

Post Pandemic Role Reversal With Workers Calling the Shots



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Looking back at 2021 and forward to 2022, I'm having one of those "pinch me; I must be dreaming" moments. After rallying for over 40 years, the fixed income market is on the edge of panic. Interest rates are nearly as low as they've ever been, and we're finally starting to see every fixed income investor's nightmare—widespread inflation. Those living on fixed income need a larger basket of securities to deliver the same amount of income as they did a decade ago. Even so, the value of that income will be eroded thanks to the rising cost of everything each year.

The latest government data pegs US annual inflation at 6.8% for the 12 months ending November 30. That's double the rate of the two worst inflationary years of this century (2000 and 2011), and as high as it's been since 1982. The core price index, which excludes energy and food, climbed 4.9%, its steepest climb in 30 years. All these add pressure to Fed policies. Between these indicators and the latest strain of coronavirus, the market is starting to get a bit nervous.

The high-yield default rate stood at just 0.5% as of December 8, with default volume totaling only \$6.9 billion. That's even lower than 2007's record low and a far cry from the \$68.1 billion in total defaults last year. For 2022, Fitch Ratings predicts a default rate of only 1% and the total number of commercial bankruptcy filings is at its lowest since the mid-80s.

That's not to say there aren't signs that distress will materialize in the first half of 2022. There are also signs that we're approaching a peak in the fixed income bubble; one clear example is China's real estate market. Chinese developers were among the last big issuers of junk-rated debt, and, in their thirst for yield, fixed income investors lent them money at the top of a highly speculative real estate bubble. Despite this, it's been a good year in terms of investment opportunities.

Securities of all types have rallied in 2021 following the Covid shutdowns and broad equity indices are all up, year-over-year. November was a choppy month, but risk-taking was widely rewarded in 2021. Yet as we head into 2022, the big question remains: What will happen with the Fed? Will it really start to taper in the first or second quarter, and when will it raise interest rates? Finally, when that happens, will we see that the emperor has no clothes?

Whatever action the Fed takes, there's simply no doubt that inflation is already here. Consumers see it in their grocery bills and at the gas pump. You see it everywhere and it's come to a point that the Fed can no longer ignore. More importantly, investors are starting to expect inflation, and those expectations are a key indicator which the Fed uses to manage the economy.

Inflation is also apparent in the labor market, with union bargaining power increasing along with wages. Currently, unemployment is very low. In April 2020, when much of the country was shut down, it reached 14.8%, the highest level since the Great Depression. Yet by November 2021, it was down to only 4.2%. The Fed has forecast that unemployment will be 4.8% this year, 3.8% in 2022 and 3.5% in 2023.

As a result, many businesses are having trouble hiring staff and retaining those they employ. According to the Atlanta Fed, Y/Y wages were up 4.3% last month, representing the biggest increase since 2007. As one of the largest employers, Amazon is fighting this by offering \$20/hour plus big sign-on bonuses. They're hiring just about everybody they can, and this is creating self-fulfilling inflation because the labor market was already so tight. Tightness in labor markets is a key driver of inflation.

There's also secular change in the labor market because the employer-employee relationship has evolved substantially since the pandemic started. Many employees now demand to work from home along with more work flexibility. Thus, large cities like New York have been turned upside down with many people no longer coming into their large Manhattan offices. Most employers accommodate them since they can't find replacements.

This secular change in the labor market is likely also inflationary. Many employers say, "My workers who work at home are more productive," and if you ask workers, they usually claim that "I work more because I spend less time commuting." But it's unclear whether that's 100% true – anecdotally, friends are often more honest in admitting to doing something else while on the clock, because no one is supervising their every move. And indeed, it's natural for some people to take liberties if given the opportunity. If this is the case for a significant portion of remote workers, that's inflationary. Employers who used to receive a 40-hour workweek may still be paying the same salary but only getting 30-hours of productivity during these times.

The Fed has two primary goals—maximum employment and stable prices. Right now, the economy is growing, with unemployment near record lows, but we're seeing widespread inflation. The entire fixed income market, from Treasuries down to distressed debt, is dependent on the outcome of how the Fed chooses to manage this dynamic going forward.

Even though defaults and bankruptcies are at a multi-decade low due to low interest rates and an accommodative Fed, there are certainly opportunities on the way for distressed securities investors. As inflation gets more serious and interest rates inevitably start to rise, there's bound to be an increase in distressed debt as the Fed responds. We're already starting to see warning signs of distress, and the pricking of the inflationary bubble. We'll know a lot more as we move into the first and second quarters of 2022. The outcome is bound to be interesting.