The Year of the Bond?

INVESTMENT GRADE TAXABLE

2023 was eagerly billed as the year of the bond after enduring the historically bad year that was 2022. The Bloomberg Aggregate Bond Index (Agg) suffered a -13% total return last year and given the consensus expectation for an economic slowdown and inevitable pivot from the Federal Reserve (Fed)'s current tightening cycle, the bond market was expected to deliver a more compelling positive total return in 2023. Given that the Agg started the year with a 4.68% yield, the anticipated Fed pivot would add capital appreciation to that income, such that even modestly lower yields could ultimately deliver a total return in excess of 7% this year. What could go wrong?

> Q1 delivered a nearly 3% total return for the Agg, as rates declined moderately amidst the fear of recession, which became an even higher probability after the regional bank crisis flared in March.

> Q2 offered no follow-through, as economic resilience and the fading effects of the banking crisis saw rates move higher once again. The Agg only suffered -0.84% as the sell-off in rates was a "bear flattener," where the front end of the yield curve underperformed while longer rates only rose by a modest amount.

> Q3 shattered all hopes of the early 2023 dreams for better total return from the Agg, as rates continued to move higher, but this time selling off in a steepening fashion, where the long end of the yield curve underperformed, driving long-term Treasury rates to levels not seen since before the global financial crisis (GFC).

> The underperformance of the long end—where greater interest rate sensitivity resides—led to very disappointing total returns across the investment grade bond market.

> Treasury rates moved as follows over the quarter:

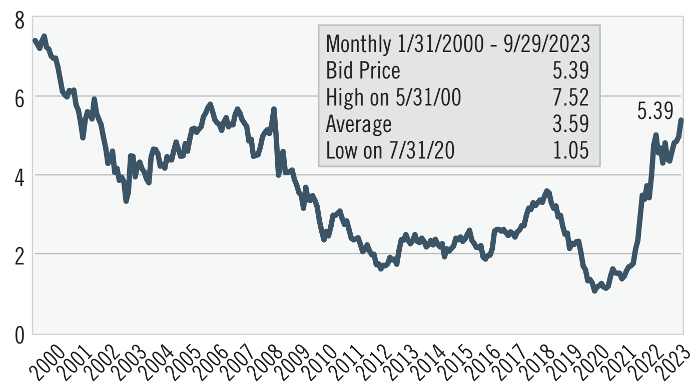
	06/30/23	09/29/23	Q323
2 Year	4.90	5.05	+0.15
5 Year	4.16	4.61	+0.45
10 Year	3.84	4.57	+0.73
30 Year	3.86	4.70	+0.84

Source: Bloomberg.

> This shift to higher Treasury yields drove the Agg's total returns to -3.23% for the quarter, dragging the year-to-date return to -1.21%.

> The long period of low rates after the GFC left the investment grade bond market unattractive and offering what many characterized as "return-free risk." At the end of the third quarter, the Agg offered a 5.39% yield, a level last seen in late 2008, and a return to the "old normal" after a decade-plus of talking about the "new normal" (as shown in the chart below).

BLOOMBERG AGGREGATE INDEX YTW



As of 9/29/23. Source: Bloomberg.

Economic Resilience Persists

Since the stress of the regional banking crisis earlier in the year, the evolution of the economic cycle has been one of continued resilience. The inevitable recession that was largely a consensus expectation at the beginning of the year has been supplanted by the 'soft' or 'no landing' scenario. Coming into the new year, the median gross domestic product (GDP) forecast from Bloomberg's monthly economic survey for the first half of 2023 anticipated no growth in Q1 and an outright contraction, -0.70% GDP, in Q2. The economy actually experienced 2.1% annualized growth in the first half of the year. The most recent Bloomberg survey shows there is no longer an expectation of any quarterly GDP contraction looking out six quarters; only Q1 2024 comes close with a median GDP expectation of 0.1%.

> Current tracking models vary somewhat, but expectations for Q3 GDP are holding firm in the low-to-mid 3% range.

> Median expectation for full year 2023 GDP is now 2.1%, up considerably from the 0.5% median at the start of the year.

> This soft/no landing, or "goldilocks outcome" has become the consensus, despite an additional 100 basis points (bps) of rate hikes from the Fed in 2023.

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> With the probability of one additional rate hike by year-end currently above 50%, the full rate hike cycle by the end of 2023 could reach 550 bps over the course of 22 months.

Total/Excess Return Summary

Using Bloomberg index data, Q3 total returns were almost uniformly negative given the backdrop of higher Treasury rates:

	Q3	Y-T-D
Aggregate	-3.23%	-1.21%
IG Corporate	-3.09%	+0.02%
Residential Mortgage-backed Securities (RMBS)	-4.05%	-2.26%
Commercial Mortgage-backed Securities (CMBS)	-1.02%	+0.16%
Asset-backed Securities (ABS)	+0.25%	+1.99%

Excess returns were mixed for the investment grade spread sectors in Q3.

IG Corporate credit generated +84 bps of excess, with the bulk of the gains coming in July before the move to higher long-term rates accelerated in August and September.

> Lower quality BBB credits moderately outperformed with +104 bps of excess return versus single-A credits at +63 bps.

> Long credit outperformed with +218 bps of excess return versus intermediate credit at +12 bps

> Utilities outperformed with +142 bps of excess, followed by industrials with +93 bps of excess, while financials only saw +53 bps of excess return.

> Spreads were little changed in Q3 with the corporate option-adjusted spread (OAS) ending at +121 vs +123 at the end of Q2.

> Corporate credit remains well supported amidst the growing consensus for a soft landing.

RMBS suffered a difficult Q3, generating -85 bps of negative excess return after a brief rebound in Q2.

> Typically a haven for both the banking sector and foreigners, this high-quality spread sector continues to suffer from a buyers' strike.

> PCC (perfect current coupon)—a generic spread proxy for the "production" coupon—remains near its widest level of the year, trading nearly +180 bps over the 10-year Treasury

CMBS managed to post +35 bps of excess return in Q3, despite persistent storm clouds around commercial real estate.

> Q1 saw the CMBS sector suffer -74 bps of negative excess return amidst the banking sector stress, but positive excess returns in both Q2 and Q3 have offered the sector a respite.

ABS excess returns were also positive at +29 bps, continuing to benefit from an overall lower duration profile, offering investors a place to hide out as intermediate and long-term rates move higher.

"PLUS" sectors offered mixed total returns but another quarter of solid excess returns in Q3.

> High Yield delivered a total return of +0.46% and excess return of +102 bps.

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

> Emerging Markets Debt (EMD) experienced a total return -2.31% and excess return of +80 bps.

Broad Financial Conditions Tighten Again

Despite the aggressive rate hike cycle the Fed has been engaged in for the past 18 months, the initial wave of tighter financial conditions saw a protracted reprieve that lasted for three consecutive quarters. The Goldman Sachs Financial Conditions Index (GSFCI) is a broader, more comprehensive measure of the impact of the tightening cycle than just looking at the tightening cycle through the limited lens of the rate hikes alone. The GSFCI incorporates the Fed's target rate, the 10-year Treasury yield, BBB spreads, stock prices, and the trade-weighted dollar to more broadly measure changes in financial conditions.

> Per the GSFCI, the first three quarters of 2022 saw financial conditions tighten dramatically.

> Over those first three quarters of 2022, the GSFCI rose (tightened) by a cumulative 376 bps.

> The reprieve from overall tightening began in Q4 2022 and persisted through the first half of 2023, allowing for the GSFCI to decline (loosen) by 125 bps, despite the Fed raising rates by 225 bps over that time frame.

> Q3 saw a return to tighter conditions, with the GSFCI tightening by 74 bps.

> As painful as tighter financial conditions can be on investors, the outcome is a feature, not a bug, as it relates to tighter monetary policy from the Fed.

> Tighter financial conditions are the conduit through which the Fed can slow the economy, push the labor market into a healthier balance, and bring inflation down toward its price stability objective.

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From Terminal to Higher for Longer

For the better part of the Fed's rate hike cycle, the emphasis on the terminal value for the Fed target rate has been the market's focus. As the market perceives the end of the rate hike cycle, the emphasis has shifted from the terminal value to the length of time the Fed target rate will remain at a sufficiently restrictive setting. As it stands, using the most recent "dot chart" the Fed offers quarterly via its summary of economic projections (SEP), the median expectation is for one more rate hike in Q4 before the Fed finally stands down. That will bring the terminal value for the target rate to 5.625% (midpoint of the 5.50% to 5.75% target range as defined by the Fed). While there was considerable debate about that terminal value over the duration of this rate hike cycle (very few anticipated it ever getting this high), the market's forward pricing always anticipated a fairly rapid pivot to rate cuts from the Fed. Historically, within about six months of reaching the peak, the Fed would indeed be cutting rates, in either a fine tuning of policy or in response to economic weakness the rate hike cycle induces.

The third quarter saw the Fed, via its many public appearances and speeches, refine this expectation such that the market is finally recalibrating its expectations for both the timing and magnitude of rate cuts going forward. This was also seen in the aforementioned "dot chart" the Fed released at their September meeting. The September "dot chart" saw the median expectation for rate cuts in 2024 get reduced to two from four. This message of "higher for longer" was consistently delivered over Q3 and the new "dot chart" offered an exclamation point. It was this dynamic that drove the Treasury market over most of the quarter, and some of the weakness seen in the longer end of the yield curve was the outcome of this "higher for longer" messaging.

The inevitable recession that was the consensus earlier in the year offered justification for the deep inversion of the yield curve that has persisted since the summer of 2022. Once a recession hits, the Fed would ease aggressively in response, and in doing so, the yield curve would steepen, or "dis-invert," with the front-end of the yield curve outperforming—moving lower, in greater magnitude, than the longer end of the curve. For many investors in the Treasury market, this macro "steepener" was a consensus expectation. Given the economic resilience, the inevitable recession was deferred, and the yield curve inversion intensified over the first half of the year. By the end of the second quarter, the 2-year to 10-year Treasury curve inversion reached over 100 bps and the July 3 market close saw the inversion peak at -108 bps.

Q3 finally introduced the shift to a steeper, or less inverted, yield curve. However, counter to market expectations, the "dis-inversion" was the result of higher long-term Treasury yields rather than lower short-term Treasury yields that typically accompany the end of a hiking cycle. As the fourth quarter gets underway, the irony is that this "bear steepening" dynamic in the Treasury market is now feared as a potential threat to the goldilocks outcome of a soft landing.

Fiscal Premium

In addition to the Fed messaging centered around the "higher for longer" theme, early August saw a Treasury refunding announcement that somewhat changed the narrative around anticipated Treasury supply. Fiscal deficits are hardly new news, and Washington has consistently produced deficits since the brief period of fiscal sanity from 1997 to 2001. The deficits of 2020 and 2021 were extraordinarily large as a result of the fiscal support provided to counter the COVID-19 economic collapse. However, even as the economy has moved beyond the COVID crisis, deficits for 2022 and 2023 remain historically high, in excess of 5% of GDP. This has forced the Treasury to expand borrowing aggressively, and the T-bill market has offered the easiest short-term outlet to accommodate these funding needs. Through August, net T-bill issuance has expanded by $1.38 trillion in 2023. At the current level, T-bills have reached 19.9% of the Treasury's outstanding marketable debt.

The Treasury Borrowing Advisory Council (TBAC) offers guidance on the optimal distribution of debt that incorporates both the minimization of taxpayer expense as well as investor preference in the Treasury market. TBAC has offered a 15%-20% range as the optimal percentage of debt to be funded via T-bills. Having reached this upper band, the Treasury is now embarking on what will be a multi-year terming out of this short-term borrowing, and the August refunding announcement offered the first increases in Treasury coupon offerings across the entire yield curve for the current quarterly refunding cycle (Aug-Oct). It is anticipated that the next three quarterly refunding cycles will see similar increases in coupon offerings to facilitate the debt term out.

Deficit projections from the Congressional Budget Office (CBO) offer little solace that any fiscal discipline will be returning to Washington anytime soon. In the CBO's spring update, deficits over the coming decade were projected to average 6.4% of GDP. Per the CBO, debt held by the public currently stands at approximately 98% of GDP, and the aforementioned deficit path of 6.4% of GDP will see that expand to 115% of GDP by 2033. For perspective, at the

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end of 2007, before the GFC, debt held by the public was only 35% of GDP. This substantially higher debt load will be a consistent headwind to economic growth, and there are many studies that focus on the deleterious effects of debt loads over 90% of GDP.

The financial repression that persisted for the better part of 15 years following the GFC allowed for the interest expense of this ever-expanding debt load to stay under the radar. As rates have normalized over the last two years, the Treasury will be refinancing the maturing debt at higher rates, and the growing interest expense will be capturing a larger and larger portion of the government's overall budget. The extraordinarily low rate period of 2009–2021 enabled Washington to spend and borrow too freely as the cost of doing so was not penal. That macro backdrop has ended, and Washington will ultimately be forced to address this chronic lack of fiscal discipline. The bond market could be the conduit for delivering this sobering message, and the underperformance of the longer end of the yield curve over Q3 may represent the first shot across the bow from the Treasury market.

Q4 and Beyond

As the tightening cycle reaches its conclusion, higher for longer has become the emphasis for policymakers and market participants alike. The inflation backdrop has seen continued incremental improvement since the spring, and many point to the three-month annualized core PCE (personal consumption expenditures) deflator hitting 2.16% through August as proof that the Fed is indeed slaying the inflation dragon. While encouraging, the evidence will need to be sustained for much longer than a single three-month interval. Caution is warranted given the very different macro backdrop today versus the more benign inflation backdrop that persisted in the post-GFC period. The inflation backdrop was shifting structurally before the pandemic, and these shifts were accelerated by the COVID-19 experience. Broadly, the economy is confronting an end of cheap labor, cheap capital, cheap goods, and cheap energy. These changes are all happening at their own pace, but collectively they represent formidable headwinds that will challenge the expectation of returning to the pre-2020 backdrop that saw core inflation struggle to meet the 2% price stability target set by the Fed.

Recession or not, economic growth over the next few quarters is primed to slow down as a result of the tighter monetary conditions set by the Fed and most other central banks globally. The backdrop of late has also been challenged by various labor strikes, the UAW being the most prominent, a resumption of student loan payments after a prolonged suspension tied to the pandemic, mortgage rates around 7.5%, and significant dysfunction in Washington that threatens to shut down the government in the middle of Q4. Globally, the EU region has seen essentially little to no growth over the last three quarters, and the eagerly anticipated 2023 reopening in China, the world's second largest economy, has dramatically underwhelmed most analysts.

Most sectors and companies will have to navigate this more challenged macroeconomic backdrop with more leverage, higher refinancing costs, and the aforementioned inflation backdrop that could prevent central banks from shifting to an easing stance as quickly as markets have become accustomed to since the GFC.

INVESTMENT GRADE TAX-EXEMPT

The third quarter saw a significant move higher in interest rates across fixed income markets as investors caved to the idea that the Fed would need to keep rates at elevated levels for an extended period of time. Following the large move higher in rates, municipals finished with a negative return for the quarter. In addition to the move in rates, weak technical factors in September led munis to underperform Treasuries, leading to negative relative returns, but more attractive ratios versus Treasuries.

The broad market index, as represented by the Bloomberg Municipal Bond Index, returned -3.95% for the quarter, bringing the year-to-date return to -1.38%. Total return performance for the quarter was strongly correlated with duration with the long end performing the worst, returning -6.66% while the one-year return was the strongest at -0.09%.

Mediocre performance was seen across the board with the Bloomberg Municipal GO Bond Index down -4.1% for the quarter and the Bloomberg Municipal Revenue Bond Index down -4.04%. Broadly, state general obligation (GO) bonds outperformed local GOs. The best performing subsectors of the Revenue Index included industrial development revenue/pollution control revenue, electric, and transportation, while the worst performing subsectors were hospital, housing, special tax, and education.

Relative to other fixed income markets, municipals underperformed the Bloomberg Corporate Index (-3.09%), the Bloomberg US Aggregate Gov/Credit Index (-3.00%) and the Bloomberg US Treasury Index (-3.06%). Muni/Treasury ratios were higher than in the previous quarter. The 2-year increased by 12.4 percentage points (pps) to 72.5%, the 5-year by 10.5pps to 73.9%, the 10-year by 7.9pps to 74.9%, and the 30-year by 1.6pps to 92.3%. With the significant adjustment, ratios are now above their 1- and 3-year averages but remain below the 5- and 10-year average levels.

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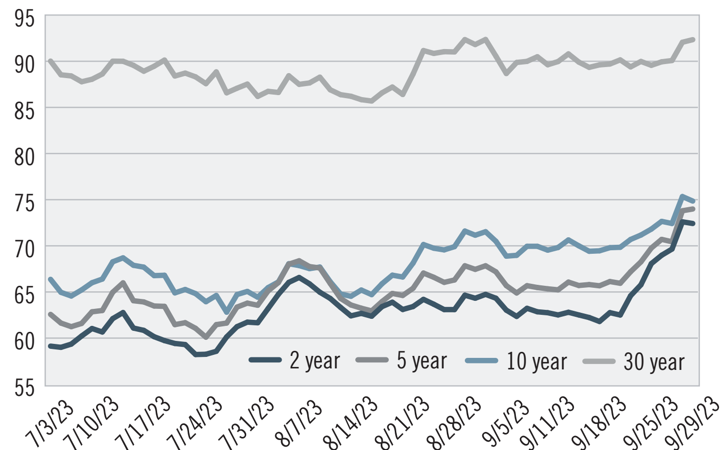
MUNICIPAL/TREASURY RATIOS



As of 9/30/23. Source: Bloomberg.

Yields were significantly higher by the end of the quarter, rising more in the long-end resulting in a steeper yield curve. The slope of the 2-year to 30-year tax-exempt curve steepened to 68 basis points (bps) from 57 bps. The 2-year yield increased by 74 bps, the 5-year by 79 bps, the 10-year by 89 bps, and the 30-year by 85 bps.

The municipal 2-year to 10-year curve inversion persists with no indication of a reversal. It reached a wide of -45 bps in late July and a tight of -13 bps in mid-September, but settled at -21 bps by quarter end.

Issuance projections continue to be below those from the start of the year. We began 2023 with projections in the $425-$500 billion range—most of which have now been revised lower to the $325-$375 billion range. We ended the third quarter at $270 billon in issuance—some 12% less than this time last year.

Monthly issuance in July and August was down on a year-over-year (YOY) basis. In September, volume rose by 1.2% YOY to $27.6 billion. However, this amount is below the $30.7 billion 10-year average. The five states with the highest volume of municipal issuance so far this year are Texas ($49.4 billion), California ($39.9 billion), New York ($28.4 billion), Illinois ($8.8 billion), and Florida ($8.7 billion). According to Bank of America, current data shows that issuers will seek $35.6 billion of debt authorization in the November election, with Texas accounting for about 75%.

While October is typically a weak seasonal month, fueled by low reinvestment rates and high supply, November and December historically feature positive returns. The current high-rate environment is a challenge for refunding and new money issuance and consequently supply could deviate from these historic averages. Supply projections for the fourth quarter range from $60-$90 billion, which are below the historic average for the fourth quarter.

Despite the increase in rates, investors remained on the sidelines and fund flows have remained negative. Year-to-date average weekly flows are -$308 million vs. -$1.5 billion last year, while mutual funds have posted $12 billion in YTD outflows, according to Lipper. It is interesting to note that more than $5 billion has come into municipal ETFs so far this year.

During the third quarter, the elevated levels of secondary selling pressure were exacerbated by mutual fund outflows and seasonal low reinvestment demand, even as primary issuance remained low. This worsened the increase in rates adding to municipals underperformance.

Despite the YTD negative returns, credit spreads continue to trend tighter as represented by the yield differential between the Baa Municipal Index and the AAA Municipal Index, which is now at 104 versus 127 at the end of June.

BAA/AAA MUNICIPAL SPREAD

As of 9/30/23. Source: Bloomberg.

And the spread between high yield (HY) muni and high grade (HG) muni continues tighter as well, with the differential between HY and HG Indices at 193 bps down from 220 at the end of June.

HIGH YIELD/HIGH GRADE MUNICIPAL SPREAD

As of 9/30/23. Source: Bloomberg.

During the third quarter, municipal credit quality generally remained strong (albeit not in all sectors), as it did in the first half of the year. On the part of the major rating agencies,

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upgrades have continued to exceed downgrades by large margins. In fact, S&P's rating activity for the quarter was exceedingly positive. The number of upgrades was more than triple the number of downgrades at 194 versus 51 for the quarter. Local governments accounted for the most upgrades at 124, but also the most downgrades at 32. However, it is also the largest sector within the municipal space. Healthcare was the only sector in which downgrades exceeded upgrades at 18 and 2, respectively. Year-to-date through September 30, S&P upgrades have totaled 642, while the downgrade tally is 199.

Notable rating upgrades during the third quarter included Cook County, IL, which saw its general obligation rating raised to A1 from A2. Moody's also changed the outlook on the Commonwealth of Pennsylvania's GO rating to Positive from Stable, as did S&P. (Ratings are Aa3 and A+, respectively.) These positive rating actions, both on the county and the commonwealth levels, were based in no small part on the accumulation of sound reserves as each received substantial federal COVID relief aid. State and local government recipients are required to allocate these funds by December 31, 2024, and spend them by December 31, 2026. After this, they will be on their own, although much of the money has already been spent. A recently released Volker Alliance study reported that 12 states were at "elevated or moderate risk" of facing a "fiscal cliff" when federal funds are no longer available, although 38 states were identified as having "low risk." We note that a substantial number of state and local issuers have achieved record reserve levels over recent years—both in absolute terms and as a percentage of appropriations—which should provide a strong financial buffer going forward.

On the transportation front, Moody's upgraded its rating on the Pennsylvania Turnpike Commission's senior lien revenue bonds to Aa3 from A1 in August. In September, S&P upgraded its rating on the North Texas Tollway Authority's first-tier bonds to AA- from A+. The toll road sector has demonstrated resilience—both during and after the COVID pandemic—particularly those with large commercial traffic components amid robust consumer spending. (Commercial vehicles accounted for about 17.5% of the Pennsylvania Turnpike Commission's fiscal 2022 traffic). Consumer Price Index (CPI)-based tolling has also contributed to the sector's resilience. The credit quality of highway user tax bonds has also remained sound.

The airport sector remains a transportation bright spot as well. According to Moody's, passenger traffic for the first eight and a half months of this year was slightly above that for the same period in 2019 (i.e., prior to the pandemic). The rating agency expects passenger traffic to remain near 2019 levels through the fall. Last month, Moody's revised the outlook on the San Diego Regional Airport Authority (senior lien bonds rated A1) to Positive from Stable.

The mass transit sector continues to face credit pressure, amid slow recovery of ridership—even amid increasing return-to-office rates. Although this is also true of New York's Metropolitan Transportation Authority, MTA saw Moody's outlook on its revenue bonds—rated A3—adjusted to Positive from Stable, due primarily to significant increases in tax support from the State of New York. Early into the current quarter (October 3), S&P upgraded its rating on MTA's bonds to A- from BBB+.

Credit quality in the utility sectors (public power, water and sewer) has also remained stable. However, surging demand amid record summer heat levels underscores the importance of ESG considerations as a credit factor. Many electric utilities will face capital spending pressure due to capacity needs, hardening of existing assets to make them more weather-resilient, and state and federal decarbonization mandates.

The healthcare sector remains under pressure with numerous credit challenges. Fitch expects healthcare downgrades to continue to outpace upgrades through the end of the year, especially for large-scale systems reporting progressively weaker margins and faced with deeper turnaround challenges.

Similarly, higher education credits are faced with declining enrollment, which is pressuring revenues with wage inflation causing expense growth. This has led several small private colleges to face a difficult choice between shuttering operations or being acquired by a larger institution. These pressures are likely to continue into 2024.

As a whole, the municipal bond sector remains strongly positioned with yields at compelling levels. Credit quality remains high. Many credits have maintained strong cash reserve levels, thanks to Federal COVID relief funds, and revenues are growing as the economy continues to expand. Yields are near decade-long highs and provide a strong source of tax-free income. Investors are well served to retain an allocation to the sector as it provides important diversification with high quality credits, a compelling tax free income stream, and low correlation to other asset classes.

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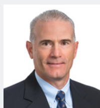
Authored by:

Investment Grade – Taxable



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The **Bloomberg U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. **Bloomberg U.S. Corporate Investment Grade Bond Index** measures performance of investment grade corporate bond funds. The index is calculated on a total return basis. **Bloomberg Municipal Bond Index** is a capitalization weighted bond index created by Bloomberg Barclays intended to be representative of major municipal bonds of all quality ratings. The **Bloomberg High Yield Municipal Bond Index** covers the universe of fixed rate, non-investment grade debt. The **Bloomberg Municipal 1-Year Index** is designed to track the U.S. short-term tax-exempt bond market, including state and local general obligation bonds, revenue bonds, pre-refunded bonds, and insured bonds. The **Bloomberg Long Bond Index** is designed to track the U.S. long-term tax-exempt bond market. The **Bloomberg AAA Index** tracks AAA-rated municipal bonds. The **Bloomberg Baa Index** tracks Baa-rated bonds. The **Bloomberg US 60:40 Index** is designed to measure cross-asset market performance in the U.S. The index rebalances monthly to 60% equities and 40% fixed income. The equity and fixed income allocation is represented by Bloomberg U.S. Large Cap Index and Bloomberg U.S. Aggregate Bond Index, respectively. The **Goldman Sachs Financial Conditions Index (GSFCI)** is defined as, a weighted average of riskless interest rates, the exchange rate, equity valuations, and credit spreads, with weights that correspond to the direct impact of each variable on GDP.

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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