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Is the Yield Curve Less of a Recession Indicator Than Previous Cycles?

> By the end of the first quarter, markets were adapting to turbocharged monetary policy tightening (also called "QT") and preparing for up to 250 basis points (bps) of tightening in addition to balance sheet reduction as early as May.

> Even Fed speakers have taken to referencing the 1994 tightening cycle as a historical analog for the current cycle. Starting in February of 1994, the Fed raised rates by 300 bps over 13 months, taking the target rate from 3% to 6%. That comparison was essentially unthinkable even three months ago.

> In one of the most difficult periods in recent market history, municipal bonds underperformed a number of other fixed income categories in the first quarter of 2022 as demand plunged. The Bloomberg Municipal Bond Index was down 6.23% and the Bloomberg Municipal Bond High Yield Index was down 7.38%—the worst quarterly performance since the third quarter of 1981.

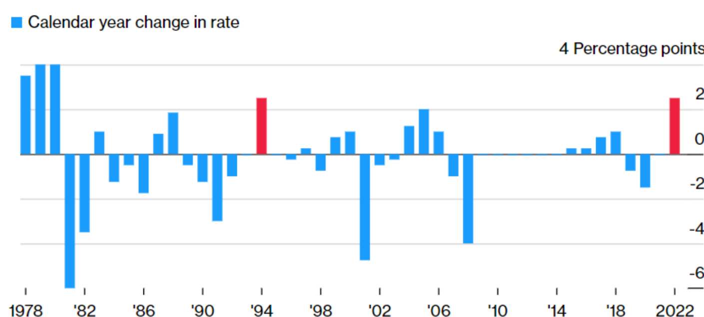
> Just as striking was the ratio of AAA-rated municipals versus Treasuries. At the beginning of the year, a five-year AAA-rated municipal bond yielded about 44% of the equivalent five-year Treasury. By the end of the first quarter, the ratio was 81%, a tremendous shift.

INVESTMENT GRADE TAXABLE

Bracing for More Rate Hikes

Following the worst inflation in 40 years, central banks led by the Federal Reserve (Fed) continued to pivot in a more hawkish direction during the first quarter of 2022, and the prospect of even tighter monetary policies triggered angst in the investment grade markets as investors contemplated a more aggressive rate hike cycle.

FED UP
Markets are pricing in aggressive U.S. monetary policy tightening this year



Source: Bloomberg.

By February, investors were beginning to price in the potential for 50 bps of a hike in March, but the Fed made it clear it wanted to start with 25 bps. While that measured first step assuaged risk assets somewhat, the prospects for a sharper upward trajectory in rates were clear by the end of the quarter. When Russia invaded resource-rich Ukraine on February 24, concerns about even higher prices for energy and food further intensified the inflation backdrop.

Yield Curve Aggressively Flattens

Even after flattening considerably in the final quarter of 2021, the pace of flattening accelerated in Q1 given the Fed's emphasis on restoring price stability following multi-decade highs in inflation. The two-year Treasury rose about 161 bps, the fifth largest calendar quarter rise since 1977; the five-year rose about 120 bps; 10s and 30s saw more muted yield gains, rising only 83 bps and 55 bps, respectively.

The Fed's persistent message on restoring price stability had an impact. Coming into the year, the market was pricing in about three hikes. By the end of the first quarter, it was pricing in eight more hikes, and that was after the initial hike that occurred in March. Currently, in mid-April, it's even higher, all of which underscores just how far behind the curve the Fed is in its battle against inflation. After all, the Fed was still buying bonds in the first half of March, only one 25 bps hike is done, the headline Consumer Price Index is at 7.9%, and with the war in Ukraine it's likely to go higher.

Vacillating between inverted and un-inverted, the yield curve is clearly signaling there is a looming policy error by the Fed and an inevitable economic impact to what it will have to do to catch up. This is somewhat consistent with pricing in the Eurodollar curve where rates peak in the second or third quarter of 2023, and then start to decline in 2024, anticipating an inevitable Fed pivot to easing, especially if there is a recession. While the curve inversion is often interpreted as signaling a pending policy error – hiking into a slowdown – the real policy error took place in 2021, when the Fed failed to begin removing emergency monetary policy settings amidst a robust economic rebound.

Total Returns

In terms of total returns, it was a tough quarter all around. Stocks (as represented by the S&P 500® Index) were down 4.6%. Small cap stocks (as represented by Russell 2000®

Index) were down 7.5%. The Bloomberg U.S. Aggregate Bond Index finished the quarter down 5.93%, its third worst calendar quarter ever. The Bloomberg U.S. Treasury Index was down 5.58%, the worst calendar quarter since its 1973 inception. The Bloomberg U.S. Corporate Bond Index was down 7.69% for the quarter, suffering more as the sector has the longest duration within the investment grade market.

All that red ink was not limited to just these broad market sectors. The Deutsche Bank Thematic Research team tracks 38 non-currency assets, of which only nine registered positive returns in the first quarter. Most of those came from the commodities complex. The Commodities Research Bureau Index, which comprises a basket of 19 commodities, was up 27%, with energy accounting for the biggest gains. West Texas Intermediate oil advanced 33.3%, while Brent crude rose 38.7%. With the war in Ukraine threatening agricultural commodities, corn was up over 26%, and wheat rose more than 30%. This backdrop of war also supported the traditional haven of gold, advancing 5.9% over Q1.

The ramifications of those price gains are going to be felt throughout the balance of the year. While energy price gains typically garner the most attention, the food inflation story is rising in importance, particularly for countries dependent on food imports. Domestically the food inflation backdrop is getting more attention, and it's worth highlighting that food is almost twice the size of the energy component in the Consumer Price Index.

Excess Returns

Excess returns in all spread sectors were uniformly negative for the full quarter. Investment grade corporates suffered about 145 bps of negative excess return, even after an impressive recovery in March. Long-maturity corporates underperformed with 249 bps of negative excess, while the intermediate sleeve posted only 74 bps of negative excess. From a sector perspective, there was not much differentiation. Finance and industrials were almost identical, delivering 140 and 144 bps of negative excess, respectively. Utilities were worst with 168 bps of negative excess—all of which underscored how much duration weighed on the market, as the sector tends to issue more longer-term paper.

In terms of credit quality, triple-Bs underperformed with 170 bps of negative excess compared to single-A exposure, which had 122 bps of negative excess. Higher quality double-A credit was still better with 109 bps of negative excess, but at only 7% of the investment grade corporate index, the opportunity set there is limited. The corporate index is 41.2% single-A and 50.4% triple-B risk, after years of leverage being added to corporate balance sheets.

Residential mortgage-backed securities (RMBS) recovered somewhat in March, but still didn't reach a positive excess return for the month like the other primary spread sectors. In addition to a difficult risk environment, the RMBS market was dealing with the loss of its large, noneconomic buyer, namely the Fed. The Fed is still buying mortgages, but it's just a reinvestment process right now. The Fed is not adding mortgages to its balance sheet anymore. So, over the course of the quarter, the RMBS sector had about 71 bps of negative excess. As we move into the spring and summer months, RMBS net supply will increase, leaving the sector challenged absent the Fed's excessive presence. While spreads have widened considerably, the sector is likely to remain challenged to deliver excess return.

Commercial mortgage-backed securities saw 58 bps of negative excess return for the quarter while asset-backed securities (ABS) had negative 31 bps of excess. The ABS sector has seen a fair number of investors selling to fund investments elsewhere. ABS is a high quality, low duration, low spread sector, so it makes sense that people are redeploying some of that allocation into areas that offer greater potential excess return.

As for the so-called "plus" sectors, high yield also underperformed with 92 bps of negative excess return—although still better than IG corporates at negative 145 bps. Within high yield, underperformance came from the higher quality Ba sleeve where there's more interest rate sensitivity than the lower quality CCC sleeve. Contrast that with the emerging market space, which suffered a much more painful 361 bps of negative excess.

Inversion and Inflation Views

The 2s/10s curve was 78 bps flatter by the end of the quarter, leaving the two points on the curve at essentially the same yield. This rattled the market somewhat, since history shows it usually takes many more rate hikes to achieve a flat or inverted curve. Like everything else, the curve in this cycle is proving to be unique in that after only one rate hike the 2s/10s Treasury curve has already inverted briefly. While this curve proxy has returned to a positive slope in mid-April, deeper and more prolonged periods of inversion are likely if the Fed follows its hawkish rhetoric with action. That the 2s/10s yield curve inversion took place this early suggests it could reach levels not seen since the early 1980s as the Fed raises rates to fight inflation that is likely to get worse in the short term.

While the Fed acknowledges the 2s/10s curve inversion, it focuses more on money market curves, or the money market versus the 10-year, which both remain positively sloped and

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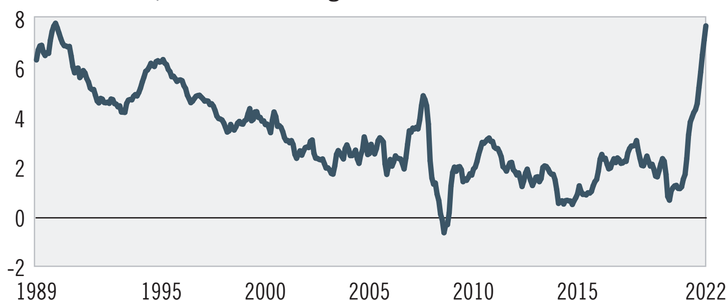
relatively steep now. Looking at the Fed's three-month to 10-year curve proxy, there was still 185 bps of positive curve slope at quarter end. The divergence is likely driven by the degree to which the Fed has fallen behind relative to the market's pricing of the anticipated rate hike cycle to come. Moving forward, the 2s/10s curve will move in and out of inversion as we progress through the second quarter, and the rest of 2022. There will also be a dramatic flattening of the three-month/10-year curve over the next few months and quarters.

Similarly, in the Treasury Inflation Protection (TIPs) sector, the breakeven curve is also inverted, which is just another way of saying that inflation expectations over the short-term are much higher than over the long-term. At quarter end the breakeven for the two-year part of the curve was above 4%. The five-year breakeven was north of 3%, whereas in the longer end, it was still below 3%. The 10-year breakeven ended the quarter around 2.83%, and the 30-year ended the quarter around 2.44%.

Just to clarify: if the inflation rate comes in above that 10-year breakeven rate of 2.83% over the life of the security, then an investor would be better off owning the inflation-linked security. If inflation comes in below 2.83% over that time frame, then owning the nominal 10-year Treasury is preferred. If an investor thought inflation for that 10-year period is likely to be 3-4%, or higher, then he or she would want to own the inflation-linked security.

Thus, the inversion of the breakeven curve reflects the view that inflationary pressures in the short-term are expected to moderate and not flow through to the longer term. The widely followed five-year/five-year forward rate is still around 2.4%, well below the high we reached back in 2010, which was over 3% and the average, if you go back to 2002, is about 2.3%. The relative stability of these longer-term breakeven rates is comforting to the Fed—offering evidence that longer term inflation expectations remain anchored, and that the Fed has managed to retain its inflation fighting credibility. Should these metrics begin to move higher, greater panic will settle in at Fed headquarters.

INFLATION IN THE OECD AREA CLIMBS TO THE HIGHEST SINCE 1990, Annual % change on Consumer Price Index



Source: OECD.

Stagflation

Is the economy heading for stagflation like the Seventies, when energy prices skyrocketed and led to high inflation and painful recession for countries that imported large amounts of oil? While such fears may be extreme, you can't discount the potential for an accelerated slowdown now.

After 5.7% growth last year, the consensus coming into 2022 was for a moderation to 4%. Tracking models are moving that closer to 3% currently amidst the challenges to growth from both more aggressive monetary policy tightening as well as a war in Ukraine and the heightened geopolitical tensions (and sanctions) that come with it. The expectation for even slower growth seems likely as we move through the balance of 2022. Those estimates may be a lot closer to 2% in short order.

A significant decline in inflation, on the other hand, seems unlikely. In a tight labor market, wage gains to date still aren't keeping up with the overall level of inflation. So, while we may not be experiencing stagflation the way it was in the Seventies, it could feel like something that we haven't had in a long time—a stark contrast to the pre-pandemic "everyday low prices" retail environment in which we could point, click, and buy everything online without delay. Price gains are forcing consumers to reassess significant purchases, potentially altering consumption patterns that have made the U.S. consumer the primary engine of global growth for many decades.

The Weaponization of the Financial System

The business and financial world's response to the Ukraine war has been swift and dramatic. And the Russian economy is going to suffer immensely.

Longer term, however, there may be important ramifications for the status of the dollar in the global economy. Every other country, every other reserve manager must be grappling with the possibility that reserves they have in dollars can be weaponized against them if they're on the wrong side of a conflict and the West imposes sanctions. Imagine what this could mean for the U.S. dollar's role as the reserve currency over the long-term. Imagine the potential implications for the U.S. Treasury market, considering the amount of debt outstanding that will need to be consistently rolled over—never mind how much more is added to it over the years as trillion-dollar deficits have become the norm.

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In any case, there are not a lot of great alternatives to diversify away from the dollar currently, hence the considerably large portion of most reserves that are held in dollars. But it will be something people will be trying to figure out going forward. China has attempted, with little success, to de-dollarize as much of its international trade as counterparties and markets will allow; the financial isolation of Russia in response to its invasion of Ukraine will only further incentivize such efforts going forward.

Summary

Coming into the year, the primary focus was on the pivot of massive fiscal and monetary tailwinds into headwinds. The drawdown of fiscal stimulus was well known as various programs rolled off without any extension. The monetary policy pivot was still being thought of in the context of the post-financial crisis standards that emphasized a measured and gradual approach to tightening policy. By the end of the first quarter, markets were adapting to turbocharged monetary policy tightening whereby markets are preparing for up to 250 bps of tightening in addition to balance sheet reduction (also called "QT") as early as May. At the start of the year, QT was a 2023 concern at the earliest. Even Fed speakers have taken to referencing the 1994 tightening cycle as a historical analog for the current cycle. Starting in February of 1994, the Fed raised rates by 300 bps over 13 months, taking the target rate from 3% to 6%. That comparison was essentially unthinkable even three months ago.

Fed Chair Jerome Powell and the Federal Open Market Committee have said that robust labor market strength has reached an unhealthy level and that price stability must be restored. Clearly, the committee is willing to sacrifice growth for price stability at this point in the cycle, which is why we can get at an inversion with essentially no pushback from the policymakers. Suffice it to say, the war in Ukraine will likely fuel even higher inflation in certain sectors. The damage done to the Ukraine crops and their fertilizer production can't be undone in short order.

With these additional inflation pressures, it's hard to envision a scenario in which the Fed gets any window of opportunity to slow the pace of rate hikes this year, and therein lies major downside risk to global growth, especially with so much uncertainty regarding the sanctions on Russia and whether they could get lifted anytime soon. On the contrary, additional sanctions are still being contemplated, further complicating the growth and inflation outlook. Add to this the ongoing challenges to the global supply chain from a zero tolerance COVID policy in China, where major provinces get locked down to fight any uptick in COVID cases. While the outlook for 2022 was hardly all that clear back in December, the view forward has turned exceptionally foggy given the developments that transpired over the first quarter. Returns will likely remain challenged, and caution is probably the appropriate approach in the short term for risk takers.

INVESTMENT GRADE TAX-EXEMPT

From Cash Tsunami to Sell-off in One Year

In one of the most difficult periods in recent market history, municipal bonds underperformed a number of other fixed income categories in the first quarter of 2022 as demand plunged. The Bloomberg Municipal Bond Index was down 6.23% and the Bloomberg Municipal Bond High Yield Index was down 7.38%—the worst quarterly performance since the third quarter of 1981. Back then, the economy had officially entered a recession as high interest rates put pressure on sectors reliant on borrowing like manufacturing and construction. As the recession worsened, then-Federal Reserve chair Paul Volcker faced repeated calls from Congress to loosen monetary policy, but he maintained that failing to bring down long-run inflation expectations would result in "more serious economic circumstances over a much longer period of time."[1]

This time around, the Fed is arguably playing catch-up. The yield curve has inverted with short-term rates eclipsing longer-term rates as if an economic downturn is on the horizon. While not everyone expects an eventual recession, quality spreads in the municipal market were tight, Muni-Treasury ratios (a key measure of relative value) were low, and the municipal bond market saw approximately $22 billion of outflows, exacerbating liquidity issues as dealers were very limited in their buys for inventory.

Against a backdrop of rising inflation, higher rates, war in Ukraine, lingering pandemic, and supply chain issues, the difference between the yield on the municipal 30 year and the municipal two year, also known as the slope of the curve, went from 125 bps at the beginning of the year to 77 bps at the end of the first quarter. The yield on the two-year rose 152 bps; the five-year, 138 bps, the 10-year, 115 bps, the 20-year, 110 bps and the 30-year, 104 bps.

Just as striking was the ratio of AAA-rated municipals versus Treasuries. At the beginning of the year, a five-year AAA-rated municipal bond yielded about 44% of the equivalent five-year Treasury. By the end of the first quarter, the ratio was 81%, a tremendous shift. The ratio for the 10-year municipal started the year at 64%, but finished the quarter at 94%, while the ratio on the 30-year went from 74% to 104%.

[1]Federal Reserve, Monetary Policy Report 1982, p. 67.

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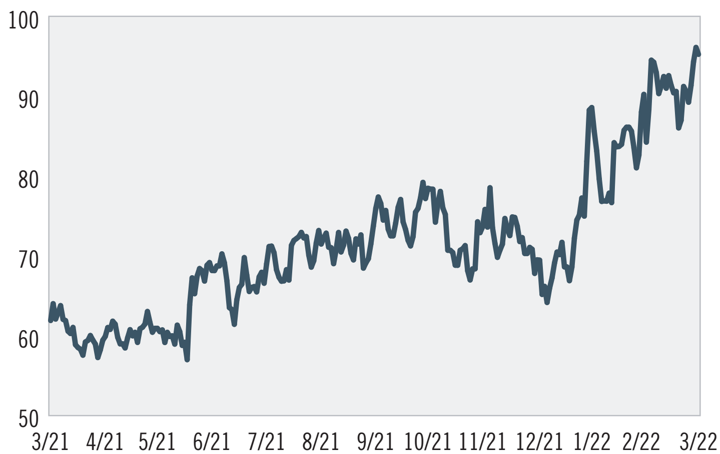
To put it differently, at this writing, the 30-year AAA municipal bond yield was 2.53% versus the 30-year Treasury bond at 2.45%.

Has the market over-reacted? We believe current ratios are attractive on a historic basis. Munis are cheaper than their five-year averages. For example, the 10-year ratio right now is at 94% and its five-year average is at 88%. Contrast that with the 30-year Muni-Treasury ratio, where the five-year average is about 96%, we are now at 104%. We do not believe these ratios will remain at current levels.

They might even get a little cheaper because of the outflows in the short-term, in our view.

MUNI-TREASURY RATIOS



As of 3/31/22. Source: Bloomberg

Sector View

Credit quality held steady during the first quarter, amid historic inflation levels and international crisis. Fueled by large infusions of federal relief aid, many state and local governments entered calendar year 2022 with record reserve levels. They will receive a second serving of American Rescue Plan Act relief funds this year. Additionally, during periods of inflation, operating revenues tend to rise as well, including sales and income taxes for most states and property taxes for most local governments. Over the longer term, rising labor costs and a generally higher cost of providing services could force some municipal issuers to make hard budgetary choices—not just state and local governments, but revenue bond issuers as well. Because of Russia's war on Ukraine, already high oil prices may spike upward even further. Rising fuel costs have already impacted the airlines. This is manifest in significant fare increases we are witnessing. We do not expect an immediate impact on the credit quality of airport bonds, as virtually all airlines report strong bookings through spring and summer, as customers endeavor to satisfy pent-up demands for travel after two years of pandemic-related obstacles. In fact, we expect leisure travel to continue to outpace business travel. International travel should continue to pick up, but not as briskly as domestic travel. The Russian invasion has placed increased focus on cybersecurity. If enemy cyberattacks were to occur, public entities would likely be just as much in the crosshairs as private ones. Milestones that occurred during the quarter include Puerto Rico's official emergence from bankruptcy and immediate testing of its bond market access. However, investment grade bond ratings are probably many years away for the island. On the last day of the quarter, Standard & Poor's upgraded New Jersey's general obligation bond rating to A- from BBB+, joining Moody's and Fitch with ratings in the A category.

Outlook

When will the municipal market stabilize? When will outflows stabilize and go flat or become positive again? From a seasonal standpoint, January and February are usually good months for the market because there are inflows from investors flush with cash available and typically lighter issuance. We saw a little of that in January, but then the market started to collapse in February and March because of selling pressure. We would expect modest improvement in late April and into May. Technicals usually turn positive in June, July, and August as more cash becomes available to investors than bonds typically issued in the municipal market.

Longer term, we believe municipals will still be an attractive asset class; the tax-exemption is valuable in all rate and tax environments to many different investors. The market was too rich last year and now has turned the other way, attracting crossover, non-traditional buyers, and insurance companies.

Should investors mitigate some of the interest rate risk by focusing on the intermediate part of the municipal yield curve? With the Fed looking to shrink its $6 trillion balance sheet and raise rates aggressively to curb inflation, 20-year maturities and shorter are probably the good part to consider in this period. As the Fed increases the pace of rate hikes, five-year maturities may become very attractive.

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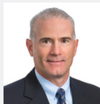
Authored by:

Investment Grade – Taxable



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