Higher Rates, Wider Spreads, Geopolitical Challenges, and Recurring Volatility Underscore Need for Continued Defensiveness

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> The Bloomberg Municipal Bond Index, a broad measure of the municipal market, returned -2.94% for the second quarter, bringing the year-to-date return to -8.98%. Year-to-date, the Bloomberg Municipal Bond Index outperformed the Bloomberg U.S. Aggregate Bond Index (-10.35%), Bloomberg Corporate Bond Index (-14.39%) and Bloomberg Treasury Index (-9.14%).

INVESTMENT GRADE-TAXABLE

Pain Management

The overriding theme of higher rates and wider spreads prevailed again in the second quarter, consistent with the market dynamics that drove returns in the first quarter. For the overall bond market, the Bloomberg Aggregate Bond Index (the Agg) suffered a -4.69% total return over the quarter. While that was better than the -5.93% total return in the first quarter, the year-to-date total return of -10.35% still leaves most participants shell-shocked. A small consolation comes from the fact that on June 14, the day interest rates peaked thus far in 2022, the Agg's total return was -12.65% – just brutal.

The movement in rates over the quarter was higher again, although the yield curve flattening witnessed in the first quarter ultimately subsided as longer term rates rose slightly more than shorter term rates. The shift became apparent in the early part of the quarter, as the first few weeks of April saw the yield curve (as represented by the yield spread between the two-year and 10-year Treasury benchmarks) steepen by over 40 bps, undoing half of the flattening seen over the first quarter. The steeper curve persisted for most of the quarter until the last few weeks of June, when the fear of an aggressive Federal Reserve (Fed) tightening cycle pushing the economy into a recession sooner rather than later reinvigorated the flatter curve trend. By June 30, the 2s/10s curve was back to about +6 bps, with fears of curve inversion and a pending recession re-entering the market narrative. The table below illustrates the Treasury yield shifts over the quarter:

FLATTER YIELD CURVE STIRS FEARS OF RECESSION

	3/31/22	6/30/22	Change
2 year	2.34	2.96	+0.62
5 year	2.46	3.04	+0.58
10 year	2.34	3.02	+0.68
30 year	2.45	3.19	+0.74

The Fed's Rapid/Belated Pivot

The Fed continued to be front and center for investors after an early April speech by Vice Chair Lael Brainard set the tone. Historically a more dovish Federal Open Market Committee voter – meaning that her bias is typically for looser or more accommodative monetary policy – Brainard emphasized the need for higher rates as well as "quantitative tightening" – where the Fed lets its balance sheet shrink. Recall, as recently as March the Fed was still purchasing Treasuries and mortgage-backed securities, which expanded its balance sheet (quantitative easing) and was a staple of the Fed's exceptionally loose policy in place since the COVID lockdown in March 2020. The Fed's need to pivot to tighter policy was happening fast and the guidance for a 50-bps rate hike at the May meeting was underway.

The early May FOMC meeting on May 4 saw the Fed deliver a 50-bps rate hike, and the consensus for this to be the new rate hike cadence strengthened with another higher-than-expected inflation report on May 11. All communication from the FOMC was consistent in emphasizing the need to return to price stability amidst year-over-year Consumer Price Index readings north of 8%. Surprisingly, amidst this shift to a more aggressive tightening cycle, the Treasury market took a pause and most rates managed to decline slightly in May. Developments in June made sure that the reprieve from higher rates was brief.

An early June inflation report that was again above the consensus expectation saw Treasury rates move higher. The timing of this inflation report was unique in that it came during the Fed's traditional blackout period where all FOMC members refrain from speaking publicly about monetary policy. A preliminary University of Michigan consumer sentiment report during this period showed longer term inflation expectations had risen by 0.3%. Both releases captured the FOMC's attention, so much so that on the Monday before the FOMC's Wednesday meeting a leak to *The Wall Street Journal* that the FOMC was considering a 75-bps rate hike instead of 50 bps recalibrated expectations in the blink of an eye. Sure enough, the FOMC delivered a 75-bps hike barely 48 hours later. In addition, the updated summary of economic projections (SEP), which the FOMC updates quarterly, included revised estimates for how high the target rate might go over this tightening cycle. The SEP includes the FOMC's infamous "dot chart" that depicts each member's estimate of the forthcoming path for the Fed target rate. The June update saw the median estimate for the year-end target rate rise to 3.375% versus the March estimate of 1.875%.

This updated median was above the FOMC's long run estimate for a neutral target rate of 2.5% – a setting that was seen as neither loose nor tight. That same median estimate for the target rate in 2023 moved incrementally higher – to 3.75% – before rate cuts return in 2024. It is important to note that the "dot chart" has proven to be a poor predictor of the actual path for the Fed's target rate. However, it is still notable that the FOMC was illustrating the need for policy to move well into restrictive territory before this cycle turns. Clearly the unique nature of this cycle and the challenge of multi-decade highs in inflation were driving the FOMC to be more aggressive, and in doing so it was effectively ratifying the tighter policy reflected in the Treasury market already.

Ironically, the rate levels established in the Treasury market on the eve of that June 15 FOMC meeting represent the year-to-date highs thus far in 2022. As quickly as the FOMC delivered the 75-bps hike, with confirmation that additional hikes of that magnitude might be necessary over the second half of the year, the market narrative shifted to the inevitable recession that would result from this more aggressive monetary policy tightening cycle. Activity over the balance of June saw Treasury rates decline, and not by an insignificant amount. As an example, the 10-year Treasury yield peaked on June 14 at 3.48% before ending the quarter at 3.02%.

Seventies Flashback: High Grade and High Yield Hit Hard

Higher rates and a more aggressive monetary policy tightening cycle produced a difficult backdrop for risk assets, and both the high grade and high yield spread sectors of the bond market suffered accordingly. Investment grade corporate credit, using the Bloomberg Corporate Index as a proxy, delivered a -7.26% total return, nearly matching the first quarter's -7.69% outcome. At -14.39% year-to-date, corporate bond investors are feeling like it is the 1970s all over again. Spreads for the corporate index were about 39 bps wider over the quarter, leading the sector to also deliver -224 bps of excess return. Intermediate corporate exposure outperformed in both total and excess return terms versus long corporate credit, while lower quality BBB exposure underperformed the single-A corporate credit sleeve. Those two quality splits make up the bulk of the investment grade corporate bond benchmark, accounting for nearly 92% of the total.

After outperforming the investment grade bond market in the first quarter, the high yield market dramatically underperformed over the second quarter. Using the Bloomberg High Yield Index as a proxy, the sub-investment grade market endured a -9.83% total return. Year-to-date its total return is -14.19%, barely 20 bps better than the investment grade credit market. Much wider spreads have made up for the high yield market's lower overall duration (interest rate risk). Spreads on the high yield index were about 244 bps wider over the quarter, which generated -792 bps of excess return for the second quarter. It was a difficult quarter to have any high yield exposure.

In the securitized markets, residential mortgage-backed securities (RMBS) were the big underperformer. The RMBS sector suffered -4.01% in total return terms and -98 bps of excess return as spreads continued to widen amidst the Fed's quantitative tightening and the potential, however distant, for the Fed to become a seller of RMBS. The Fed has expressed its desire to return to a Treasury-only balance sheet and given the current backdrop the cash flow "run-off" of RMBS will not meet the caps initially established by the FOMC for its balance sheet reduction plan. To prevent the RMBS exposure on the Fed's balance sheet from growing over time as the Treasury exposure runs off, at some point the Fed will be forced to transition to selling RMBS. While this is NOT a 2022 concern, it is probably something the market will have to contend with in 2023. Commercial mortgage-backed securities (CMBS) fared better with -2.85% in total return and -36 bps of excess return while asset-backed securities (ABS) generated -0.91% in total return

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and -11 bps of excess return. The RMBS segment represents the primary risk within a strategy benchmarked to the Agg, while the CMBS and ABS sectors are considerably smaller.

Record Tightening of Financial Conditions

As if these returns are not painful enough, the stock market offered even more pain for investors. The total return for the S&P 500® was -16.1% on the quarter, bringing the year-to-date tally to -20%. As the Fed often reminds, it is trying to tighten financial conditions, and that is best captured by an index that incorporates the performance of both the stock and bond markets. Take, for example, the Goldman Sachs Financial Conditions Index (GSFCI), which showed a record amount of tightening in the second quarter of approximately 187 bps. Looking at data back to 1982, that is the most tightening for the GSFCI over any one calendar quarter, even worse than the tightening seen over the first quarter of 2020 (COVID) or the fourth quarter of 2008 (global financial crisis). The GSFCI incorporates stocks, rates (both the 10-year Treasury yield as well as the Fed target rate), BBB credit spreads, and the trade-weighted dollar. All inputs contributed to the tighter conditions over the second quarter. The graph below offers some context for the GSFCI looking back over time. Having started at record lows – meaning exceptionally loose or accommodative financial conditions – the move higher (tighter) has been rapid, but overall financial conditions are still not as tight in absolute terms as experienced many times before.

GOLDMAN SACHS FINANCIAL CONDITIONS INDEX

As of 6/30/22. Source: Bloomberg

As emphasized in prior quarterly updates, an economic slowdown is underway as the primary tailwinds of fiscal and monetary support transition into headwinds in 2022. While the inception of the monetary policy tightening was late, the pace of the withdrawal is accelerating, and the fear of a cycle that goes too far is factoring into the market narrative. As the new calendar year unfolded GDP expectations were around 4%, well below 2021's robust 5.7% advance. The first quarter saw a surprise -1.6% contraction, driven largely by the net export sector. Real final domestic sales less inventories and net exports still grew by a 2.3% annualized rate in Q1. GDP tracking models for Q2 estimate an approximate 1% advance, so clearly GDP will not come close to that original 4% expectation. The Citi Economic Surprise Index illustrates the underperformance of incoming data relative to the expectations of economists:

CITI ECONOMIC SURPRISE INDEX

As of 6/30/22. Source: Bloomberg

Has a Recession Already Begun?

The positive surprises of March and April gave way to negative surprises in May and June. In tandem with the increased hawkishness from the FOMC and a tightening cycle that could see the target rate double from the current 1.75% rate to 3.5% by year end, fears of recession have grown in the last few months. So much so that the yield curve is once again moving into modest inversion as the doldrums of summer set in. Looking at market indicators for the target rate in 2023, the market is already pricing in rate cuts over the second half of 2023, anticipating that the Fed will need to reverse course quickly. The market's sensitivity to such a policy error from the Fed is palpable on some days, with some going so far to question whether a recession has already begun. Inflection points in the economy are incredibly difficult to identify in real time under normal circumstances. Coming off the COVID lockdown and all the economic challenges that entailed – bottlenecks, supply chain breakdowns, chip shortages, worker shortages, etc. – accurately assessing the prospects for recession for this cycle becomes that much more difficult, if not impossible.

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Outlook: Continued Volatility Warrants More Defensiveness

The Fed has proclaimed inflation as enemy number one, with a return to price stability a critical prerequisite for long-term economic growth. Peak inflation may be at hand, then again, it may not. Recent history should offer pause to anyone making a high conviction call on future inflation outcomes. More important will be the level inflation settles at over the next 12 to 24 months as the policy tightening in motion takes hold and has an impact. While peak inflation may be close at hand, it is difficult to conclude that a glide path back to 2% inflation is as easily achievable as what is implied by some of the markets' forward inflation expectations. Such policy impacts come with long and variable lags, so the outcome will take time to observe and react to. The market's read on both a pending recession as well as an inflation battle won feels premature. The challenges to this unique economic backdrop warrant considerable humility on a go forward basis. The additional challenges that come with the geopolitical backdrop – war in the Ukraine, a global energy transition/crisis – to name just a few, only further complicates the investment landscape. While risk assets have certainly begun to price in a more challenged backdrop, a more defensive posture still seems warranted entering the second half of the year, as the volatility that has prevailed over the first half is unlikely to recede any time soon. A return to some form of Seventies-like stagflation driven by high energy prices remains possible given current economic trends and monetary headwinds.

INVESTMENT GRADE-TAX EXEMPT

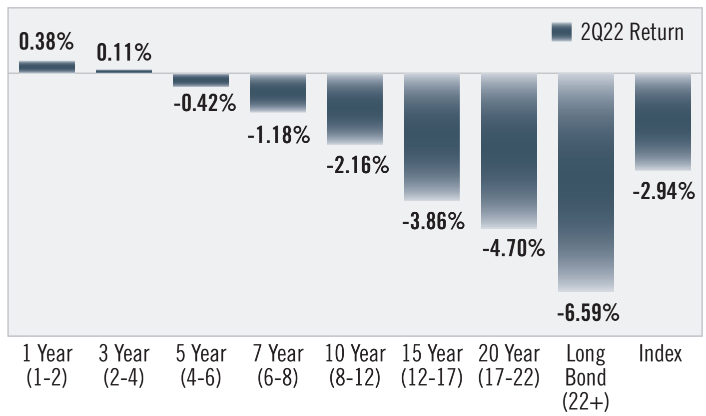
We Continue to Recommend High-Quality Paper for Both Defensiveness and Liquidity

Just as in the first quarter, yields in the second quarter moved higher across the curve. Volatility remained above average as the market vacillated between fears of extraordinary inflation and recession. The Bloomberg Municipal Bond Index, a broad measure of the municipal market, returned -2.94% for the second quarter, bringing the year-to-date return to -8.98%. Year-to-date, the Bloomberg Municipal Bond Index outperformed the Bloomberg U.S. Aggregate Bond Index (-10.35%), Bloomberg Corporate Bond Index (-14.39%) and Bloomberg Treasury Index (-9.14%).

During this period, the municipal market posted its first positive monthly return for the year (1.49% in May), although not enough to overcome the negative bias that gripped the market from the beginning of the quarter. Yields in the long end rose more than yields in the front of the curve in a bear steepener. The slope of the curve (2-year/30-year) increased from 77 bps to 123 bps as the 2-year increased by 19 bps, the 10-year by 54 bps, and the 30-year by 65 bps.

Given the changes in yield, the longer the duration the larger the negative return. The Bloomberg Municipal 1-year Index was the best performer, with a positive return of 0.38%, while the Bloomberg Long Bond Index was the worst at -6.59%. Credit spreads widened during the quarter – more the result of selling pressure than credit fundamentals – though future economic headwinds may exacerbate this trend. The Bloomberg AAA Index outperformed the Bloomberg Baa Index by 200 bps (-2.52% versus -4.52%).

BLOOMBERG MUNICIPAL BOND INDEX MATURITY DISTRIBUTION



As of 6/30/22. Source: Bloomberg

Negative fund flows, as reported by the Investment Company Institute (ICI), continued to pressure the market as more than $60 billion was redeemed from municipal mutual funds, bringing the year-to-date total to $88 billion.

The yield on the 10-year Muni was a good example of the volatility that characterized this quarter – the yield rose only 54 bps but ranged as much as 86 bps. The lowest yield for the quarter was 2.16% (April 4), the high was 3.02% (May 17), and the yield ended the quarter at 2.72%. A closer look at this movement highlights the speed with which both corrections and illiquidity happen in the market. The Municipal Market Data (MMD) 10-year AAA-rated Muni hit a 12-month high on May 17 at 3.02%, a level that appeared to be the catalyst investors needed. As the Treasury market benefited from a flight to quality bid and weaker economic numbers, so did the municipal market. The 10-year municipal yield dropped 59 bps between May 19 and June 1 to 2.43%. That rally however, quickly reversed over four days beginning June 8, sparked by fears of record-setting inflation. Ten-year yields moved higher by 46 bps.

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Municipal credit quality remained sound. Virtually all states ended Fiscal Year 2021 with surpluses, and budgetary reserves hit new record highs thanks to growing revenues and the final serving of federal relief under the American Rescue Plan Act. Local governments also boosted their reserves over the last two fiscal years, leaving them in a materially stronger position. The challenge will be to see if credits can remain strong in the face of inflation, slower growth, fewer employed, and rising pension costs.

Some states did not have as much of a loss of revenue as they initially feared. So, all of a sudden, fundamentals looked better, at least for the short-term. How long this lasts in the face of long-term fundamental issues is another matter. Take the heavily indebted State of Illinois, for example. If the nation goes into a recession, Illinois will still have very big budget issues to address.

Other states are trying to address budget issues with fiscal stimulus they have received from the federal government. Researching how well they manage their finances amid mounting economic uncertainty will be crucial, as some jurisdictions will no doubt face increasing pressure.

OUTLOOK

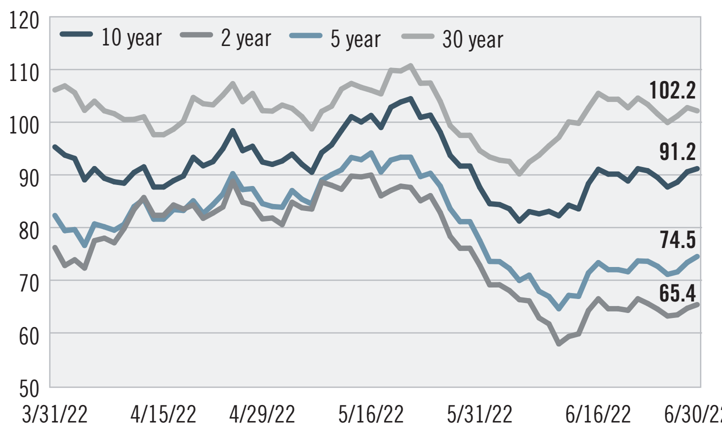
While optimistic for better performance in the second half of the year, we expect market volatility will likely continue until the market gains more insight and confidence in the Fed and the economy. A decline in issuance and an increase in demand during the near-term summer months will mitigate some spread widening. The overall cheapening of the market has created attractive reentry levels for high-quality sectors like state general obligation and water/sewer bonds. We continue to recommend high-quality paper for both defensiveness and liquidity.

What we saw in the first half was a little bit of panic and investors getting out at any cost. However, June, July, and August are seasonally very favorable times for the municipal market, which is to say, much more money is coming due to investors (in the form of coupon payments, maturities, and bonds being called) than what is being brought into the new issue market.

Some of those proceeds are coming back into the municipal market, especially in 10-years. Ratios have gone from the end of the month of being very cheap in that part of the curve to being fully valued, all of which illustrates what happens when there is much more demand than supply. Dealers do not have the inventory. The demand is there. They have to search for these bonds and pay up for the bonds, so they can sell it at even stronger levels to retail investors.

As a result, we think July and August are going to be on a relative basis very attractive for municipal bonds. September, October and maybe a little bit of November is usually a more adverse and seasonal period. The end of the year—mid-November to December—is usually favorable.

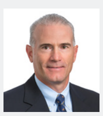
MUNICIPAL BOND/TREASURY RATIOS



As of 6/30/22. Source: Bloomberg

Authored by:

Investment Grade – Taxable



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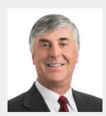
Investment Grade – Tax-Exempt



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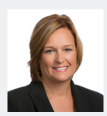

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