TC Wealth Partners

Trust Company *of Illinois*

OPPORTUNISTIC FIXED INCOME

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Interest rates increasing: is 2022 the year for opportunistic fixed income?

With the most recent consumer price index data indicating that the annual inflation rate is now at a four-decade high it has increased the urgency for the Federal Reserve's (Fed) to start raising interest rates this year to control inflation. The data reinforces the Fed's intentions to begin raising rates next month to combat broad-based inflationary pressures and could lead markets to expect even more aggressive action from the central bank. After the data was released, traders have boosted their expectations for a half-point increase in the federal funds target rate at the next Fed meeting that ends on March 16. While most economists expect a more gradual approach to increased rates, the acceleration of inflation on the heels of rapid wage gains will keep the possibility of a half-point hike on the table. So given the likelihood of rising interest rates this year, it might be worth examining why opportunistic fixed income could be a good asset class to add to your portfolios.

Opportunistic Fixed Income

The fixed income market consists of many different types of bonds. Interest rate sensitivity can differ substantially across fixed income asset classes based on bond duration (how the sensitive the bond price is to changing interest rates), credit quality of the issuer and type of security. Broadly speaking, higher quality sectors (such as US government bonds) and longer duration bonds have tended to be the most vulnerable to interest rate volatility, while lower duration and more credit sensitive bonds have historically fared better in rising rate periods. Over time fixed income strategies that are well diversified across a mix of bond classes and a wide array of maturity dates stand the best chance of outperforming across a full range of interest rate scenarios.

In today's market environment opportunistic fixed income funds are one of the more attractive areas of fixed income because the fund managers have a variety of tools at their disposal to position their funds in a rising rate environment. Opportunistic fixed income funds try to reduce the correlation of their holdings from the interest rate cycle to generate alpha—which is particularly beneficial in a rising rates environment. Due to their flexible mandate, these funds are both able to help preserve capital and generate alpha for positive returns, by tactically reducing duration amid rising rates. Duration management is critical when managing interest rate risk. If the expectation is that interest rates will increase, the portfolio's average duration can be shortened (by adjusting the holdings in the portfolio), moving it closer to zero, to lessen the negative effect on prices. Since it is difficult to predict the level and direction of interest rates, opportunistic fixed income managers are also able to diversify across different fixed income asset classes and add an additional layer of protection from higher interest rates.

When considering if opportunistic fixed income is right for your portfolio, we recommend discussing this with your advisor to determine if adding this asset class to your portfolio may be beneficial. The key is understanding the impact of adding an opportunistic fixed income fund to your total portfolio, and whether it will deliver on its proposed objective.

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