global Cash
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Navigating Short-Term Fixed Income Amid Inflation, Tightening, and the Pandemic

Featuring James Palmieri
Managing Director and Senior Portfolio Manager

James Palmieri is the head of structured credit and co-portfolio manager of State Street Global Advisors' US Ultra-Short-Term, Short-Term and Core Fixed Income Strategies. He has been managing a 1–3 year short-term multi-sector strategy since 2006, and began his fixed income career a decade earlier in the insurance industry.

Market Insights

You've been handling fixed income assets for a quarter century, through many market cycles. How does your perspective inform current investment decisions?

Over the past 25 years I've seen two significantly different capital market regimes: one with quantitative easing (QE) and one without. Throughout, I've tried to keep my pre-QE fundamental hat on, while incorporating the influence of QE into risk positioning, especially in the context of market drawdown opportunities.

The QE regime is characterized by three key changes. First, market drawdowns have been significantly shorter. Second, fixed income market returns per unit of volatility have increased. Third, liquidity requires greater care. As we saw in March 2020, broker-dealer balance sheet capacity can be absorbed much faster now than in the pre-QE period, largely due to Dodd-Frank and the Fed's bank regulation. This has forced us to be more disciplined in seeking liquidity when markets are favorable, so that we can offer more liquidity during a drawdown.

Analysts predicted transitory inflation following the vaccines rollout, but some now believe inflation may be more structural. What is your view?

Inflation may continue to surprise us in the near term. There's nothing normal about this economic cycle. It's highly compressed and driven by the pandemic, which is probably why analysts are smarting from their historically driven inflation forecasts.

Odds are that we are experiencing a one-time inflation bump. Base effects should cause inflation prints in the second half of 2022 to recede notably. Meanwhile, it appears that global central banks are pivoting toward a more aggressive unwind of monetary policy, erring on the side of caution and fortifying the view that this is a one-time event.

Longer term, we feel that elevated inflation will remain contained within this economic cycle. This is because the secular trends — particularly globalization, slowing demographics, and technological displacement — that have kept a lid on wage inflation for more than a decade remain in place.

In August 2020, the Fed announced its flexible average inflation target (FAIT) policy. Can you summarize FAIT and talk about how the policy has changed short-term fixed-income investing?

The Fed's dual mandate is maximum employment and price stability. In a nutshell, FAIT tilts the dual mandate in favor of maximum employment, allowing the Fed to tolerate more inflation than they have in the past.

How does this affect the short-term fixed-income space? All other factors being equal, FAIT suggests a lower terminal Fed Funds rate. You can see that priced into the market, where the terminal rate remains near 1.5%, which is significantly lower even than in 2018. Yet FAIT is being tested by the super-compressed COVID-19 economic cycle, which has pushed inflation to levels not seen in a long time.

How should investors position their portfolios given inflation, rates, and credit conditions? How are you adjusting your portfolio decisions?

Given where we are in the economic cycle, coupled with rich valuations and the inception of global monetary tightening, we are carrying modest risk. We are a little overweight in duration toward the front end of the curve where the roll down and carry is significant. Compared to a year ago, we've paired back a lot of credit risk. We are positioned with dry powder in case the Fed runs into trouble with its monetary tightening in 2022.

You've said before that the recovery is linked to 4 legs of a stool — with COVID, monetary policy, fiscal policy, and oil representing the four legs. Can update us on where we stand now?

If you look at measures like the nominal output gap, the US economy has already largely recovered, which speaks to how short this cycle has been. After the Global Financial Crisis, it took 10 years for output to recover, compared to about two for the current cycle.

Let's consider the four legs individually. On COVID, each wave seems to have less impact on the economy, yet with Omicron causing record daily cases this trend may be challenged. Meanwhile, fiscal policy has been a big economic driver during the pandemic, sustaining consumers through high unemployment and supporting the recovery. Many governments now have record deficits, so we expect much less fiscal support, but we don't see this as a headwind, at least for the first half of 2022. Regarding oil prices, obviously they have normalized over the past year. Higher oil prices tend to hurt the US consumer, but now that the US exports so much oil the overall economic impact is more balanced.

Out of the four factors, monetary policy is the main economic risk in 2022. Inflation pressures may push the Fed to tighten policy at a pace that would negatively impact the US outlook. Again, this is the reason we're being cautious in risk positioning.

Nearly a year ago you said, "Given where we are in the credit cycle, plus significant government stimulus, we still see value in investment grade corporate credit. We also see value in commercial mortgage-backed securities, as pockets of that market have lagged the reopening trade." Has that outlook changed?

It has. Amid continued US economic growth, tighter Fed policy, and rich valuations, we have been forced to pare back risk targets substantially, not only on corporate credit but also commercial mortgage-backed securities (CMBS). This is enabling us to look for opportunities to invest in credit in 2022 given the tightening cycle.

What do you see as offering the best value in the front end of the yield curve?

Two areas are intriguing. One is risk-free rates, such as the 2-year Treasury Note, given the enormous carry and roll-down, which is on the order of 100+ basis points. This is certainly favorable to the longer part of the yield curve and to short-duration corporate credit spreads, which are cyclically quite tight.

The second opportunity is in the AAA CMBS floater market, in very stable properties such as industrial warehouses involved in e-commerce and cold storage facilities for supermarkets. These offer significant yield pickup compared to AA or A corporate credit floaters. In fact, AAA CMBS floaters offer as much yield as BBB corporate credit with far less fundamental credit risk.

Considering current spreads and the yield curve, how should investors think about risk and return?

I believe investors should be more concerned about risk than return in 2022. We are in more of a principal protection environment as the Fed embarks on a tightening cycle in the context of tight credit spread valuations. Our funds' risk exposure is about as mild as it has been in a long time.

You use futures to hedge interest-rate risk. What are some common misconceptions around the use of derivatives in the types of portfolios you manage?

It's essential to point out that we use derivatives to mitigate risk. Many investors assume that derivatives are adding risk or leverage to a strategy, but that doesn't apply here.

Another common misconception is that derivatives lack liquidity compared to the cash markets. This idea, however, does not apply to futures contracts tied to the US Treasury market. On the contrary, there is data showing that Treasury futures offer nearly as much daily liquidity as the Treasury cash market.

How do mandates that prohibit derivatives affect performance?

Prohibiting the use of futures can result in a loss of fund return efficiency for investors. For instance, a prohibition limits the ability to take advantage of market environments when short-term fixed-income paper is offering relative value compared to floating-rate paper. In this scenario, we would use futures to hedge duration — to reduce it or have it remain in line with our objective. We also use futures in a high-velocity drawdown environment like the one that occurred in March 2020, to add duration and hedge spread risk. In either case, we're mitigating risk. In fact, derivatives allow us to surgically target the duration risk we seek.

Tell us about State Street Global Advisors' fixed income investment framework. What is your investment philosophy, and how do you construct portfolios?

We believe that inefficiencies exist on multiple time horizons due to the complexity of supply and demand in the fixed income markets. We initially construct our investment portfolios from a top-down perspective by establishing modest amounts of strategic risk — consistent with the client's risk/reward appetite — to take advantage of long-term inefficiencies in the fixed income market. Examples of such risk would be modest amounts of positive duration and incremental credit spread duration relative to a pre-defined performance benchmark.

The second time horizon has to do with the shorter-term or cyclical movement of the markets. In this case we seek to take advantage of opportunities when market pricing deviates from our estimates of fundamental fair value. We hold a monthly asset allocation meeting where we conduct a full review of the economy and market pricing to detect deviations from long-term fair value. Ultimately the goal of the meeting is to set risk targets.

Finally, for portfolio construction we use a collaborative approach with a bottom-up fundamental fair value perspective. For each segment of the fixed income market, the security selection process includes contributions from portfolio management, research, and trading. Whether it's corporate credit or fixed income securitized markets, the respective teams get together and examine the fair value of the opportunities and select securities that ultimately make up the portfolio.

How does your approach differentiate you from competitors?

In addition to the benefits inherent in State Street Global Advisors' global platform, I believe our differentiation arises mainly from two factors. One is our multiple time horizon approach — the strategic and the cyclical — which I summarized in the previous point.

The second stems from our use of quantitative techniques that enhance our fundamental fair value approach. State Street Global Advisors has a deep heritage in quantitative investing. In short-term fixed income, we use factor models to generate long-term fair value estimates for a variety of risks. This helps us identify cyclical opportunities. In addition, we use momentum and dispersion techniques to help the portfolios maximize returns. For example, we held a pretty big cyclical overweight to credit at the start of the pandemic in March of 2020, and we held it through the announcement of vaccines and into 2021, as our momentum and dispersion models maintained a buy signal. This helped the funds maximize the returns from their credit overweight, whereas if we had depended on pure fundamental fair value, we may have cut this risk sooner.

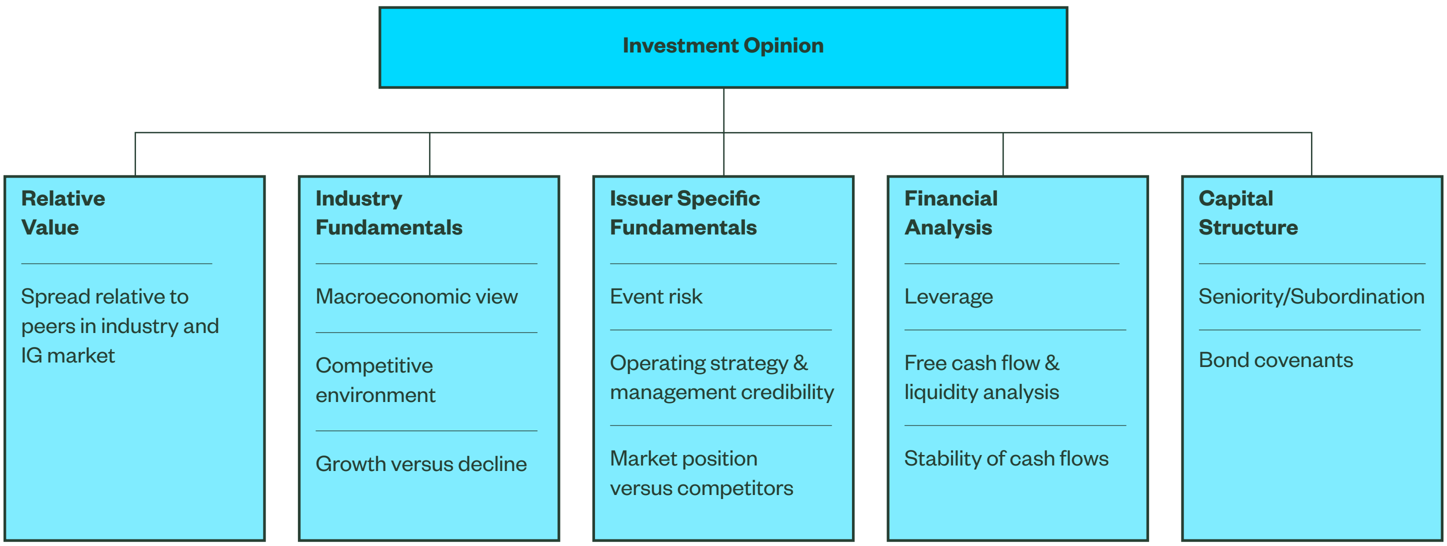
In a nutshell we're fundamental fair value investors, but we use these quantitative techniques to "sweat the assets" a little harder to the benefit of our clients.

How do you handle credit research?

That's another State Street Global Advisors competitive advantage. We have a very experienced credit research team that has a framework for examining corporate credit from both a top-down and bottom-up perspective. The team puts together credit scores for different industries, as well as for each name, and determines whether there are any deviations from fair value. This approach enables us to efficiently rank the credit space.

Additionally, our corporate credit portfolio managers meet with at least one analyst every day to review each credit risk position and their contribution to risk at each fund level, to ensure that we are leaning in the right direction and that we have the proper amount of risk relative to the risk/reward appetite of each client mandate.

Figure 1
Investment Grade Credit Research Inputs



Source: State Street Global Advisors. The information contained above is for illustrative purposes only.

Finally, why are short-term and ultra-short-term strategies important in today's investment environment?

The front end of the curve is becoming an interesting place, considering the Fed's FAIT framework, the pulling forward of rate potential rate hikes, and what appears to be a lower terminal Fed funds rate. We think that the front end is offering a lot of value compared to the back end.

About State Street Global Advisors

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of December 31, 2021 and includes approximately $61.43 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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