Rising Uncertainty as Economy Slows and Credit Tightens

- Between nagging inflation, failed regional banks, bailouts of uninsured depositors, two additional Federal Reserve (Fed) rate hikes, and a slowing economy, investment grade investors had quite a ride in the first quarter of 2023.
- In March alone, volatility and banking sector stress factored into the market's expectation for the path of the economy, monetary policy, and consequent asset class performance. Expectations for the final rate hike change daily, but odds for it to occur at the May meeting remain near 50% as Q2 gets underway.
- Stark contrasts marked the Municipal market in the first quarter of 2023. January started out strong with a larger than normal return of principal and income payments to municipal investors, setting up a demand driven rally as municipal issuance was less than average.
- February, however, brought quite a chill as investors worried that inflation was out of control and the Fed was going to continue raising rates—all of which offset the big rally that we saw in January. Come March, there was renewed concern that the Fed would raise rates further and the economy was still going stronger than anticipated. Ratios got rich.

RESULTS MASK VOLATILE Q1 PATH

The first quarter of 2023 had enough drama for a full year. While it delivered positive total returns again for the investment grade bond market, that outcome was still unlikely as late as the first week of March, where banking sector stress prompted a massive rally in the Treasury market that drove rates considerably lower.

Interest rates declined over the full quarter, as the wrenching March shift to lower rates overpowered the shift to higher rates (and a more extreme inverted yield curve) that the market endured through the end of February. Recall how rates moved over the quarter:

	12/30/22	3/31/23	Q123
2 Year	4.43	4.03	-0.40
5 Year	4.01	3.58	-0.43
10 Year	3.88	3.47	-0.41
30 Year	3.97	3.65	-0.32

Source: Bloomberg.

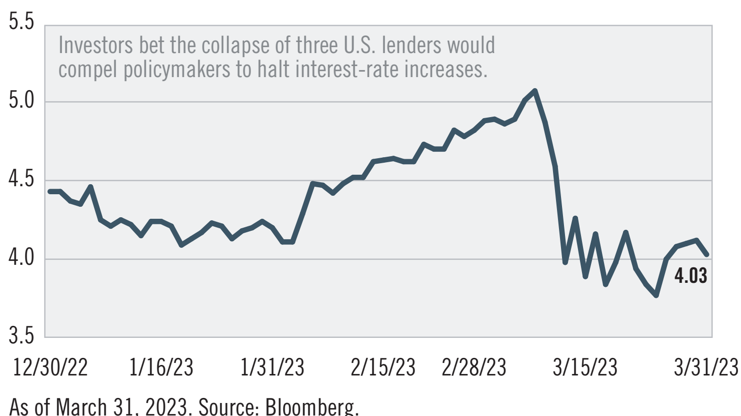
January saw rates decline modestly, with the curve flattening (into a deeper inversion). Fears of imminent recession persisted, as Institute for Supply Management survey data (manufacturing and services) slipped into contractionary territory while retail sales and industrial production data also came in below consensus expectations. Longer term Treasury yields declined in anticipation of an economic slowdown.

In contrast, February saw rates reverse and rise considerably, again with the curve flattening (and deeper inversion). This was largely the result of a return to stronger data releases, with the February 3 employment report showing another 500,000+ payroll gains that quickly revised the macro backdrop. Recession fears dissipated, and the market narrative pivoted to anticipating either a soft landing or no landing at all, implying that the economy's resilience would keep a recession at bay. Shortly thereafter, another higher-than-expected inflation report reinforced the expectation that the Fed would continue to hike and the terminal rate would probably exceed the 5.125% level the Federal Open Market Committee (FOMC) offered in their December "dot plot."

Entering March, the yield curve inversion peaked at -108 bps on March 8 and the 2-year Treasury closed at 5.07%. This coincided with Chair Jerome Powell's Capitol Hill testimony, where he intimated that the Fed's terminal value for the tightening cycle was likely higher than estimated in December (higher than 5.125%). Shortly thereafter, the market pivoted again. Only days after Powell's testimony, two regional banks collapsed, heightening fear that the historic tightening cycle underway since March 2022 had finally begun to break things. Silicon Valley Bank (SVB), and Signature Bank came under FDIC control, Silvergate Bank went into a voluntary liquidation, and all three highlighted the stress bank balance sheets were under after 450 bps of rate hikes (through end of February). Market participants immediately braced for additional banking sector damage. Regional banks in particular were under intense scrutiny while the large money center banks were seen in a marginally better light.

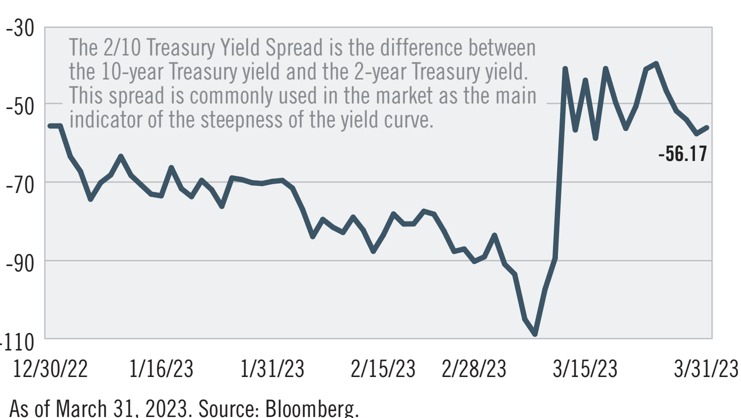
Exhibits 1 and 2 below show the volatility of the move in the two-year Treasury yield and its influence on the yield curve (2s/10s) over the course of Q1.

EXHIBIT 1. TWO-YEAR TREASURY YIELDS PLUNGED AS...



As of March 31, 2023. Source: Bloomberg.

EXHIBIT 2. ...THE 2S/10S YIELD CURVE GYRATED



As of March 31, 2023. Source: Bloomberg.

Total/Excess Return Summary

> Using Bloomberg index data, Q1 total returns were uniformly positive given the backdrop of lower Treasury rates:

- Aggregate: +2.96%%
- Investment Grade Corporate: +3.50%
- Residential Mortgage Backed Securities: +2.53%
- Commercial Mortgage Backed Securities: +1.81%
- Asset-Backed Securities: +1.86%

> Excess returns were modestly positive for the credit sectors but negative for the securitized sectors for the quarter.

- IG Corporate credit generated +20 bps of excess, as a solid outperformance in January managed to offset the underperformance seen in February and March.
  - Lower quality BBB credits marginally outperformed with +29 bps of excess against single A credits at +9 bps.
  - Long credit outperformed with +34 bps of excess against intermediate credit at +12 bps.
  - Given the stress in the banking sector in March, financials were the underperformer with -39 bps of negative excess return; utilities were also modestly negative at -8 bps while industrials outperformed with +58 bps of excess.
- RMBS saw a return to underperforming in Q1, with the banking stress in March generating another negative backdrop for the sector; retained bank portfolios now in the FDIC's care contain large allocations of Agency MBS, which will have to be sold.
  - Q1 saw the RMBS sector suffer -50 bps of negative excess return.
  - PCC (perfect current coupon) – a generic spread proxy for the "production" coupon – widened from +151 bps to +158 bps.
  - Early April saw the FDIC hire BlackRock as an advisor to liquidate the SVB and Signature Bank MBS portfolios, confirming the fears in March that asset sales are forthcoming in the sector.
- CMBS also underperformed in Q1, suffering immensely in March amidst the banking sector stress, as most small regional banks have considerable allocations to commercial real estate on their balance sheets.
  - Q1 saw the CMBS sector suffer -74 bps of negative excess return.
  - ABS excess returns were not material over Q1 at -5 bps.
- The "PLUS" sectors offered positive total returns as well, but mixed results in excess return terms, as high yield generated positive excess while emerging market debt underperformed, according to Bloomberg.
  - High Yield total return at +3.57% and excess return of +123 bps
  - EMD total return +2.15% and negative excess return of -84 bps

Broad Financial Conditions Eased Again

> Using Goldman Sachs's broad financial conditions index (GSFCI), Q1 saw another 46 bps of easing, despite another 50 bps of rate hikes.

- The GSFCI has now seen overall conditions ease over 100 bps over the past two quarters.

continued

> The GSFCI incorporates the Fed's target rate, the 10-year Treasury yield, BBB spreads, stock prices, and the trade weighted dollar.
  – Back-to-back 7.5% total returns for the S&P 500® Index over Q4/Q1 are driving the easing, with lower rates also helping.

Conviction Low with Narrative Swings

Expectations about the prevailing macro backdrop are changing rapidly. Entering 2023 an imminent recession was the consensus, as intimated by the inverted yield curve and very depressed leading economic indicators. By mid-quarter, as payroll and inflation data continued to outpace expectations, the narrative for the economy shifted to either a soft landing or no landing.

Long and variable lags typically associated with monetary policy were seemingly longer and more variable, and despite the exceptional pace of policy tightening seen over the last year, economic resilience persisted, thereby pushing out most recession forecasts.

Only weeks later, with the FDIC's takeover of SVB and Signature Bank, banking stress forced another pivot to fear of an imminent recession again given the tighter credit conditions that will likely result from greater scrutiny on the regional banking sector and an accelerated disintermediation of deposits out of banks into money market funds.

This latest episode saw the yield curve steepen considerably in March (technically a "dis-inversion"), which is the typical behavior of the curve right before a recession begins.

Amidst the volatility of March, the FOMC still raised the target rate by 25 bps (the second 25 bps rate hike of the quarter), highlighting their ability to manage the price stability mandate via the interest rate target tool and the financial stability issues highlighted by the recent bank failures through their macro prudential tools (in this latest instance, the Bank Term Funding Program, or BTFP).The latest hike brought the target rate range to 4.75%-5.00%. The March "dots" implied no change from the December estimate for the terminal rate at 5.125%—implying only one more rate hike.

The banking sector stress clearly changed the FOMC's calculus, given Powell's early-March statement that the terminal rate was likely going to be higher than the December estimate. Powell stated at the March press conference that the tighter credit conditions that would result from the regional banking stress were equivalent to at least one rate hike, and possibly more.

The Commercial Real Estate Conundrum

With post-pandemic office and retail vacancy rates still high, there is also concern about the $1.5 trillion in debt that is due for repayment before the end of 2025 for commercial properties, a lot of which is on regional bank balance sheets. This is essentially a slow-moving freight train that is going to be working its way through the system for the next few years.

In the case of direct loans that are on the balance sheet, banks have more flexibility. So, look for a number of loan extensions over the next few years. For loans that have been securitized, such as in a conduit deal, refinancing could be more difficult. Chances are high that rates going forward to refinance any commercial real estate risk will not remotely resemble the low rates it enjoyed when originally underwritten over the last five to 10 years. Yet another delayed bill to pay after a decade plus of financial repression by the Fed.

A lot of commercial space will be repurposed. However, that is exceptionally expensive and will require considerable investment on behalf of the sponsor or the owner of the property.

That workout dynamic, building by building, will be a problem for the economy for a while as borrowers, lenders, and bond holders jockey for advantage.

Looking Forward: Rising Uncertainty

Uncertainty is on the rise as the March volatility and banking sector stress factor into the market's expectation for the path of the economy, monetary policy, and consequent asset class performance. Expectations for the final rate hike change daily, but odds for it to occur at the May meeting remain near 50% as Q2 gets underway. Despite the Fed's guidance that rates need to remain very restrictive for some time—higher for longer—the market has returned to pricing in rate cuts in 2023. Since the initial shock of the early March bank failures, expectations have oscillated from two to four rate cuts by the end of the calendar year. The market has pivoted to pricing in rate cuts in 2023 many times over the past year.

Data dependency remains the primary overriding theme the Fed attaches to any forward-looking policy guidance—and they remain steadfast that the updated dots are only the current opinions of all FOMC members—not a formal forecast or explicit forward guidance.

Treasury rates have moved lower to start the new year and as a result benchmark yields across the investment grade market have followed suit:

continued

> Bloomberg Aggregate y-t-w ended Q1 at 4.40%—down from 4.68% at the end of 2022.

> While still attractive given the exceptionally low levels seen over the past decade, the Aggregate y-t-w is well off the 5.21% high seen last October (October 20).

Spread changes over the quarter for the primary investment grade sectors were somewhat subdued given the much higher uncertainty the market is facing entering Q2.

> Spreads were wider intra quarter amidst the introduction of the banking stress, but for the quarter overall investment grade corporate credit spreads only widened +8 bps (+138 bps vs +130 bps).

> PCC (perfect current coupon)—a generic spread proxy for the "production" RMBS coupon—widened from +151 bps to +158 bps.

> Even more impressive, the sub-investment grade credit sector saw spreads compress slightly over the quarter—tighter by 14 bps (+455 bps vs +469 bps)

The economic slowdown that has been underway is expected to persist in 2023.

> However, the resilience of the economy has actually seen the expectation for GDP in 2023 improve to about 1% from a 0.5% estimate at the end of 2022 (using the most recent Bloomberg economic survey).

> More critical to the balance of the year will be the tighter credit conditions that will emanate from the recent regional banking stress and any additional collateral damage that materializes from the Fed's aggressive tightening cycle.

Core Inflation Remains Critical

Inflation remains well above the Fed's desired 2% core rate.

> Core PCE deflator at 4.6% y-o-y through the end of February

> Core CPI at 5.5% y-o-y through the end of February

> Super-core, or core services ex shelter, remains a focus for the FOMC, particularly after an unwelcome m-o-m acceleration in the February data.

The downside growth fears from the banking stress are perceived as highly deflationary by those anticipating imminent recession.

Expectations vary regarding the degree of improvement for core inflation in 2023. Should the core PCE deflator run the balance of the year at half the monthly rate experienced in 2022, the y-o-y rate would decline to 2.7% by the end of 2023. 2022 saw core PCE inflation run at an average 0.38% m-o-m, or 4.53% annualized rate. For context, over the three-year period leading up to the pandemic (2017-2019) the core PCE deflator average was ~ 15 bps m-o-m, or 1.79% annualized. Will the Fed be content with a 2.7% core inflation rate? Close enough to 2% to declare victory? Thankfully, that is a call for another day…

INVESTMENT GRADE-TAX EXEMPT

Strong Demand, Thin Market, Rich Ratios

Stark contrasts marked the Municipal market in the first quarter of 2023. January started out strong with a larger than normal return of principal and income payments to municipal investors, setting up a demand driven rally as municipal issuance was less than average.

February, however, brought quite a chill as investors worried that inflation was out of control and the Fed was going to continue raising rates—all of which offset the big rally that we saw in January. Come March, there was renewed concern that the Fed would raise rates further and the economy was still going stronger than anticipated. Ratios got rich.

Little did the market expect the banking crisis that ensued. After Silicon Valley Bank and Signature Bank collapsed, a lot of money went into fixed income—Treasuries, as well as Treasuries and Muni's, which precipitated another good rally that caught quite a few people offhand.

Muni's were again in short supply despite expectations to the contrary. In fact, supply estimates dropped. At the beginning of the year, a lot of market watchers anticipated supply of about $400 billion for the year. Instead, we're on pace for $350 billion, and that might be optimistic. It seems like many municipalities still have a lot of cash from the federal bailouts. Some just may not need the money now. Instead, they may be waiting until the second half, assuming the Fed will be done raising rates, in which case there would be less volatility in the market. In any case, the lack of supply and stronger demand from retail has pushed performance. By the end of March, Municipals looked rich compared to Treasuries, especially of one to ten years duration.

Between strong retail demand and lack of supply, volatility increased, and liquidity issues continued throughout the quarter. If it was a bearish market environment, the bid side was very weak. Dealers just do not buy a lot of bonds for inventory anymore. In a bearish market like we saw in February, bid and offer spreads were pretty wide. In the bullish market we saw after the banking crisis unfolded, people wanted to buy bonds and there were not enough bonds to buy. Suddenly, the bid side was very aggressive, but the offer side was even more aggressive.

continued

HISTORICAL RATIOS (%)

As of December 31, 2022. Source: Bloomberg.

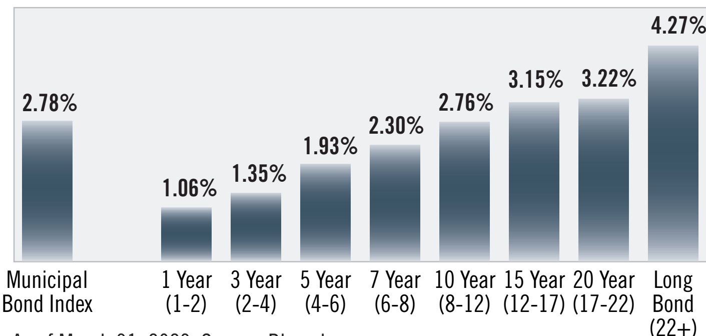
Performance

The Bloomberg Municipal Bond Index, a broad measure of the municipal market, returned 2.78% for the first quarter, underperforming the Bloomberg Aggregate Bond Index (+2.96%), the Bloomberg Corporate Index (+3.50%) and the Bloomberg Treasury Index (+3.01%) for the year.

Yields dropped during the quarter. The 2-year AAA Muni went down 22 bps. The 5-year went down 30 bps. The 10-year was down 36 basis points; the 20-year, 27 basis points, and the long end, about 28 bps.

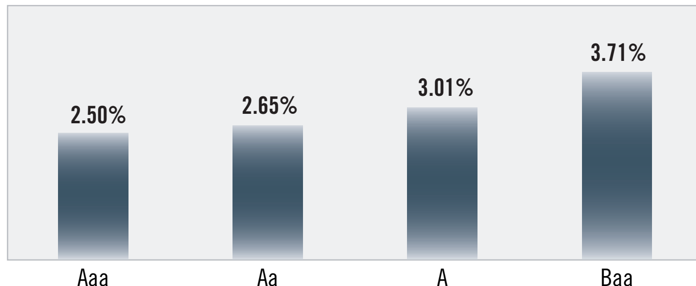
In terms of returns, the longer end outperformed. In general, the longer you were, the more return you would get, especially with the lack of supply and some investors feeling rates and spreads perhaps had peaked or were close to peaking. Some investors were looking at lower quality paper because with the lack of supply, if demand picks up, there won't be enough lesser quality paper in the market. So, for the quarter, AAA returned 2.50%; AA, 2.65%;. Single-A, 3.01%, and Baa, 3.71%.

BLOOMBERG MUNICIPAL INDEX RETURNS BY MATURITY DISTRIBUTION



As of March 31, 2023. Source: Bloomberg.

BLOOMBERG MUNICIPAL INDEX RETURNS BY RATING DISTRIBUTION



As of March 31, 2023. Source: Bloomberg.

Sector Comments

We are definitely more concerned about healthcare given their budgetary pressures. They have wage pressure. They have product pressure. They have less revenue coming in. As a result, we make a big distinction between individual site hospitals versus the big systems that have grown throughout the country. Bigger hospitals should do all right. To be sure, 2022 was a difficult year; 2023 might also be difficult, perhaps not as much as 2022. But they might get more things under control in 2024.

Bigger systems' credit ratings should be stable. Single sites are very much in jeopardy and are probably looking for somebody to buy them and be part of the bigger system. So, in healthcare, we are definitely very particular on what we buy.

In education, the bigger-is-better dynamic should also apply. Smaller schools are under incredible pressure, especially ones with declining enrollments. Costs are going up. Tuition is not going up and in some cases, it is going down. But larger institutions like Penn State, Harvard, Yale and Princeton are all solid.

Unfunded Pension Liabilities Remain a Concern

As part of our rigorous research process, we continue to monitor state and municipal pension funds where funding has gone down in the current market environment. But the municipal market as a whole looks at this as a long-term liability, not a short-term effect on the credits. Obviously, if the stock market got hit hard here, it would be more of a factor. If the market stays here or rallies, then it is not going to be too much of an issue. We will look at management. We will look at how people are dealing with deficits. But there has been a lot of capable management and upgrades. Even New Jersey recently got upgraded. Illinois got upgraded. All the federal money municipalities received in the last two years contributed to their stable credit outlook.

continued

OUTLOOK

We expect liquidity will be a factor for the remainder of this year. April is typically a neutral month. May is slightly more on the positive side. June, July, and August tend to be very bullish for municipals because a lot of money comes due to retail investors as a result of coupon payments, maturities, and bonds being called. If there is still a lack of supply then, municipals could benefit even more.

In any case, some of the Muni-Treasury ratios do not make sense. For instance, the ratio on the 5-year is currently 62%—quite a difference from the five-year average of 78%. Even if you are in the top tax bracket, you can buy a 5-year Treasury 5-year and pretty much break even and obviously have a lot more liquidity. The 10-year ratio is even richer at 64% as opposed to the five-year average of 87%.

For their part, retail investors do not seem to be fazed by rich ratios. They still want to buy tax-exempt bonds. They do not want to pay taxes on fixed income investments, and that dynamic should continue through the summer.

Against that backdrop, we are pretty much fully invested because we do not want to be short going into the summer. All eyes will be on the Fed. After the latest inflation numbers, many market watchers are anticipating one more 25 basis point hike. Some are even expecting cuts later this year. At this juncture, we have our doubts about such a scenario.

Still, the municipal asset class is very strong. It is very much in demand. The panic of last year is forgotten. Now it is all a matter of when investors feel like Treasuries have stabilized. Once that happens, flows into municipals should be quite positive.

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The indexes are unmanaged, their returns do not reflect any fees,expenses, or sales charges, and are not available for direct investment.

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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