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CAPITAL MARKETS INTELLIGENCE

THE OUTLOOK FOR THE BOND MARKET IN 2022

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Trying to predict upcoming trends is always a risky business but no one could have foreseen a war at the heart of Europe before the end of the first quarter of 2022. What we did predict correctly in our last research paper however, was the rise in inflation and its effects on monetary policy and the markets. Only last November, economists and financial commentators were arguing about whether the inflationary pressures recorded were transitory or not and whether central banks should act to supress inflation. Fast forward six months and it is now clear that inflation is here to stay, and that all central banks want to put an end to quantitative easing but fear the repercussions higher interest rates might have on the already sluggish world economic growth.

Inflation, and how central banks respond to it, coupled with slow growth represents the biggest risk for bond markets. Increasing short-term rates too quickly is likely to result in greater risk and volatility in the bond markets, and at the same time, the conflict in Ukraine and its potential escalation have only exacerbated the situation, prompting fears of stagflation.

We believe that this heightened uncertainty will result in the short-term paralysis of fixed income primary markets and high volatility in the secondary bond markets. At the same time, there will be limited liability management exercises within the investment grade space with all the action happening within high yield bonds. Like with the 2007 financial crisis, the combination of investor churn and investors' inquiries will require issuers to invest in, and expand, their fixed income investor relations activities.

INFLATION & THE BOND MARKET

Since the world economy bounced back from the coronavirus-led recession, price increases have dominated headlines in the US, UK and Europe. Until late last year, many central bankers and market commentors dismissed inflation fears believing the current price increases are only transitory as its driving forces were deemed as temporary. In reality, as mentioned in our previous research paper, government responses to the Covid recession resulted in such a supply of liquidity that inflation is here to stay unless central banks put the brakes on quantitative easing. The big question is no longer if interest rates will rise, but by how much and how quickly in order to avoid stagflation.

At the same time, the war in Ukraine is a powerful impetus to global inflation and has dampened the recovery from the pandemic recession with spiralling food & commodities prices and supply disruptions that are both fostering inflation and lowering growth prospects. Economists see Euro area inflation running at 5.7% (1.8% higher than expected), while UK inflation is currently at 6.2% and is expected to reach 6.7% by the end of the year. At the same time, the average forecast for Euro area growth has fallen by 0.7% to 3.2% in the last four weeks, with Germany being downgraded by 1.1% to 2.4% (Source).

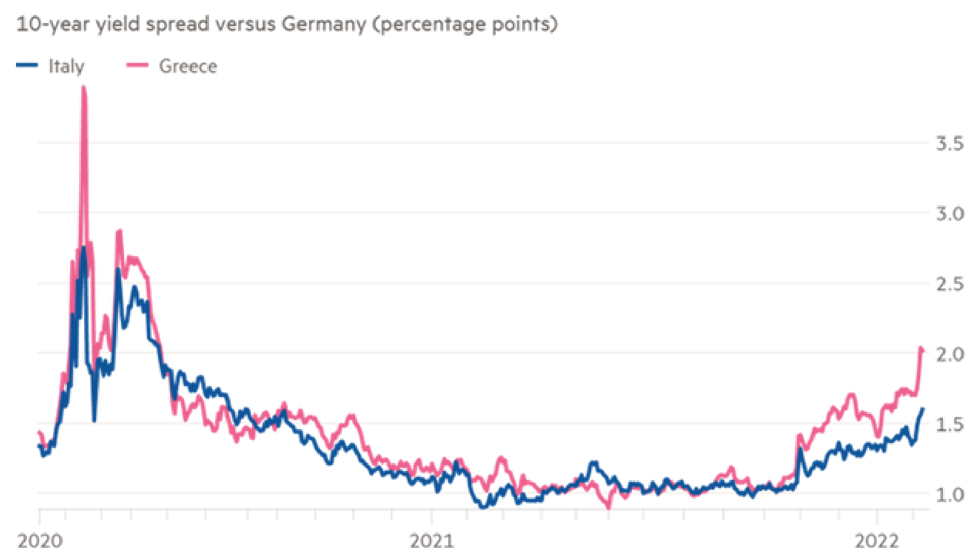
The combination of rising inflation and slowing growth makes it especially important for central banks to time their actions carefully. If they increase the rates too quickly, they risk halting growth but if they increase rates too slowly, they risk inflation spiralling out of control. Last week, the Federal Reserve and the Bank of England both increased interest rates by 25bps and the markets expect further increases throughout the year, until rates hit 2% (Source). The European Central Bank is also expected to tighten its monetary policy, although the speed and extent will very much depend on the war in Ukraine. Central bankers will need to carefully navigate the trade-off between inflation and growth.

WHAT CAN CORPORATE ISSUERS DO?

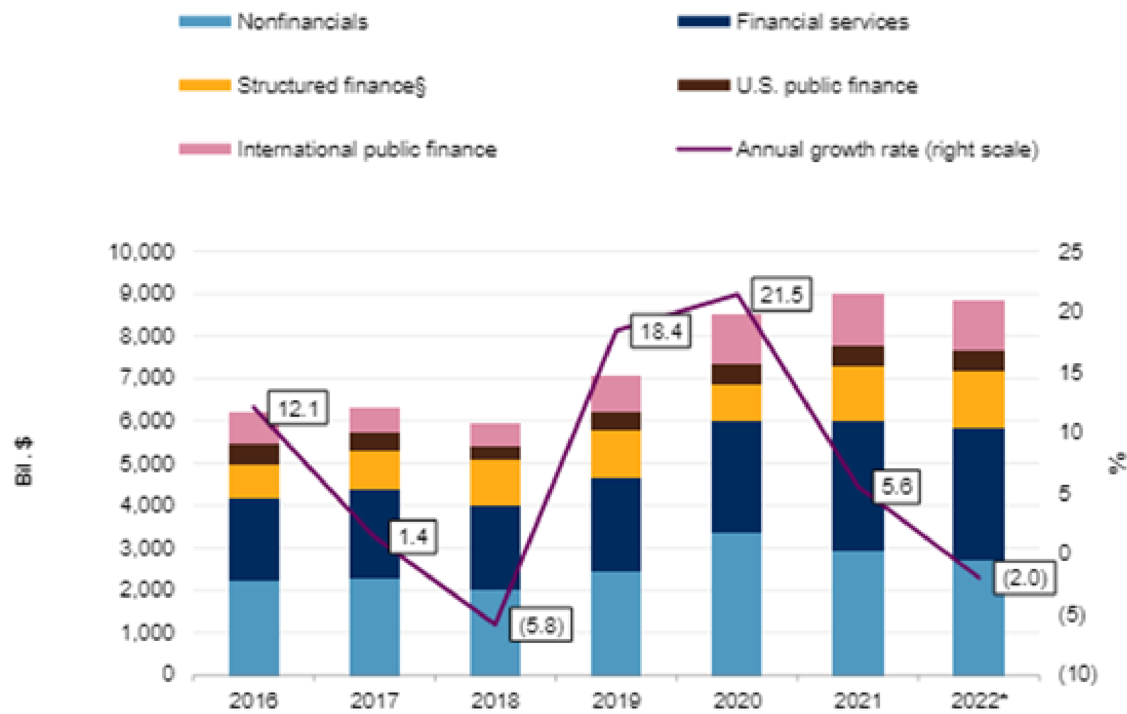
But what does this mean for bond markets? Besides the obvious increase in yield (see graph 1), we can expect a clearer demarcation between those credits with, and those without, adequate liquidity to ride out the next few months (Source).

For this reason, we expect little primary issuance and limited liability management exercises within the investment grade space. Any issuer that does not need to refinance will sit in the side-lines and wait this crisis out. S&P Global Ratings Research had been predicting a slowdown in global bond issuance by about 2% in 2022 (see graph 2 on next page) before the Ukrainian/Russian conflict broke out (Source). We now expect global primary issuance to contract even further as inflation and interest rates continue to rise further than expected.

Graph 1 - Eurozone bond yields surge (Source)



Graph 2 - Historical global issuance and forecast (Source)



**Full year forecast. Structured finance excludes transactions that were fully retained by the originator, domestically rated Chinese issuance, and CLO resets and refinancings. Sources: Green Street Advisors, Refinitiv, and S&P Global Ratings Research. Copyright 2022 by Standard & Poor's Financial Services LLC.*

Corporates that are not in a strong financial position, however, might not have such a luxury and be forced to refinance and/or carry out a liability management exercise to avoid defaulting. CMi2i has already seen a significant increase in liability management exercises requiring bondholders' meetings and consent.

Even those issuers that are planning to ride out this crisis by staying put will have to address a likely increase in investor engagement coupled with an increase in secondary market trading that will inevitably affect bond yields. This is because investors need to mitigate risk, especially in the context of higher inflation and slowing growth and will inevitably become more discerning. As mentioned by Bond Vigilantes, M&G's fixed income blog, investors are already trying to spot investment opportunities that will protect their capital in the current environment and one of these ways could be to move away from traditional fixed income notes onto High Yield Floating rate notes (Source). Against this backdrop, having a clear understanding of ones' bondholder base coupled with a proactive debt IR function will help issuers successfully navigate the next year.

CONCLUSION

2022 may prove to be another challenging year for issuers and the bond market as spiralling inflation and potential risks to growth leave little room for mistakes. For central bankers, finding the right policy balance will be no easy task. For corporates wishing to successfully navigate 2022, the key will be to proactively engage with their bondholders.

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ABOUT CMi2i

CMi2i provides unique capital markets intelligence and guidance to issuers and their advisors.

CMi2i is known for the world's most accurate share and debtholder identification service, supporting both corporates and their advisors with investor relations, M&A, shareholder activism, capital restructuring and proxy solicitation. Our team has provided intelligence and advice to over 500 of the largest, most structurally complex companies in the world, and supported numerous corporate transactions and general meetings. As a result, we offer clients a unique combination of skills, experience and methodologies within the following areas:

- Capital Market Intelligence & Investor Relations Support
- ESG & Corporate Governance Advisory
- Proxy Solicitation & Engagement

Contact info@cmi2i.com for more information on our services.