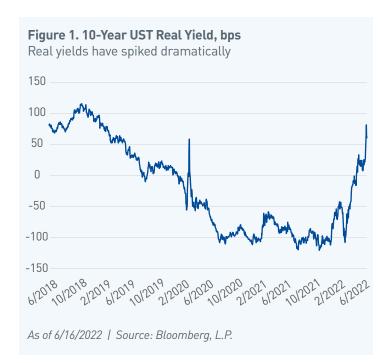
I THINK I'VE SEEN THIS FILM BEFORE, AND I DIDN'T LIKE THE ENDING..."

— "Exile" by Taylor Swift and Bon Iver

The Federal Reserve's (Fed's) two-front war on inflation and its credibility has materially shifted the investment landscape in 2022. Reflecting the Fed's increasingly hawkish stance, markets are not only pricing in a higher terminal rate, but also a rising probability that restrictive Fed policy helps arrest an inflation acceleration. Market developments in 2022 are reminiscent of fourth quarter 2018 when the Fed was more than two years into a gradual tightening cycle. Volatility rose, financial conditions tightened and risk assets repriced lower as Chair Jerome Powell indicated a further withdrawal of monetary policy accommodation was warranted.

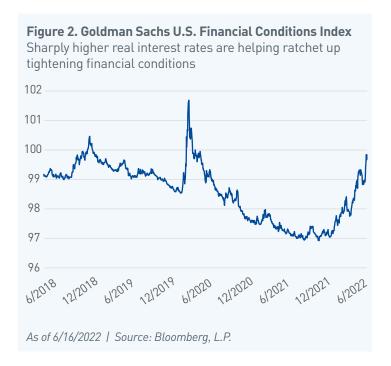
There are, however, notable differences this time around, primarily the level of inflation. The core personal consumption expenditure price index was just over 2.0% then compared to almost 5.0% now. More strikingly, the headline consumer price index (CPI) is nearly four times higher today at 8.6%. In our view, this affords the Fed far less flexibility to pivot away from restrictive policy until they see "compelling evidence that inflation is moving down."

After a brief respite in May, nominal U.S. Treasury (UST) rates jumped due to broadening inflationary pressures. The once-hoped transitory impacts from the pandemic have been slow to abate, while services, food and owner's equivalent rent continue to rise. In May, over 70% of CPI components were rising at a year-over-year rate of more than 4%. At the same time, the Fed's tightening stance drove up real yields materially, and breakeven spreads on Treasury Inflation Protected Securities (TIPS) fell. The real yield on 10-year TIPS shifted from -100 basis points (bps) at the beginning of 2022 to about 60 bps in mid-June (Figure 1).



# It Just Got Real

The change in real rates is acting to further tighten financial conditions, which we believe will begin to impact demand and slow economic growth (Figure 2). Economic data began softening in mid-May; recent readings on the housing market and retail sales weakened, driving estimated second-quarter 2022 GDP growth from the Atlanta Fed GDPNow Forecast from around 2.5% in toward 0%.



High inflation is not solely a domestic phenomenon — it is prevalent across the United Kingdom, Australia, Canada and much of Europe. Vastly accommodative fiscal and monetary policy was the salve generously applied to counteract the considerable economic impacts of the pandemic. Now, developed market central banks are moving aggressively to withdraw policy accommodation as fiscal impulses simultaneously slow or reverse.

The U.S. recovery was more rapid than anticipated, and demand remains strong. These factors, combined with ongoing supply chain disruptions, the war in Ukraine and continued tight labor markets, are pushing inflation to multi-decade highs. In response, the Fed has adopted a progressively hawkish policy stance. This month, the Fed initiated its previously announced quantitative tightening

program, whereby it will allow its almost \$9 trillion balance sheet to naturally wind down (subject to monthly caps). In February, markets began to discount a greater frequency of increases in the fed funds rate throughout 2022 (see our commentary, *Hike-steria: Fear and Loathing in a Rising Rate Environment*). The Fed has followed suit and increased the amplitude of increases at successive meetings. At its June policy meeting, the Fed raised its target rate by 75 bps, the largest single increase since 1994, and reported a median forecast among committee members of 3.4% by the end of 2022 — 150 bps higher than the March projection.

#### **Navigating the Markets**

In drawing parallels to the last tightening cycle, Figure 3 highlights a number of key market datapoints we are monitoring. Fed policy is driving the increase in real rates, and thus financial conditions, as both breakevens fall and nominal UST yields rise. Credit option-adjusted

**Figure 3. Comparison of Select Bond Market Statistics**There are similarities but also stark differences between the last tightening cycle and now

	4Q2018	QTD through 6/16
Change in 10Y UST TIP Real Rate	3 bps	111 bps
Change in 10Y UST TIP Breakeven	-43 bps	-25 bps
CBOE VIX Index (50-day moving average)	27.7	27.9
Bloomberg US Credit Index OAS	143	133
Bloomberg US Credit Index Average Dollar Price	\$99.50	\$91.88
ICE BofA US Bond MOVE Index (100-day moving average)	53.4	110.5
Bloomberg US MBS Current Coupon Spread	90 bps	141 bps
Bloomberg US Credit Trailing 3-Month Excess Return	-2.84%	-0.18%
Bloomberg US MBS Index 3-Month Excess Return	-0.53%	-1.53%
As of 6/16/2022   Source: Bloomberg, L.P.		



# It Just Got Real

spreads and equity volatility (as measured by the 50-day moving average of the CBOE Volatility Index) are reasonably close to levels observed in late 2018,

particularly when considering the current discount to par on the index. However, bond volatility, as measured by the MOVE Index, is significantly higher and more persistent, with the 100-day moving average approaching 110. This is a level last observed in late 2009 as we exited the Global Financial

WE CONTINUE TO POSITION CLIENT PORTFOLIOS DEFENSIVELY AND AWAIT OPPORTUNITIES TO ADJUST SECTOR ALLOCATIONS WHEN RISK-RETURN DYNAMICS BECOME MORE FAVORABLE.

Crisis. In addition, the current coupon spread on mortgage-backed securities (MBS) is considerably wider than late 2018 reflecting both elevated volatility and concerns about the Fed's balance sheet unwind.

As a result, during second quarter 2022, MBS underperformed Credit and generated a negative excess return. We used this opportunity to reduce our

MBS underweight in Aggregate strategies but remain cautious overall given our expectation for continued bouts of volatility. While we maintain a modest overweight to Credit, we have not materially shifted our risk positioning since the end of the first quarter. Given the deteriorating outlook

and expectations for both more restrictive financial conditions and elevated volatility, we continue to position client portfolios defensively and await opportunities to adjust sector allocations when risk-return dynamics become more favorable.

# For more information, please contact your PNC advisor.

#### **Indices**

**Bloomberg U.S. Credit** measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

**Bloomberg U.S. MBS Index** measures the performance of the agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginne Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac FHLMC).

**Goldman Sachs U.S. Financial Conditions Index** is a weighted average of riskless interest rates, the exchange rate, equity valuations, and credit spreads, with weights that correspond to the direct impact of each variable on GDP.

Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500 Index (SPX) call and put options.

**ICE BofA U.S. Bond Market Option Volatility Estimate Index (MOVE)** measures U.S. bond market yield volatility by tracking a basket of over the counter options on U.S. Treasury notes and bonds. The basket is comprised of a-the-money one month options on the current 2-year, 5-year, 10-year and 30-year Treasuries. The index value is equal to the average of the implied normal yield volatility of the four options, where the 10-year option is given a 40% weight and the other basket components each hold a 20% share.

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