Continued Resilience Versus Stubborn Inflation and Hawkish Fed

INVESTMENT GRADE MARKET REVIEW: NEGATIVE TOTAL RETURNS IN Q2; STILL POSITIVE Y-T-D

Following two consecutive quarters of positive total returns, the investment grade bond market reverted to negative total returns as higher Treasury rates more than offset the income component and any additional excess return from tighter spreads. That being said, the robust Q1 returns leaves the mid-year total returns positive across the board as shown below.

Treasury rates rose over the quarter, with short and intermediate Treasuries (2yr/3yr/5yr) bearing the brunt of the move higher, while longer term rates (10yr/30yr) rose considerably less than those shorter tenors, leaving the yield curve flatter (more inverted) by the end of Q2.

Treasury rates moved as follows over the quarter:

	3/31/23	6/30/23	Q223
2 Year	4.03	4.90	+0.87
5 Year	3.58	4.16	+0.58
10 Year	3.47	3.84	+0.37
30 Year	3.65	3.86	+0.21

Source: Bloomberg.

April saw financial markets return to some semblance of calm following the volatility seen in March amidst the brief regional bank crisis. Rates were only modestly lower for the month and most spread sectors generated modestly positive excess returns. Cross currents from rising expectations of another rate hike in early May as well as growing concerns about the debt ceiling deadline kept risk taking somewhat in check. The T-bill market bore the brunt of the volatility from the debt ceiling drama as investors shifted about based on ever changing estimates for the "X-date" that would fully constrain Treasury and incite a technical default. Yield spreads across the short end of the T-bill curve experienced some massive swings as a result.

May started with a reminder that the regional banking crisis was still lingering with the May 1st failure of First Republic Bank. This was the third Federal Deposit Insurance Corporation (FDIC) bank to fail in 2023 and JP Morgan acquired most of its assets. Shortly thereafter the Federal Reserve (Fed) delivered another rate hike, bringing the cumulative tightening cycle to +500 bps. Despite this ominous start, the balance of the month saw continued evidence of fundamental economic resilience with a 53-year low in the unemployment rate, continued payroll gains, along with persistent core inflation prints. Early month thoughts that the terminal rate had been reached diminished over the balance of May such that expectations for additional rate hikes re-entered the market narrative, and Treasury rates moved higher, led by the front end of the yield curve. Heightened concern over the debt ceiling deadline also cast a pall over the market for most of May, and the T-bill market volatility persisted – certain T-bills even traded above 7% ever so briefly before the dust settled. A deal was eventually struck on May 27th that ended fears of a larger political stalemate that threatened a potential U.S. default and considerable market tumult.

June saw the continuation of higher rates that began in May, despite the Fed pausing for the first time in this tightening cycle. The Fed's June 14th pause was hawkish in that despite the decision to not hike the target rate, their updated "dot chart" implied two additional rate hikes to bring the terminal rate range to 5.5%-5.75% at some point in 2023. The higher terminal rate assumption Chair Powell signaled back on March 8th – subsequently deferred by the regional banking crisis – returned on June 14th. Progress on core inflation – or even the super-core the Federal Open Market Committee has highlighted – remains stubbornly slow. Continued economic resilience, particularly over the second half of the month, kept the Treasury market on its heels, and the front end of the yield curve bore the brunt of the move to higher rates.

TOTAL/EXCESS RETURN SUMMARY

Using Bloomberg Index data, Q2 total returns were uniformly negative given the backdrop of higher Treasury rates:

	Q2	Y-T-D
Aggregate	-0.84%	+2.09%
IG Corporate	-0.29%	+3.21%
Residential Mortgage-backed Securities (RMBS)	-0.64%	+1.87%
Commercial Mortgage-backed Securities (CMBS)	-0.60%	+1.20%
Asset-backed Securities (ABS)	-0.12%	+1.74%

Excess returns, on the other hand, were positive for the investment grade spread sectors in Q2. IG Corporate credit generated +131 basis points (bps) of excess, with the bulk of the gains coming in June.

> Lower quality BBB credits modestly outperformed with +149 bps of excess against single-A credits at +117 bps.

> Long credit outperformed with +170 bps of excess against intermediate credit at +110 bps.

> Financials rebounded after their Q1 underperformance to gain +159 bps of excess return, while industrials generated +125 bps of excess and utilities followed with a more modest +63 bps of excess.

RMBS rebounded in Q2 to generate +76 bps of excess return after underperforming in Q1.

> Relatively orderly sales of mortgage-backed securities portfolios by the FDIC allowed for a more constructive view of the sector.

> PCC (perfect current coupon) – a generic spread proxy for the "production" coupon – still widened from +158 bps to +179 bps.

CMBS also rebounded in Q2 after the sector underperformed in Q1; the sector gained +81 bps of excess return, despite continued stress in various sectors of commercial real estate. Q1 saw the CMBS sector suffer -74 bps of negative excess return.

ABS excess returns were also positive at +58 bps after a muted Q1 performance.

Meantime, "Plus" sectors offered positive total and excess returns in Q2.

> High Yield saw a total return of +1.75% and excess return of +279 bps.

> Lower quality outperformed as CCCs easily beat the higher quality Ba/B sleeve.

> EMD total return +1.12% and excess return of +260 bps.

BROAD FINANCIAL CONDITIONS EASED AGAIN

Despite the ongoing tightening cycle, the Goldman Sachs broad financial conditions index (GSFCI) eased again for the third consecutive quarter. (The GSFCI incorporates the Fed's target rate, the 10-year Treasury yield, BBB spreads, stock prices, and the trade weighted dollar.) Relative to the tightest level seen last fall (Oct 14th), the GSFCI has now seen overall financial conditions ease by 140 bps.

Another solid quarterly advance for the stock market (+8.7% total return for the S&P 500® Index) and modestly tighter credit spreads helped offset the move higher in the Fed's target rate and higher Treasury rates.

RECESSION DEFERRED

Entering 2023 an imminent recession was the consensus, as intimated by the inverted yield curve and very depressed leading economic indicators. Multiple narrative shifts over the course of the first half of the year have evolved with the economy; soft, hard, and no landing have all taken a turn as the market's updated consensus. Long and variable lags associated with the anticipated effects of tighter monetary policy continue to frustrate economists, strategists, and investors alike.

The resilience of the economy over the first half of the year has persisted and easily outperformed growth expectations. Coming into the new year the median GDP forecast from Bloomberg's monthly economic survey for the first half of 2023 anticipated no growth in Q1 and a contraction, -0.70% GDP in Q2. The economy experienced 2% annualized growth in Q1 and Q2 is currently expected to come in at a similar pace based on several different tracking models (GDPNow, Goldman Sachs, JPMorgan). The expectation for the eventual slowdown has been deferred, with Q3 now expected to be flat and Q4 to fall into contraction, per the most recent Bloomberg economic survey.

The magnitude of support from both fiscal and monetary policy into and out of the pandemic has offered even more support than most analysts originally estimated. The excess savings pool that came from multiple rounds of massive fiscal stimulus continues to backstop consumption, particularly for the lower income cohorts most negatively impacted by the higher inflation experienced this cycle. The extended period of exceptionally easy monetary policy offered another long window for debt, at both the corporate and consumer level, to be refinanced at exceptionally low rates, leaving the economy in a much better position to handle higher interest rates.

MID-YEAR REASSESSMENT:

Higher for Longer Rates and Tighter Credit Conditions Ahead

> Q2 did see one additional rate hike in May, bringing the target rate range to 5.00%-5.25%

> The FOMC's "hawkish" pause in June established a higher terminal rate target for this tightening cycle, essentially returning to where the FOMC was gravitating to in early March before the regional banking crisis. The FOMC's updated "dot chart" implied two more rate hikes this year, although the market has refrained from fully pricing in both hikes at this point.

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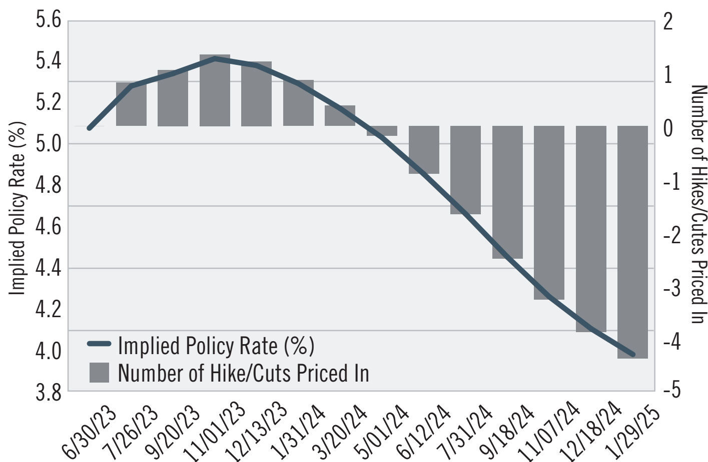
> The Fed's guidance that rates need to remain very restrictive for some time – higher for longer – has finally resonated with the market. Several times over the past year the market consistently priced for a relatively quick pivot by the Fed that would anticipate an easing of policy before the end of 2023. Entering Q3, market pricing for the first rate cut is not until June 2024, as seen on Exhibit 1 below.

IMPLIED OVERNIGHT RATE AND NUMBER OF HIKES/CUTS



As of June 30, 2023. Source: Bloomberg.

> No different from last quarter end, data dependency remains the primary overriding theme the Fed attaches to any forward-looking policy guidance – and they remind the market frequently that the updated dots are only the current opinions of all FOMC members – not a formal forecast or explicit forward guidance.

> Treasury rates moved lower to start the new year, but reversed that move and then some over Q2; the front end of the yield curve has endured the most stress given the constant recalibration of the tightening cycle and as a result the yield curve – using the 2s/10s curve as a proxy – has returned to its most inverted level since the early 1980s.

> The Bloomberg Aggregate y-t-w ended Q2 at 4.81% – up from 4.40% at the end of Q1 but still below the cycle high of 5.21% from last October.

CORPORATE CREDIT WELL SUPPORTED

Corporate credit remains well supported and spreads for both the investment grade and high yield sectors tightened in Q2 given the economic resilience and attractive all-in yields. The investment grade corporate sector saw spreads tighten from +138 bps to +123 bps. The high yield (sub-investment grade) sector saw spreads tighten from +455 bps to +390 bps.

Investment grade credit, as measured by the Bloomberg U.S. Corporate Index, has maintained an all-in yield in the 5% to 5.5% range for most of 2023, with the ebb and flow up or down driven primarily by shifts in the U.S Treasury market and only modestly by spread changes for the sector.

Depending on an investor's overall tolerance for duration risk and credit risk, some blend of this credit sector can offer a 4.5% to 6% yield. Compare that to the better part of the recovery after the global financial crisis which saw this corporate credit index offer on average around 3.4%.

Should an investor have any appetite for some high yield exposure, that all-in yield gets even better. This backdrop has attracted a fair amount of capital into the sector that is comfortable with that level of all-in yield and not put off by the short-term gyrations in total return driven by Treasury rates or modest spread changes.

Some of this capital allocation is coming from atypical buyers of credit that will likely reallocate into a more risky investment after the impact of the Fed's tightening cycle is felt more broadly across the economy and risk markets.

The emphasis on the tightening cycle has been all consuming, given the speed and magnitude of the FOMC's actions over the last 15 months. While obviously closer to the terminal rate, the conclusion of the tightening cycle then leads to an inevitable credit cycle.

Recession or not, economic growth most likely will slow because of the tighter monetary conditions set by the FOMC and most other central banks globally – Japan being the primary holdout to date. Most sectors and companies will have to navigate this more challenged macroeconomic backdrop with more leverage, higher refinancing costs, and an inflation backdrop that could prevent central banks from shifting to an easing stance as quickly as markets have become accustomed to since the global financial crisis.

While the market has moved on from the regional banking crisis that flared in March, the regulatory review and response have just begun. This should lead to even tighter credit conditions moving forward as a broader section of the banking system will now be subject to increased capital requirements that will further tighten lending conditions.

CORE INFLATION NOT SLOWING ENOUGH

Inflation remains well above the Fed's desired 2% price stability target.

> The Core PCE deflator is now at 4.6% y-o-y through the end of May, where it has been for the last six months.

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> The monthly Core PCE deflator has averaged 0.38% thus far in 2023, the same average seen for all of 2022, and slightly lower than the 0.41% average seen in 2021.

> Super-core, or core services ex shelter, remains a focus for the FOMC, and has only seen modest improvement over the last few months.

> Both these core measures remain at a pace well above what is consistent with the Fed's price stability mandate.

As a result, the FOMC's forecast for the Core PCE deflator has been revised higher over the past year, and the price stability objective is not attained until 2025.

> For the end of 2023, the FOMC forecast is 3.9%, up from 2.9% one year ago.

> For the end of 2024, the FOMC forecast is 2.8%, up from 2.3% one year ago.

QUANTITATIVE TIGHTENING UPDATE

The Fed's quantitative tightening (QT), or balance sheet reduction, continues to run in the background although it rarely gets a question at the Fed's press conferences after each FOMC meeting. More focus of late has been on the ramping up of borrowing by the Treasury through the T-Bill market. Because of the debt ceiling constraint, the Treasury's general account (TGA) was run down to a very low balance. Once the debt ceiling was lifted, the Treasury began replenishing the TGA by increasing borrowing via the T-bill market. The big question is whether we wind up with a downward move in bank reserves as a result of this borrowing ramp up and ongoing QT.

One saving grace is that the monthly pace of QT is not really hitting its cap. That's because the Fed's mortgage portfolio is not generating the cash flow/paydowns to meet the $35 billion monthly cap. The Fed's RMBS portfolio is generating more like $19 or $20 billion in monthly pay downs. That is helping at the margin.

The other dynamic is that a good portion of ramped up T-Bill borrowing is really being funded by lower takedowns by money market funds at the Fed's reverse repo (RRP) facility. That is basically where money market funds invest directly with the Fed. An important distinction to note is that the RRP balance is already outside the traditional banking system, so to the extent the additional T-bill issuance is funded mostly out of funds currently invested in the RRP, then this Treasury borrowing ramp up should not create a potentially dangerous drawdown in bank reserves.

It will be important to monitor the evolution of these cross currents over the second half of the year. Should the combination of QT and additional Treasury borrowing drive reserves low enough, the short-term money market could become stressed and force the Fed to abandon QT or even return to balance sheet expansion. The exact level of reserves that triggers this stress is unknown and only apparent after the fact. In 2019 this very issue forced the Fed to return prematurely to balance sheet expansion, something that the Fed would be reticent to pivot to given the current inflationary backdrop.

INVESTMENT GRADE TAX-EXEMPT

Hawkish Fed Aches

During the second quarter market technicals really were not enough to lift munis to positive territory, but they did avoid a large-scale sell off as the rest of the fixed income market realized that the Fed is probably going to be raising rates two more times this year rather than the two cuts it had been anticipating. Munis proved once again that they could continue to outperform in weakness.

However, the market is bumping up against some rich valuations that are challenging technically positive seasonality. The broad market index as represented by the Bloomberg Municipal Bond Index returned -0.10% for the quarter, bringing the year-to-date return to 2.67%. Total return for the quarter was mixed across the curve with the long end performing the best, returning 0.67%, while the 7-year and 5-year returns were the weakest at -0.78% and -0.72%, respectively.

Long duration and a lower credit profile of the Bloomberg Municipal Revenue Bond Index helped it outperform the Bloomberg Municipal GO Bond Index by 0.04% versus a -0.41% for the quarter. The best performing subsectors of the revenue index included industrial development revenue/pollution control revenue, and tobacco, and hospitals. The worst performing subsectors were housing, education, and water/sewer.

Outperforming Other Fixed Income Markets

Relative to other fixed income markets, municipals outperformed the Bloomberg US Corporate Index (-0.29%), Bloomberg US Aggregate Gov/Credit Index (-0.93%), and the Bloomberg US Treasury Index (-1.38%). Ratios were slightly higher from the previous quarter. The 2-year increased by 1.1 percentage points to 60.1%, the 5-year by two percentage points to 63.4, the 10-year by 2.1 percentage points to 67, and the 30-year increased by 1.1 percentage points to 90.6.

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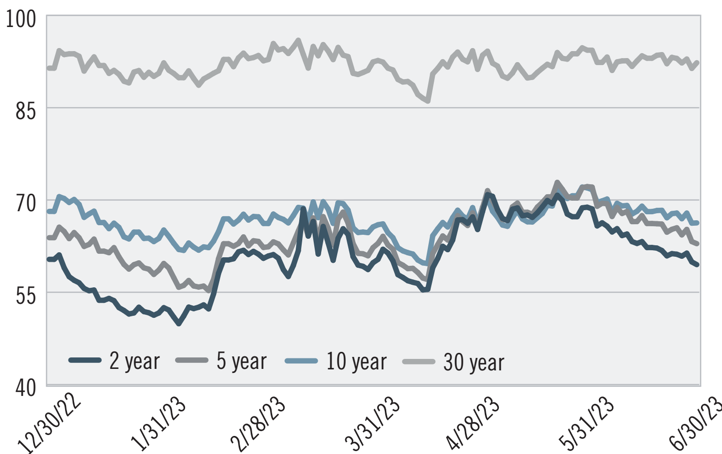
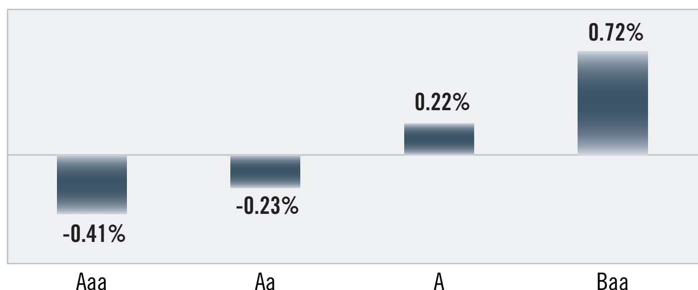
In addition, despite being slightly more attractive on the quarter, ratios are still below their 1- and 5-year averages. Yields were higher by the end of the quarter, rising more in the short end, resulting in a flatter yield curve. The slope of the 2s to 30s tax-exempt curve flattened 56 bps from 92. The 2-year increased by 55 bps and the 5-year by 40 bps. Increases moderated the further you went out the curve. The 10-year increased by 29 bps, and the 30-year by only 19 bps.

HISTORICAL RATIOS (%)



As of June 30, 2023. Source: Bloomberg.

BLOOMBERG MUNICIPAL INDEX RETURNS BY RATING DISTRIBUTION



As of June 30, 2023. Source: Bloomberg.

Inverted Curve Persists

The municipal 2s-to-10s curve inversion persists with no indication of a reversal. It reached a wide of -53 bps in mid-May on the news that some Fed officials supported more rate hikes, but dropped to -37 bps by quarter end.

Some of the most encouraging news of the quarter was the liquidation of the Federal Deposit Insurance Corporation's $7 billion municipal portfolio previously owned by Silicon Valley Bank. In early May the market was concerned that the portfolio would be difficult to place given its out of favor structure – mostly low coupons, long matured securities – and would create pressure on the municipal market. Additionally, it was uncertain as to the extent that there would be other bank portfolios that would also need to be liquidated.

By early June all of those fears were unfounded. The liquidation of the portfolio was orderly, and in the end nearly 85% of the list was bought by customers to be held in their portfolios. And only 15% was stocked by dealers for potential resale.

Some Encouraging Technicals

More encouraging news on the technical front includes the continued lowering of annual issuance projections. We began 2023 with projections in the $425 billion to $500 billion range, most of which now have been revised lower to the $325 billion to $400 billion range.

We ended the half-year with $172 billion in issuance, nearly 21% less than this time last year. As we go into the second half of 2023, supply should remain a constraint. It is unlikely that issuance will dramatically pick up at this point, as there are no catalysts on the horizon that would result in higher issuance. Strong economic growth has been a previous driver at issuance, while higher rates challenge both the funding and new money issuance.

Limited supply and manageable fund flows have been moderators to tax-exempt market so far this year. There has been no pressure to buy or sell based on flows, and certainly no pressure from excess supply. Investors should return to the municipal market once they are confident in the direction of rates. In the meantime, flows have been restrained. Year-to-date average weekly flows are negative $274 million versus negative $1.5 billion last year.

Elevated Trading Volume

During June, while it was still a net outflow month, the tax-exempt market did see two weeks of inflows and two weeks of outflows. And year to date, mutual funds have posted $8 billion in outflows according to Refinitiv. What is interesting to note is that more than $1 billion has come into municipal ETFs so far this year. This product flow into ETFs is helping to explain in part the elevated trading volume we have seen this year, where along with those additional flows, the market volatility is causing investors to trade more to manage interest rate and duration risks in their portfolios.

Spreads Continue to Tighten

According to the Securities Industry and Financial Markets Association, the average daily volume of municipal trades year to date is $12.9 billion, more than 5% higher than this

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time last year. As reflected in returns mentioned earlier, credit spreads continue to tighten as represented by the yield differential between the Baa Municipal index and the AAA Municipal index, which stood at 127 bps at the end of June versus 146 bps at the end of March.

The spread between high yield and high grade continues to tighten as well with the differential being at 220 bps down from 243 bps at the end of March. The credit profile of municipal market issuers has been stable in 2023, as a resilient consumer and residual COVID relief funds, particularly in the tax-backed sectors, have helped steady balance sheets. However, a recession potentially looms on the horizon as does moderating consumer spending, and both would impact budgets across the board. Most state and local governments should be well prepared to manage through the tension.

States' Rainy-Day Funds Have More Than Doubled While…

Most states completed their 2023 fiscal year on June 30th. According to the National Association of State Budget Officers, state rainy day fund balances more than doubled over the last two fiscal years with 39 states expecting fiscal 2023 audits to show further increases. One noticeable exception has been California, which struggled to close the gap in its fiscal 2024 budget without drawing on reserves because of disappointing revenue performance in fiscal 2023.

…Cities Cope with Lower Commercial Property Values and Mass Transit Pressure

For local governments, lingering work from home arrangements have exerted downward pressure on commercial property values, which might have negative implications for some cities going forward. For a similar reason, the mass transit sector remains under duress. In June we saw Standard & Poor's downgrade its rating on the Bay Area Rapid Transit, California's BART system GO Bonds to A+ from AA- due to anemic ridership and large forecast general fund deficits.

New York City's Metropolitan Transportation Authority, which is also under financial pressure, recently received final approval to implement congestion pricing on motor vehicle traffic entering the busiest parts of Manhattan. A noticeable bright spot has been the airport sector. Moody's reports that roughly half of the airports it rates regained 2019 passenger levels in the first quarter of 2023, with airports serving tourist destinations demonstrating the strongest performance. Summer passenger traffic has been robust, although not without travel glitches, and advanced ticket bookings for the remainder of the season appear to be strong, which bodes well for the credit quality of this sector.

Healthcare and Colleges Also Under Pressure

Healthcare trends generally saw an erosion in credit quality over the first half of the year. Inflation has dramatically increased labor and supply costs while patient volumes have remained depressed. Many healthcare systems have deferred capital projects in an attempt to maintain higher levels of cash which has caused issuance in the sector to decline by 73% year-over-year.

Senior living, a sector we have had minimal exposure to, has been similarly affected. Demand since COVID remains down, and many seniors who would like to sell their homes to move into such facilities have seen higher interest rates hamper such efforts.

Meantime, as we previously reported, segments of higher education remain under credit pressure. According to J.P. Morgan, spring enrollment for 2023 at American colleges and universities was down 7% from 2019 levels. Small private colleges have been especially hard hit, contributing to numerous negative rating actions.

OUTLOOK

Year to date on a macro basis, municipal rating upgrades on the part of Moody's and S&P have continued to outnumber downgrades. Should rate volatility subside, the tax-exempt market should continue to do well, as supply is constrained, outflows have moderated, and the credit profile of the market is still largely on solid footing.

Yields across the curve are at decades high and provide an advantageous entry point. Furthermore, municipal bonds have long been a safe haven as they are largely uncorrelated to other asset classes.

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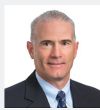
Authored by:

Investment Grade – Taxable



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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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