Steeper Curve, Record Liquidity, and Robust Growth Prospects

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> In the tax-exempt market, many investors, particularly those in high-tax states facing even higher taxes, continued to stretch for yield from riskier credits despite limited supply and anticipated stronger economic growth thanks to record stimulus and pandemic mitigation.

> Municipal/Treasury ratios became even more expensive and quality spreads continued to tighten. Even if there was an overvaluation, funds still had cash that they had to invest to satisfy robust retail demand.

INVESTMENT GRADE-TAXABLE

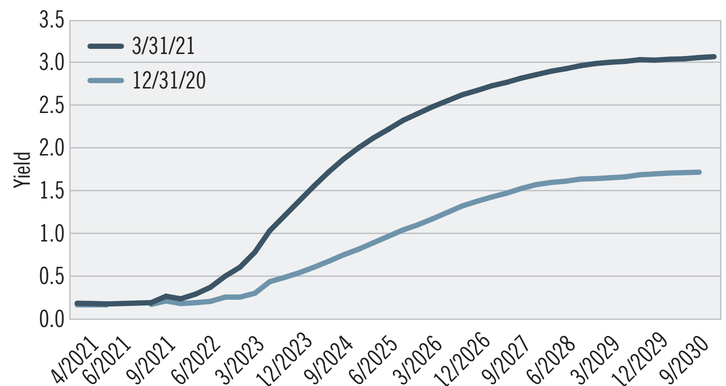
The Dot Plot Thickens

The narrative that drove financial markets in the first quarter was the prospect of higher growth and inflation that would turn into a sustainable level of above-trend growth largely driven by exceptionally loose fiscal and monetary policy as the COVID-19 vaccination roll-out continued.

The latest chapter included a $900 billion fiscal package approved in the lame duck session of Congress in December. Then came a $1.9 trillion stimulus bill in the first quarter. Estimates for 2021 GDP took off. The consensus U.S. GDP forecast jumped to 5.7%. It was 4% in December. Some firms projected 7% or even 8% growth as wrangling over a massive infrastructure program now takes center stage as expansionary fiscal stimulus continues to drive expectations for higher growth and inflation. The International Monetary Fund raised its 2021 global GDP forecast from 5.5% to 6%, which would be the highest growth rate since 1984.

While inflation forecasts varied, the yield curve steepened as the 10-year Treasury rose 82 basis points (bps) to 1.74%, the largest absolute increase since 4Q16 following the election of Donald Trump. The yield on the 2-year Treasury rose only four bps to 16 bps, anchored by the Federal Reserve's (Fed) commitment to a zero interest rate policy into 2024 as extrapolated from the Fed's "dot plot." With the Fed cautioning people not to read too much into the dot plot, the market started to price in a rate hike sooner, as evidenced in the Eurodollar futures curve (implying a hike in second half of 2022).

EURODOLLAR FUTURES SUGGEST A FED RATE HIKE IN 2H22



Source: Bloomberg

Scrambled AGG, But Thirst for Yield Continues

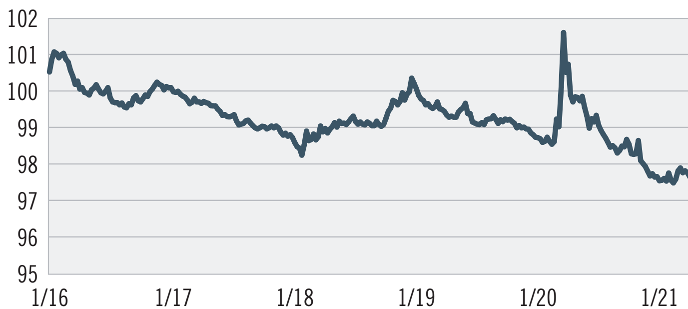
The Bloomberg Barclays U.S. Aggregate Bond Index, comprised of a broad range of fixed income securities, had a 3.37% negative return—its worst quarterly performance since Q3 1981. The corporate sector, which has the longest duration of the sectors in that index, dropped 4.65%. However, with spreads modestly tighter, corporate bonds still had a positive excess return. The Bloomberg Barclays U.S. Treasury Index fell 4.25%, its worst quarter since Q3 1980. (The long Treasury index was down 13.51%.)

With rates rising every month of the quarter and negative total returns across the board, one might assume that would lead to massive outflows in the investment grade category. On the contrary, it was the exact opposite. An unquenchable thirst for yield led to consistent inflows throughout the quarter: nearly $195 billion for taxable bond funds and taxable bond ETFs, according to preliminary figures from the Investment Company Institute. That would translate to about half of the $392 billion of bond fund and ETF inflows for all of 2020.

While the rise in Treasury rates has the attention of the global capital markets, the Fed has been consistent in its belief that the move higher is not alarming, and is happening for the right reasons. The Fed has said it is not focused on any one measure of accommodation. It's looking at a very broad range of metrics. Take, for example, the Goldman Sachs Financial

Conditions Index, which incorporates the level of the U.S. dollar, Treasury yields, the stock market, the Fed target rate, and BBB corporate bond spreads. That index started the year at around 97.54, but only tightened 21 bps, even though the 10-year Treasury rose 82 bps over the quarter.

BROAD ACCOMMODATION PERSISTS
Goldman Sachs Financial Conditions Index, 1/1/16-4/7/21



Source: Goldman Sachs. The Goldman Sachs Financial Conditions Index is defined as 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.

Excess Returns Were Positive

Given that spreads generally tightened over the first quarter, excess returns were positive, just not as much as market participants have become accustomed to, particularly since the second quarter of 2020. In the corporate bond market, there was about +95 bps of excess return. That marked the fourth consecutive quarter that the sector generated positive excess return, albeit the lowest of the four quarters. The main driver was long corporate credit with +236 bps of excess return, while the intermediate sleeve was essentially flat (+3 bps).

From a sector perspective, the industrial sector produced the best excess returns with +124 bps compared to utilities with +90 bps of excess, and financials around +36 bps. From a ratings standpoint, lower quality segments ruled: BBB's had +136 bps of excess compared to +45 bps of excess for the single-A sleeve.

Meanwhile, the securitized sectors were positive, but in an insignificant way. Residential mortgage backed securities (RMBS), the largest portion of securitized market, generated +15 bps of excess—no surprise given how tight spreads are there. The Fed is still buying $40 billion of RMBS (net) a month, so there's not much potential for excess returns being long RMBS, particularly in the midst of a very prolonged prepayment wave. Commercial mortgage backed securities (CMBS) generated +46 bps of excess, while asset backed securities generated about +15 bps of excess.

High yield managed to eke out 0.85%of total return despite the rise in rates—that equates to about +260 bps in excess return terms. Similar to the IG corporate credit sector, HY performance was led by the lower quality sleeve, as CCC's delivered +440 bps of excess compared to the high quality Ba/B sleeve at +224 bps of excess.

Fed Watch

Fed officials have made it clear they will let the economy run hot, but while they have suggested they're closer on the attainment of their full employment mandate than the price stability mandate, it seems unlikely they're close on either. Thus, the Fed's rate policy will remain on hold this year and likely next year as well.

For the Fed to hike rates sooner, it would be due to a combination of things. First, a reemergence of some sustainable inflationary trends that are not transitory leaves the Fed behind the curve (a low probability outcome). This would likely allow the bond vigilantes to reemerge with even greater force, triggering bond yields to rise to the point where they genuinely upset the stock market. The Fed is typically forced to react when bond vigilantes roil the stock market. Keep an eye on the 5-year part of the yield curve because that will probably signal the market's interpretation of future Fed policy. For now, though, it's clear that Fed officials are content with higher bond yields and a steeper curve because they reflect a more optimistic growth outlook.

The Fed in unlikely to react to the employment mandate because the economy remains far away from reaching what's typically considered a fully employed economy given the declines in both the participation rate and the employment to population ratio. It's doubtful there will be a sustained increase in core inflation of 2.5-3% for a very extended period of time. Core CPI is likely to top out 2.5-2.7% this spring. Core PCE, which is the preferred measure of the Federal Open Market Committee appears headed to a peak of2.5% in May, before returning to around 2% by year end.

Outlook

The economy is about 72% re-opened now. As that trend continues, GDP numbers may rise further, but not as much as some forecasts would suggest. According to the Census Bureau's Household Pulse Survey of March 17th – 29th, of those respondents who specified a usage of stimulus funds received, about 50% went to pay down debt, 32% was used to increase cash reserves, while 18% was actually spent. Should that dynamic continue, there could be a surprise to the downside, given that consumption is anticipated to drive the growth rebound in 2021.

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While a lot of growth and a lot of inflation are priced into Treasury bonds right now, in the short-term they are technically "oversold". Massive infrastructure spending (with unrelated pork) faces a long, uncertain road, and inflation concerns may be tempered by excess capacity in the labor markets for both the manufacturing and service sectors. Employment remains 8.4 million jobs below the pre-COVID level and the output gap is estimated anywhere from 3% to 6% of GDP.

The labor participation rate (the total labor force as a percentage of the working age population) is still almost two percentage points below where it was pre-COVID. The employment ratio (the number of people employed as a percentage of the working age population) stands about 3.3 percentage points below its pre-COVID level. Four million people have left the workforce in the past 13 months. Six million people outside the labor force told the Bureau of Labor Statistics that if offered a job, they'd take it. Then there's another six million who would work full-time if they could convert from their current part-time status. With all that excess capacity, the Fed clearly has a lot more work on the employment front. Never mind the ongoing challenges of the pandemic, as surveys show that many workers won't return to work for fear of infection.

Capacity utilization rates are still very anemic: 73.8% in the overall industrial economy and 72.3% in the manufacturing sector. Generally, the capacity utilization rate needs to be above 81% before you start to see any pricing pressures.

It is important to remember that excessive debt is deflationary, not inflationary, especially when combined with the structural forces of unfunded liabilities, excess global capacity, low productivity growth, and aging demographics. (The old maxim, "demographics is destiny," still resonates.)

Zombie companies (companies that earn just enough money to continue operating and service debt but are unable to pay off their debt) continue to get funded in the current easy money environment. That not only leads to a misallocation of capital, but also feeds into the deflationary narrative. As long as Fed policy allows zombie companies to continue to fund themselves, the excess global capacity issue is further exacerbated. This has been an issue since the Fed initiated its zero interest rate policy back in 2008.

When it comes to yields, the inflation boogeyman that many bond bears fear is more a narrative than economic certainty. There is a lot of Treasury supply that needs to be digested, but traditional stalwarts of demand appear poised to step up. In the past few weeks, banks bought a net $49 billion of Treasuries, even though the Fed decided not to extend the supplemental leverage ratio (SLR) exemption for Treasuries that banks enjoyed for the last year. Amidst the pandemic, Treasury holdings and bank reserves were temporarily exempt from the SLR calculation, which allowed for a higher than normal allocation to Treasuries. While the Fed recently allowed the exemption to expire, they opened debate for a more permanent exemption, implying that some regulatory relief is still likely later this year. As a result, it seems likely banks will continue to add to their Treasury exposure. Pension fund demand should also pick up as funding ratios have improved dramatically since the middle of 2020, compliments of a higher discount rate that lowers liabilities along with soaring asset values. Finally, Treasury yields moving higher have only improved their relative value amongst developed bond markets globally, offering reserve managers an attractive yield in both nominal and currency-hedged terms.

We are employing a safe income at a reasonable price strategy. It's more about security selection than it is about sector allocation given the richness of the spread sectors in this environment. It's important to note that in the corporate sector, leverage adjusted spreads are at all-time record tights as this is written.

INVESTMENT GRADE TAX-EXEMPT

Historic Low Ratios, Powerful Momentum. More Supply Ahead?

Quality didn't matter much in the first quarter of 2021. Many investors, particularly those in high-tax states facing even higher taxes, continued to stretch for yield from riskier credits despite limited supply and anticipated stronger economic growth thanks to record stimulus and pandemic mitigation.

As a result of such extraordinary demand, the Bloomberg Barclays Municipal Index, a broad measure of the municipal market, returned -0.35% for the quarter. AAA-rated bonds were down 0.90%; AA's were down 0.65%; A's eked out a 0.06% gain, and Baa's gained 1.28%.

Municipal/Treasury ratios became even more expensive and quality spreads continued to tighten. Even if there was an overvaluation, funds still had cash that they had to invest to satisfy robust retail demand.

Remember when the yield on a five year, AAA-rated municipal bond as a percentage of an equivalent Treasury was normally around 82%? In the last quarter, the Municipal/Treasury ratio dropped to a historic low of 54.4%. (For the 10-year, that ratio fell to 64.2%; the 30-year ratio was 72.3%.) At those levels (and if the top federal tax rate returns to 39.6%), some investors may have to revisit their taxable equivalent yield assumptions.

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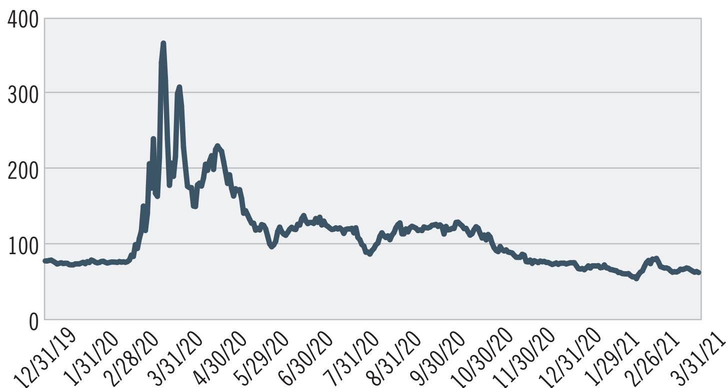
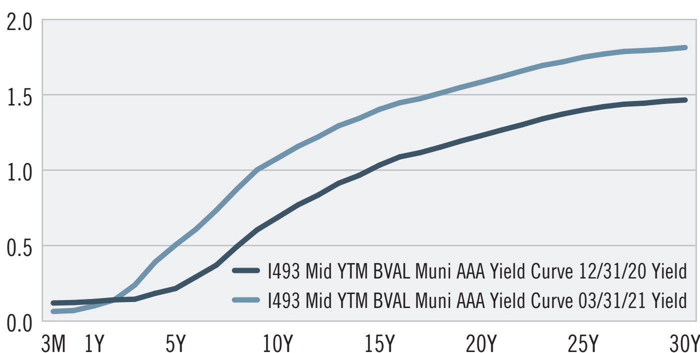
MUNICIPAL/TREASURY RATIO HITS RECORD LOW



Source: Bloomberg. Data from 12/31/2019-3/31/2021.

As rates rose in the quarter, there was strong retail demand for longer maturity municipals, much to our surprise, as if concerns about inflation in other markets were overblown. In that environment, investors who had been focused on the highest quality municipal bonds were bound to give up impressive gains they achieved in the uncertainty of 2020. We anticipated rates going up. We anticipated that the yield curve might steepen. However, we didn't really anticipate the strong demand at the long end. We were thinking the longer end would be hit harder than the 10-year segment. That did not happen. The return for the five-year part of the curve for the quarter was down 0.31%. The seven-year was down 0.54%. The 10-year segment was down 0.57%. The 20-year was down 0.30%. And the long bond was down 0.47%.

HOW THE MUNICIPAL YIELD CURVE STEEPENED



Source: Bloomberg

Biden Time

Adding to municipal bond investors' enthusiasm, The American Rescue Plan Act signed by President Biden in March provides $350 billion in emergency funding for state, local, territorial, and tribal governments to remedy the mismatch between rising costs and falling revenues. This includes:

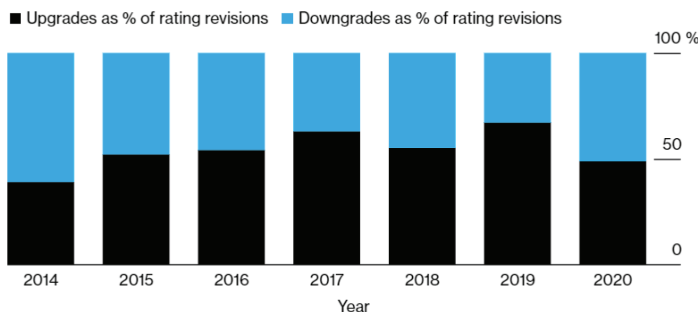
- $195 billion for states, (a minimum of $500 million for each State);
- $130 billion for local governments (a minimum of $1.25 billion per state is provided by the statute inclusive of the amounts allocated to local governments within the state);
- $20 billion for tribal governments; and
- $4.5 billion for territories

The rescue plan came after municipal bond downgrades topped upgrades for the first time since 2014, according to Moody's Investors Service.

One bright spot in that picture, though, was the State of Connecticut, a widely acknowledged leader in pandemic mitigation, which received its first bond rating upgrade in 20 years. Recognizing positive changes in the state's fiscal management combined with stronger revenues and increased rainy day funds, Moody's raised Connecticut's bond rating on two types of bonds from A1 to Aa3—from its fifth-highest ranking to its fourth-highest. The Aa3 rating means Connecticut moved into the "high quality" bond category rather than "upper medium" grade.

DOWNGRADES CONTINUE

Moody's downgrades top upgrades for the first time since 2014



Source: Moody's Investors Services

Outlook

We are reassessing where we want to be on the yield curve. However, the obvious overarching consideration is that municipals are in extraordinary demand. The retail market loves tax exempt bonds. We think that flows will continue, especially with the possibility of increased taxes down the road.

Meanwhile, the credit crisis has abated now that so much money is flowing to municipalities that it's a significant part of their budgets. Take Detroit, for example. That city's allocation of federal stimulus was equivalent to approximately 98% of its general fund revenue. All that money will certainly help in the short run, but the city still faces longer term issues. So does Illinois, with its huge pension liabilities,

continued

declining population, and challenging political situation. New Jersey, meanwhile, has a big budget issue, but for the short-term, with a growing economy, strong real estate market, and massive federal stimulus, all of a sudden its credit concerns have been put to the side. That trend should continue across the United States.

For all the talk about increased federal spending, debt, and deficits driving up inflation, we can envision inflation over the two percent range—for a short time period. It really does come down to wages, and we're not seeing significant wage inflation right now. However, commodities prices are up and real returns on fixed income are still negative. Even if the economy strengthens and inflation is at two percent, conservative investors might still be looking at negative returns. But while there is still some upside risk in interest rates, the Federal Reserve is intent on doing everything it can to keep rates low as long as it can.

When it comes to proposed infrastructure spending and the potential effect on states and municipalities, there's a real possibility that the Biden Administration may revive Build America Bonds (BABs), taxable municipal bonds introduced during the Obama Administration that featured federal tax credits or subsidies for bondholders or state and local government bond issuers.

According to The Securities Industry and Financial Markets Association (SIFMA), the two types of BABs created back then were: (i) Direct Payment bonds; those on which the United States Treasury Department pays state or local government issuers a payment equal to 35% of the coupon interest payments on such bonds, which is intended to lower the issuers' cost of funds; and (ii) Tax Credit bonds; those on which bond holders receive a tax credit equal to the 35% of interest on such bonds. Proceeds of these bonds can be used for the most of the same purposes as proceeds of regular tax-exempt government bonds.

There's also talk in Washington about reinstating rules that would allow states and municipalities to refund outstanding tax-exempt bonds with tax-exempt bonds. That tactic had been eliminated by the Trump Administration. As rates continued to stay low, issuers have been refinancing tax-exempt debt with taxable municipals at a savings. Now that Treasury rates have moved higher than taxable muni rates, it is more difficult to find savings. So reinstatement of the refunding rule could be a big boon for the issuance of tax-exempt paper because with the ratios as low as they are, the savings could be substantial.

Suffice it to say, the combination of a BAB revival and reinstatement of the refunding rule could dramatically increase supply, setting the stage for correction in Municipal/Treasury ratios. While all this bodes massive amounts of money entering the municipal market, such policy changes will require a lot of work. We will be monitoring developments closely.

As for credit quality, we do not believe massive amounts of stimulus will result in an increase of upgrades. It is likely we will see some outlooks change from negative to stable, and in some cases, from stable to positive. But the rating agencies know that stimulus is a one-shot deal—not a fix to a deep-seated budgetary problem. Nor is stimulus a long-term solution. It's a one-time advantage. Substantial challenges remain. If rating agencies see stimulus money is being used the right way and fiscal management is being handled well, it could enhance an upgrade that was already on the border line.

In any case, our outlook for the overall municipal class is very positive, and we expect it could deliver significant outperformance for the rest of this year.

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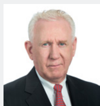
Authored by:

Investment Grade – Taxable



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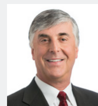
Investment Grade – Tax-Exempt



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The **Municipal/Treasury Ratio**, M/T ratio or muni-Treasury ratio, as it is more commonly known, is a comparison of the current yield of municipal bonds to U.S. Treasuries. It aims to ascertain whether or not municipal bonds are an attractive buy in comparison. The ratio uses indices from the Thomson-Reuters Municipal Market Data (MMD) series.

The **Bloomberg Barclays U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. **Bloomberg Barclays Long U.S. Treasury Index** includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have $250 million or more of outstanding face value. **Bloomberg Barclays U.S. Corporate Investment Grade Bond Index** measures performance of investment grade corporate bond funds. The index is calculated on a total return basis. **Bloomberg Barclays U.S. Corporate High Yield Bond Index** measures fixed rate non-investment grade debt securities of U.S. corporations, calculated on a total return basis. **Bloomberg Barclays Municipal Bond Index** is a capitalization weighted bond index created by Bloomberg Barclays intended to be representative of major municipal bonds of all quality ratings.

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