SEIX INVESTMENT ADVISORS LLC®
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Rising Inflation Risks as Economy Decelerates

> Fed tapering of asset purchases is highly likely to start in November and run through the middle of 2022, even though the economy is clearly decelerating and potentially quite a bit, if reduced GDP expectations from the Atlanta Federal Reserve are any indication.

> Is inflation transitory, or are recent spikes in key prices going to have a longer-term effect? We have supply chain issues that no one anticipated we'd still be talking about in October. Bottlenecks, chip shortages, and shipping delays have all persisted, and relief is still several quarters away. Shelter/rent costs, relatively large parts of core inflation, could drive the cyclical inflation impulse even higher in 2022.

> Healthy technicals supported the municipal bond market early in the third quarter, but September ushered in a turning point of sorts. The municipal yield curve adjusted higher in September in near tandem with Treasuries; however, by the end of the quarter the 5-year advanced only one basis point (bp), the 10-year 15 bps, and the long end increased 17 bps. Ratios were expensive, and credit spreads remained very tight.

> As the quarter wound down muni issuance outpaced demand even though flows remained positive. September marks the beginning of softer seasonality as more supply comes to the market, while less cash is returned to investors as maturities and coupon payments.

INVESTMENT GRADE TAXABLE

Spread Alert: Not Much in the Way of Tightening or Widening

The third quarter was very muted from an interest rate and credit perspective, with short rates (two-year Treasuries) up a mere three bps and long rates (30-year) down four bps, and two/10's down one basis point to 121. The five-year was the underperformer and that was up only eight bps—all of which reflected the bond market's range-bound mindset and heightened anticipation of what the Federal Reserve (Fed) might do next. Intra-quarter the skew was towards lower rates, as the 10-year Treasury yield did trade as low as 1.12% before re-tracing and closing the quarter at 1.49%. Spread changes were muted over the quarter, hence both total returns and excess returns across most of the investment grade spread sectors were also muted, and particularly so in the context of the returns market participants have enjoyed since the mid-2020 lockdown economy.

Volatility also returned by the end of September, with a spike in energy prices and many other commodities feeding the narrative of an economy still challenged by supply chain bottlenecks, component shortages, and exceptionally long delivery times. The Chicago Board Options Exchange's CBOE Volatility Index (VIX) was back up above 25 in mid-September before settling back down around 23 at quarter end. Recall, the VIX had settled at 15.8 by the end of Q2. It nearly breached 15 in early July, a level not seen since before the pandemic.

Money supply growth peaked in February and has been slowing ever since. M2, for example, closely watched as an indicator of money supply and future inflation, was up 13.2% in August on a year-over-year basis, compared to a 27.1% rate back in February. Before the COVID lockdown, M2 was growing at a 6.8% year-over-year rate.

If the Bloomberg Consensus is right, GDP for all of 2021 is poised to grow by 5.9%. That estimate is too high, but even if it proves accurate, it will have to be deemed a major disappointment reflecting how weak the underlying organic economy is given the extreme magnitude of fiscal and monetary intervention. Just last spring expectations were building for growth to potentially top 7%, but since Q2 the direction of economic surprises have been mostly to the downside.

After all, Congress delivered significant fiscal support this year – $2.8 trillion – and the Fed's balance sheet has expanded by an additional $1.1 trillion via direct asset purchases. The combination of both fiscal and monetary support rounds to approximately 17% of GDP, all while the Fed has remained committed to a zero-interest rate policy environment, and that's in addition to an elevated savings rate most considered a tailwind coming into 2021. Now the savings rate is down to 9.4% versus 14% at the end of 2020. The aggressive stimulus of 2020 saw the savings rate average a little over 16% for the year, more than double the 7.6% average seen in 2019 before the pandemic and economic lockdown.

An inventory rebuild, which was another tailwind many expected for 2021, has yet to manifest itself. Supply chain interruptions and ongoing bottlenecks remain a considerable challenge, but an inevitable inventory cycle remains a potential tailwind for the economy over the next few quarters, especially considering the Delta variant did not incite another broad government lockdown.

Against that backdrop, the Fed seems prepared to announce the tapering of asset purchases in November, allowing for a gradual reduction until ending asset purchases by the middle of 2022. The commencement of the taper is in line with the market's consensus expectation, but the pace, revealed at the September FOMC press conference, is somewhat faster than most expected and faster than the Fed's last asset purchase taper back in 2014.

Suffice it to say, it will be interesting to see if the Fed fully tapers, let alone raises rates by the end of 2022. Since the global financial crisis of 2008, the Fed has become the guardian of the stock market and its mantra is "Do No Harm" at the expense of all else. So, if the stock market suffers even a 15% drawdown, the Fed will likely turn dovish and offer support to the market once again.

Performance

The third quarter was replete with muted returns, both in total and excess return terms, with little in the way of rate or spread moves. Interestingly, real rates were little changed as well, such that we had no big move in inflation break-evens over the quarter—quite the juxtaposition with a period that was rife with inflation jitters. The conundrum of lower Treasury rates over the second quarter also carried into the summer, further frustrating a market still inclined to only anticipate higher rates, such that two-, five-, and 10-year Treasuries all made their lows for the quarter in early August.

Also noteworthy regarding the rates market was pricing in the options market. By the middle of July, for the first time in over a year, buying insurance against a decline in yields cost more than getting insurance on rates rising. It took a while, but the market finally became more worried about further declines in yields. Beyond that, Treasury yields spent most of the quarter in a tight range with 10-year Treasuries largely trading between 1.20% and 1.35%, and the break of the upper band did not occur until the week of September 23rd, when the inflation narrative awakened as commodities, particularly the oil complex, traded higher. This modestly stirred up inflation expectations from what had been mostly a slumber that saw ten-year break-evens exhibit little directionality within a 2.25 to 2.40 range. Recall, 10-year break-evens peaked at nearly 2.60 back in May

The narrow trading ranges over the quarter generated total returns that can be measured in basis points. The Bloomberg Barclays U.S. Bond Index total return was up only five bps, the corporate sector total return was zero, while the residential mortgage-backed securities (RMBS) sector was up 10 bps in total return terms, to name just a few.

The investment grade credit sector's flat total return included a rare -0.15% of excess return, the first quarterly underperformance since Q1 2020. Long corporates drove the underperformance with -0.50% of excess return while intermediates fared better with +0.06% of excess. Differentiation by rating was very muted. BBB's were the outperformer with +0.11% total return and -0.04% in excess return, while A's recorded -0.12% total return and -0.27% in excess return. Contrast that with high yield credit, where the higher quality BB's led the way with +1.09% total return and +1.04 in excess return, compared to CCCs +0.75% total return and +0.75% in excess return.

In the securitized sector, there was pretty much nothing significant to make note of. RMBS generated +0.10% in total return terms and +0.03% of excess return; commercial mortgage-backed securities had -0.03% in total return terms and -0.03% of excess return and asset-backed securities had +0.05% in total return and +0.03% of excess return.

Inflation

Is inflation transitory, or are recent spikes in key prices going to have a longer-term effect? The year began with a Core Personal Consumption Expenditure Price Index ("core PCE") deflator of around 1.5%; by June it had risen to 3.6%, which is where it remained through August. Even if we have a slowdown of monthly inflation from September through December, say 0.2% monthly, which is about half the rate seen so far this year, the core PCE deflator will end 2021 at about 4%, higher than where it stands now. Yet, the Fed is telling us that the core PCE deflator is going to come all the way back down to almost 2% by the end of next year. That's a rapid deceleration amidst a very challenging macroeconomic backdrop. We have supply chain issues that no one anticipated we'd still be talking about in October. Bottlenecks, chip shortages, and shipping delays have all persisted, and relief is still several quarters away. Shelter/rent costs, relatively large parts of core inflation, could drive the cyclical inflation impulse even higher in 2022.

This shelter/rent backdrop will play a critical role in determining where inflation goes in 2022. The key determinants will center on the dueling impact of core service sector inflation moving higher as the reopening continues versus whatever happens in the core commodity sector, where there was a much larger uptick in 2021 than anyone anticipated. Cyclical inflation forecasts for 2022 require tremendous humility, as the challenges of the economic reopening have introduced extraordinary circumstances the likes of which have not been seen for a long time, if ever.

Whatever happens with inflation in the short term, the Fed is likely to start tapering asset purchases in November with the objective to finish by the middle of 2022. However, the timing of rate hikes appears to be a coin toss. Nine members of the FOMC see no rate hike in 2022; nine see at least one; and three of those nine see two rate hikes in 2022. Looking farther out, the 2023 and 2024 dot plots imply three additional hikes in each of those years bringing the target rate to 1.75% by the end of 2024. Regardless of the

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questionable predictive value of dot plot expectations, that's a significant shift considering there were no rate hikes forecast at the beginning of the year through 2023. In any case, keep your eye on the FOMC, where significant turnover, beyond the normal annual voter rotation, is likely next year. Regional Fed President turnover in addition to potentially three or four new appointees (term expirations as well as one vacancy) at the Board of Governors represents a clear opportunity for the Biden Administration to put its mark on the central bank.

Other Themes to Watch

Consumer Sentiment. There have been some shifts in consumer sentiment, and one of the most interesting ones relates to purchasing plans for durables and housing. According to the University of Michigan's monthly Survey of Consumers, those planning on, or see it as a good time to purchase a home, are at levels we haven't seen since the early 1980s when mortgage rates were about 15%, and we have mortgage rates today at about 3%. The reason is that housing prices have advanced to record highs, which has really pushed a lot of people out of the market, thus reducing sentiment there in a dramatic way. Less dramatic, but still significant, is dampened enthusiasm for automobile and appliance purchases plans.

Higher Energy Prices. Higher oil prices generally serve as a tax on the consumer, and over a prolonged period they can lead to economic slowdowns and potentially a recession, so concern about higher energy prices is more than just an inflation story. Cyclically, though, in the short-term higher oil prices are going to fuel higher headline inflation, which the market views as an inflation outcome the Fed is more willing to look through, given its focus on the core inflation components. That ultimately means less discretionary income to spend in other places and worse economic growth over the intermediate/long term.

A China Slowdown. Between the tech sector crackdown and the over-leveraged Evergrande drama that is fueling fears of a property meltdown, the world's second-largest economy has a great wall of worry of its own, and we must pay attention to ongoing policy responses.

Beltway Blues. While Congress may have avoided a government shutdown until December 3rd, in addition to kicking the can on the debt ceiling until December, the potential for a crisis of our own making sometime before the end of the year remains. Then there's all the wrangling over infrastructure, be it the bipartisan component or the partisan reconciliation bill, all of which are mired in negotiation and very difficult to handicap.

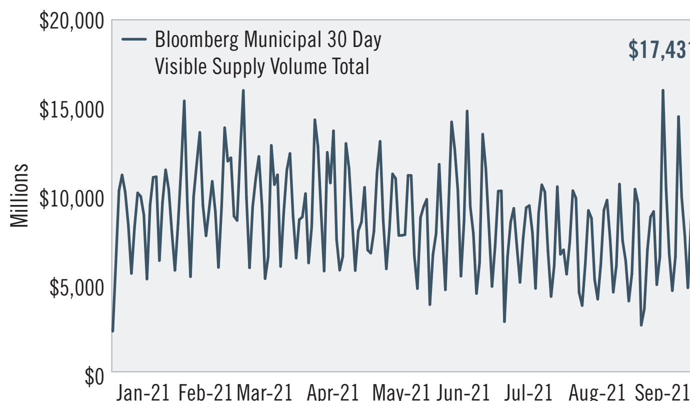
INVESTMENT GRADE-TAX EXEMPT

Tighter Spreads, Softer Flows, Fatter Risk Appetites

Healthy technicals supported the municipal bond market early in the third quarter, but September ushered in a turning point of sorts. The municipal yield curve adjusted higher in September in near tandem with Treasuries; however, by the end of the quarter the 5-year advanced only one bp, the 10-year 15 bps, and the long end increased 17 bps. Meanwhile the 5-year Treasury advanced 7 bps, the 10-year 3 bps and the long bond was lower by 1.6 bps. Ratios were expensive, and credit spreads remained very tight.

As the quarter wound down issuance outpaced demand even though flows remained positive. September marks the beginning of softer seasonality as more supply comes to the market, while less cash is returned to investors as maturities and coupon payments.

MUNI SUPPLY SURGE States and localities slated to sell nearly $16 billion over the next month



As of September 30, 2021. Source: Bloomberg.

Performance

Following such dynamics, the Bloomberg Municipal Index, a broad measure of the municipal market, returned -0.27% for the third quarter as lesser quality paper kept its edge and longer maturities did not. The five-year return was + 0.13%, the 10-year was -0.15%, and the long bond was -0.74%, giving back some of the big gains the market had earlier in the year. In terms of quality, AAA was down 0.41%, AA was down 0.28%., single-A was down 0.28%, and Baa was a positive 0.11%. Quality spreads remained strong.

In September, some ratios cheapened as Treasuries backed off, but Munis underperformed. Demand was not as strong as it had been earlier in the summer. Long bond funds and ETFs were still the big winners of flows this year. Mid to late September flows showed signs of softening as weekly inflows were in the millions rather than billions, and high yield was seeing redemptions albeit small.

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We are still mindful of the pressure a persistent redemption cycle would put on the investment grade market. What happens if rates get more volatile in the fourth quarter or next year and investors grow more cautious? The risk/reward ratio for lesser quality paper does not appear too advantageous. Lesser quality and longer duration have been the trades of the year as evidenced by the returns: five-year municipals have returned 0.30%; 10-year 0.41%; and the long bond has been up 1.57% year to date. In terms of quality, year to date, the AAA performance is -0.35%, AA is up 0.23%, single-A added 1.55%, and Baa gained 4.02%. This is a strong rebound from the depressed levels of last year, which is why we think lesser quality paper is fully valued now and question how long it can outperform.

Sector Details

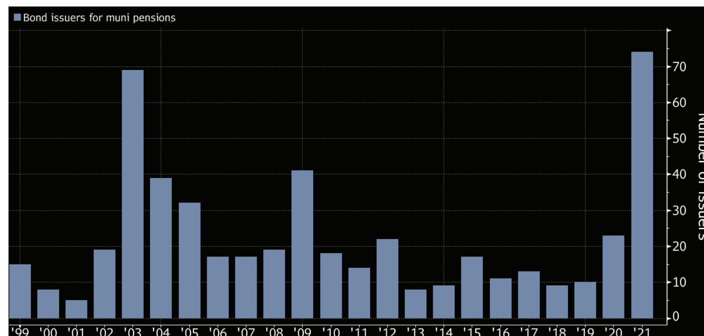
As mentioned previously, lower quality bonds continued to perform well during the quarter as investor demand for yield remained strong. While transportation bonds were heavily out of favor a year ago, primarily because of concerns related to slumping demand for business and personal travel, in recent months these sectors have rebounded with significant demand increases. The toll road sector performed exceptionally well as projected traffic decreases never fully materialized. Commercial traffic, buoyed by strong Internet sales and the pickup in commercial activity, helped many roadways retain a significant percentage of their pre-pandemic traffic levels. Additionally, airport bonds have strengthened, thanks to a continued pickup in airline passenger traffic. The potential impacts on these sectors from a large infrastructure bill wending its way through Congress remain very much in question. We believe that the legislation, as currently proposed, will not have a large impact on the municipal market.

Pension funding ratios have largely improved across all sectors. The combination of significant federal aid and tax revenue outperformance, versus previous dire budget projections, have given entities surplus funds that, in some cases, have been used to reduce pension liabilities. This increase in funding and the ongoing stock bull market have served to produce outstanding returns which improved funding ratios.

The higher education sector remains bifurcated. While well-endowed Ivy League schools are seeing increased demand and strong investment returns, smaller private schools are facing declining enrollments and rising costs. Schools that previously had a strong online presence have fared better, but the sector is fraught with challenges. Ultimately, this could lead to school closures and bankruptcies for the most heavily affected credits. With this outlook, we are cautious in the private higher education space and generally avoiding small second- and third-tier institutions.

RECORD WAVE

Unprecedented Number of Muni Issuers Selling Pension Debt



Source: LEAG YTD data compiled by Bloomberg through September 9 each year.

Outlook

Our outlook remains positive given continued robust demand for tax exempt securities, especially with the potential for higher income taxes in the current political environment. Additionally, massive infrastructure, and social spending packages have stoked fears of inflation and higher budget deficits, while increased tension with China has exacerbated geopolitical uncertainty. In combination, these factors could result in significantly increased volatility during the fourth quarter, and to combat this, we expect retail investors to shorten duration, preferring one- through 10-year securities rather than longer dated maturities. Given the expected reduction in demand, we are not as bullish as the market on the longer end of the municipal curve. The long end is very thin, with mutual funds or long ETFs reflecting much of the buyer interest. Should such interest in the long end dry up (or even reverse), bidders might be hard to come by.

As we move into the fourth quarter it will be a challenge to sustain momentum. While October and November could face some difficulty, December typically sees more demand than supply, setting the stage for very favorable months in January and February. We maintain our focus on higher quality, and our portfolios remain more oriented in the AA/AAA portion of the market. While we maintain some exposure to A-rated and BBB-rated paper, it is significantly less than our peers and lesser quality funds have. We remain more heavily weighted in the five- to 10-year area of the curve, which helps explain some of our underperformance this year. We expect that this positioning will work out in our favor, if volatility increases, individual investors start to reorient to shorter maturities, or major inflows to the market stop.

In terms of overall issuance, it's important to note that a sizable portion of this year's issuance has been taxable munis, the proceeds of which have been used to refund tax-exempt issues.

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Investment Grade – Taxable

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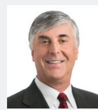
Investment Grade – Tax-Exempt



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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 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 U.S. Long 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 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 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 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. The **Russell 2000® Index** is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. The **Russell 1000® Value Index** is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. The **Dow Jones Transportation Average™** is a 20-stock, price-weighted index that represents the stock performance of large, well-known U.S. companies within the transportation industry.

A **Basis Point (bp)** is equal to 0.01%. **Average Coupon** is the weighted average coupon (annual rate of interest on the bond's face value that the issuer agrees to pay the holder until maturity) of all the securities in a fund.

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