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Navigating The New Bond Market Conundrum: Can the Fed Dampen Inflation Without Roiling Markets and the Economy?

> Total returns in the investment grade space are being challenged just like last year, which also saw rates rise and drive returns negative at the inception of the new calendar year (as represented by the Bloomberg U.S. Aggregate Bond Index); total returns stayed negative the entire year, finishing at -1.54% for the full year, but well ahead of their early year drawdown.

> Clearly the Fed is trying to engineer a soft landing for the economy. It wants to contain inflation, but it doesn't want to go too far and cause a recession. We would argue that it is also attempting a second soft landing—for risk assets, that is. The Fed wants to tighten financial conditions, but not in a way that precipitates a disorderly correction in risk assets.

> In the tax-exempt space, phenomenal retail demand continued with mutual fund flows for the calendar year topping $101 billion as volatility stayed low.

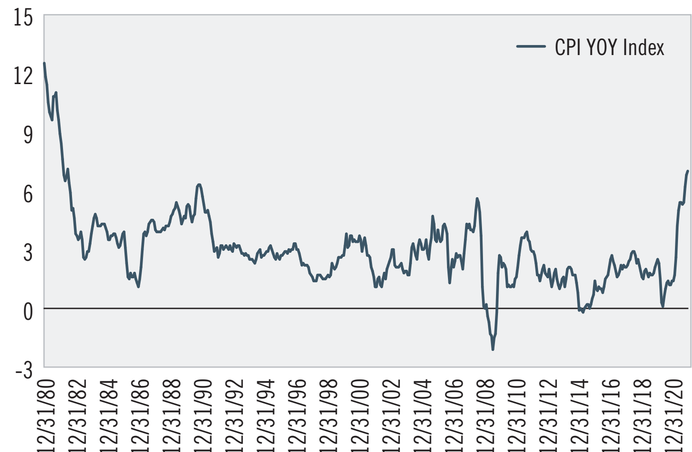
> For the full year, the Bloomberg Municipal Bond Index showed a 12-month return of 1.52%, adding 0.72% during the fourth quarter. Taxable municipals also performed well, returning 0.44% for the fourth quarter, bringing the year to 0.94%.

INVESTMENT GRADE TAXABLE

Returns Challenged as Inflation Eclipses Infection

Amid strong economic growth and concern that the Federal Reserve (Fed) was falling behind the curve in adjusting its exceptionally accommodative monetary policy, Fed officials finally acknowledged in early December that inflation was more persistent than "transitory" and resolved to pivot to a less accommodative posture. After all, the Consumer Price Index, in year-over-year terms, jumped from 1.4% in December 2020 to 7.0% in December of 2021, and on the core side (which excludes food and energy), from 1.6% to 5.5%. Exhibit 1 below shows the multi-decade highs consumer prices are exhibiting. As a result, at its mid-December meeting, the Fed doubled the pace of its "taper", thereby further reducing the pace of additional asset purchases. The original "taper" policy shift was only put in motion at its early-November meeting, so this was a quick adjustment. As it stands, asset purchases by the Fed should conclude by mid-March. The timetable for rate hikes, however, remains uncertain, fueling divergent interpretations about where rates are ultimately headed, the shape of the yield curve, and just how quickly the Fed could transition to balance sheet run-off (where the Fed no longer reinvests the cash flow generated by the assets on its balance sheet). Balance sheet run-off is also called quantitative tightening.

Y-O-Y JUMPS IN CPI SINCE 1980



As of December 31, 2021. Source: Bloomberg.

While two- and five-year Treasuries rose 46 basis points (bps) and 30 bps, respectively, in Q4, the 10-year Treasury rose only two bps and the 30-year declined by 14 bps. For the full year, five-year notes, the "belly" or middle of the curve, saw the largest uptick, with yields rising about 90 bps for the year. The yield for two- and 10-year notes were each up around 60 bps. The 30-year, on the other hand, only saw its yield move up 26 bps on the year—an interesting dynamic amidst consensus expectations for much higher long-term Treasury yields.

Taper Tempo Twist

Let's re-cap how Fed policy evolved in Q4. In early-November we got the "taper" announcement with a mid-November commencement. Under that original plan, asset purchases by the Fed were scheduled to end by the middle of June 2022—or so it seemed at the time. In December, the Fed decided to double the "taper" pace, meaning those active purchases would consequently end by the middle of March.

Just as quantitative easing was finally on the wane as 2021 came to an end, so too was the Fed's zero interest rate policy. Think back to March 2021 when there were no rate hikes projected by the Fed's infamous "dot chart" through the end of 2023. Now fast forward to December's update that projected three rate hikes in 2022, followed by another three in 2023, and two more in 2024.

Granted, all these rate hike expectations stem from individual Fed participants' views of how the target rate might evolve through 2024. Trouble is, that "dot chart" historically has proven to be a very poor predictor of the ultimate path for the target rate, but the market appreciates the insight it offers into the Federal Open Market Committee (FOMC) members' thinking, even though it doesn't represent an official forecast.

Muted Excess, Total Returns in Q4

Total returns were mixed over Q4, with shorter duration sectors within the securitized markets suffering modestly negative total returns because of the more aggressive upward shift of short-term rates that accompanied the Fed's hawkish pivot. Meanwhile, sectors like corporate credit that have a fair amount of longer duration exposure benefited from the more benign movements in 10-year and 30-year Treasury yields over the quarter. This allowed corporates to post a modestly positive total return in Q4.

Like Q3, Q4 excess returns were again relatively muted across the investment grade markets. Investment grade corporate credit had a negative 29 bps of excess return, marking its second consecutive quarterly decline (Q3 saw negative 15 bps of excess return). There wasn't much differentiation by credit quality, as single-A exposure saw negative 33 bps of excess while lower rated triple-B exposure was only modestly better with negative 24 bps of excess. The securitized sectors also saw modest negative excess returns over the quarter, led by residential mortgage-backed securities (RMBS) at negative 26 bps, while commercial mortgage-backed securities (CMBS) had negative 17 bps and asset backed securities (ABS) had only negative 12 bps. In contrast to the investment grade spread sectors, the sub-investment grade, or "high yield" corporate credit sector outperformed with positive 106 bps of excess returns.

For the full year, following higher-than-expected economic growth (compliments of another big dose of fiscal support), the investment grade spread sectors did relatively well in excess return terms, with the exception being RMBS, which had a negative 68 bps of excess. From a valuation perspective, the sector has been exceptionally rich due to the Fed's asset purchases since March 2020, leaving little excess spread to cushion for any adverse price performance. The investment grade corporate sector generated 161 bps of excess for 2021 while CMBS had a solid year with 105 bps of excess. ABS, the smallest spread sector, generated only 31 bps of excess return. The government related sector produced about 68 bps of excess. For the "plus" sectors, the outperformance of high yield in Q4 held true for the full year with an overall 663 bps of excess return. For emerging market exposure, the excess return was positive but far more muted at 71 bps.

The New Bond Market Conundrum

In his February 2005 congressional testimony, then-Fed chair Alan Greenspan noted that even though the FOMC had increased the federal funds rate 150 bps since June 2004, the 10-year Treasury yield remained essentially unchanged. He posited several possible explanations for what he believed was the aberrant behavior of long-term Treasury yields. Rejecting each in turn, he called it a "conundrum", and there was very little movement in long-term rates after subsequent tightening.

The same can be said of the current bond market. Consider the backdrop of ~ 5.5% GDP, an acceleration in consumer price inflation to ~ 7% and longer-term Treasury yields—the 10-year Treasury ended 2021 at 1.51% and the 30-year at 1.90%. In short, those economic and long-term rate outcomes created a juxtaposition many market participants don't fully understand. Some suggest that the long end of the curve is already signaling that the Fed is going to make a policy error and precipitate a recession. Other analyses point to pension funds' formidable demand for high quality, long duration assets as they de-risk given their greatly improved funding status over the last 12 to 18 months (back to levels not seen since before the global financial crisis). Of course, foreign participation in our market remains a supportive influence as well, as the U.S. Treasury market remains the high yielder amongst developed markets globally. Whatever the factor, or combination of factors, the behavior of longer-term Treasury yields is evoking another bond market "conundrum".

In any case, as 2022 begins total returns in the investment grade space are being challenged just like last year, and the consensus fully expects to see higher rates through 2022. Last year saw a maximum drawdown (in total return terms) for the Bloomberg U.S. Aggregate Bond Index at -3.66% on March 18th. Its total return stayed negative the entire year and it ultimately finished at -1.54% for the full year. Even so, it makes sense to not extrapolate early year returns as the economic and policy backdrop will remain highly uncertain and subject to considerable change as the year progresses.

Outlook

As huge fiscal and monetary support roll off in 2022, exceptionally strong tailwinds are morphing into headwinds. Currently, tracking models project Q4 GDP finishing as high as 6-7%; if accurate, that would bring 2021's overall growth rate to just over 5.5%. The current consensus expects a slowdown to around 4% for 2022, which remains well above the post-financial crisis average of 2.3%. Given lower odds of any large fiscal support this year, particularly considering

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the recent rejection of "Build Back Better" legislation, 4% GDP growth seems aggressive. Given some of the more recent Fed rhetoric and the increasing likelihood of a more rapid withdrawal of monetary policy support, the path to another year of well above trend growth will be fraught with obstacles, to say the least. Add to that the ongoing challenges from additional COVID variant flare-ups and the consequent labor shortages and supply chain disruptions, assuming something lower than that 4% consensus becomes easier.

Clearly the Fed is trying to engineer a soft landing for the economy. It wants to contain inflation, but it doesn't want to go too far and cause a recession. We would argue that it's also attempting a second soft landing—for risk assets, that is. The Fed wants to tighten financial conditions, but not in a way that precipitates a disorderly correction in risk assets. By virtue of its actions that have persisted since the financial crisis (some argue for even longer), the Fed has become the guardian of the stock market. Will the Fed's tolerance for lower stock prices be different now than in the past?

Recall how quickly the Fed pivoted "dovishly" in January 2019 after the stock market buckled amidst quarterly rate hikes and quantitative tightening (the S&P 500 total return was -9% in December 2018 and -13.5% for Q4 of that year). The inflation backdrop has changed dramatically, so much so that if inflation fails to recede as much as the Fed anticipates, its natural inclination to pause or pivot "dovishly" again to support the stock market (and risk assets in general) may not be viable policy option. Inflation will be the ultimate governor on what the Fed can and can't do in 2022.

Additionally, as we approach mid-term elections in 2022, politicians who have already jumped on the bandwagon will no doubt continue to excoriate the Fed for letting inflation escalate because they're hearing it from their constituents, especially since inflation may get a little worse before it gets better in early 2022.

Should inflation persist, or even moderate to say 4-5% by the second half of 2022, the Fed will have no choice but to tighten further, and that could pose a very difficult backdrop for risk assets overall. Investors will have to be nimbler and more tactical to take advantage of what the market may offer this year. Complacency has always been one of more consistent consequences of the Fed's exceptionally accommodative policy settings. It seems very reasonable to expect that complacency to be replaced with much greater uncertainty and higher volatility as 2022 evolves.

Given that backdrop, returns this year will be driven more by security selection in the corporate credit sector rather than any broad overweight, hence our neutral weighting vs. the benchmark. A focus on companies and sectors that stand to benefit from the ongoing re-opening of the economy, even at a more measured pace, will also help to drive excess returns in 2022. In the securitized sector, we have been and remain underweight RMBS, where pricing is likely to adjust aggressively in 2022, with the Fed moving to the sidelines and a lot of net supply having to be picked up by other buyers. It's going to take much wider spreads to entice investors to add exposure to the RMBS sector.

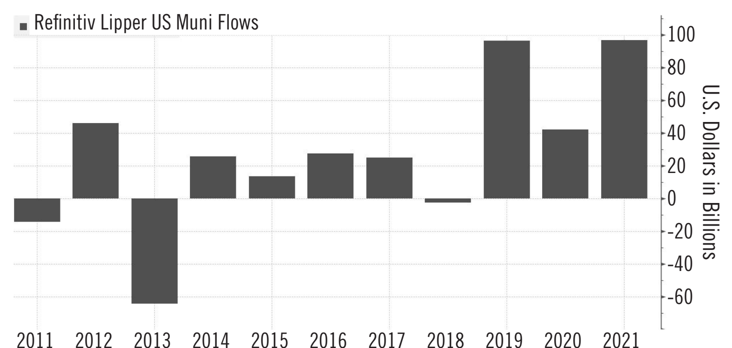
INVESTMENT GRADE TAX-EXEMPT

In many ways, the fourth quarter of 2021 was a continuation of the one-way bull market of the previous three quarters with lesser quality paper outperforming, albeit at a reduced pace. Phenomenal retail demand continued with mutual fund flows for the calendar year topping $101 billion as volatility stayed low. The magnitude of this insatiable retail demand is best captured in an observation by Refinitiv/ Lipper, which reported municipal bond funds have seen inflows in 85 of the past 86 weeks (period ending January 5, 2022) totaling a record $164.3 billion, and a record since the inception of the data in 1992.

Issuance for 2021 was approximately $481 billion, which was 3% below 2020. The 2022 pipeline could be similar, with current estimates ranging between $450 billion and $525 billion. Taxable issuance for 2021 was nearly 30% of overall issuance, the third time issuance has been more than $100 billion. Taxable issuance in 2022 is expected to drop as short-term Treasury rates rise, creating a potentially important technical indicator for the sector. Overall, for the year, demand was strong and spread across retail, separately managed accounts (SMA), and even institutional channels.

RECORD DEMAND

Muni inflows above $96.8 billion in 2021 topped 2019's high of $96.5 billion



Source: Refinitiv Lipper and Bloomberg. Note: Data through Dec. 29 in 2021; full year for all other years.

Performance

For the full year, the Bloomberg Municipal Bond Index, a broad measure of the municipal market, showed a 12-month return of 1.52%, adding 0.72% during the fourth quarter. Taxable municipals also performed well, returning 0.44% for the fourth quarter, bringing the year to 0.94%.

In Q4, longer duration outperformed continuing the trend of the previous three quarters. The five-year total return for the quarter was 0.04%, the 10-year returned 0.55%, and the long bond added 1.58%. For the full year, the five-year had a total return of 0.34%, the 10-year was up 0.96%, and the long bond gained 3.17%.

In terms of credit quality for the quarter, spread movement was rather muted: the AAA Index was up 0.82% as the Baa Index gained 0.80%, and the AA and A Indices returned 0.69%. For the full year, the difference was amazing: the AAA Index was a positive 0.47%, while the Baa Index returned 4.85%—a tremendous outperformance that reflected the hefty demand for yield and exemplified the resilience of spread tightening from very wide levels that occurred in early 2020.

Trading activity, however, was down approximately 30% for the year, limiting opportunities to take advantage of inefficiencies in the market.

Sector Details

The $1.9 trillion American Rescue Plan Act (ARPA) was signed into law in March 2021, with $350 billion allocated to state, local and tribal governments. Buoyed by yet another infusion of federal relief funds amid a solid economic recovery, the overall credit quality of the municipal market remained sound. As a result, unlike 2020, rating upgrades exceeded downgrades; while first-time municipal defaults fell to 65 from 86, with senior living facility financings accounting for about half of the 2021 total. Over the last two years, many state and local governments were able to add to their financial reserves. Overall, this makes the sector better prepared to respond to possible new waves of the pandemic and/or potential future economic setbacks. While the recently passed $1.2 trillion Bipartisan Infrastructure Deal is also likely to benefit municipal issuers by potentially lightening their capital spending needs, new tranches of federal aid of the magnitude we witnessed over the past two years are very unlikely. State and local governments received about half of their ARPA funds in 2021 and will receive the second half in 2022. This means that issuers that had difficulties balancing their budgets prior to the pandemic may ultimately have similar problems in the future. We will keep this in mind as we make investment decisions in 2022.

Outlook

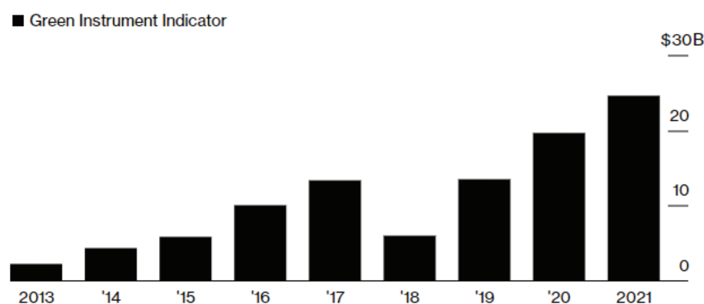
With investors clamoring for yield in a low-rate environment (especially in high-tax states), we expect demand for municipal bonds will remain strong in 2022. However, the combination of Fed tapering of asset purchases and raising rates to help quell inflation will likely prompt an uptick in volatility.

While we believe there is room for quality spreads to widen from their very tight levels at present, we would not expect that widening to be significant. Much will depend on demand from SMAs and institutions. While we do not foresee another year of demand like we had in 2021, should demand remain strong, yield will continue to be an important piece of the performance puzzle. Lesser quality paper will likely outperform, albeit to a lesser degree than seen in the last year.

As investors attach more importance to environmental, social, and governance ("ESG") metrics, green bonds may continue to draw greater interest. Green criteria are not as well defined as they need to be, resulting in little spread or yield differentiation for those designations. A water and sewer bond, for instance, may help finance environmental protection, but it may not be designated green under certain rubrics, and will trade without the implied benefit of ESG. At Seix, we explicitly integrate the review of ESG factors into our existing credit process and formulation of our credit opinion and will continue to monitor the development of this investment trend.

MUNIS GO GREEN

State, local-government green debt sales hit record high in 2021



Note: Long-term sales only, includes bonds tagged with a green indicator

Source: Bloomberg

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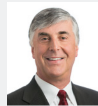
Investment Grade – Tax-Exempt



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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.

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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