

## The Quarter of the Bond

### INVESTMENT GRADE TAXABLE

Our Q3 recap lamented the bond market’s lackluster performance over the first three quarters of 2023, given the elevated expectations coming into the year. After the horrific year that was 2022, expectations were for a respectable bounce in total return for the Bloomberg Aggregate Bond Index (Agg), but by the end of Q3 the Agg’s year-to-date total return was still negative at -1.21%. October offered little hope of any recovery, delivering another -1.58% monthly total return, bringing the YTD return to -2.77%. Then came November and December, a pretty historic two-month period, even going back to the inception of the Agg (1976). Total returns for November and December were +4.53% and +3.83%, respectively, or +8.53% for the two-month interval. For context, that two-month total return is the seventh best two-month total return since the inception of the Agg; the six returns that were higher all date back to the early 1980s when rates were significantly higher and the 40-year secular bull market in bonds was just getting started. For 2023, the Agg delivered a +5.53% total return, remarkably closer to the hopes and dreams of market participants earlier in the year. The path to that return, however, did not remotely follow the early 2023 script.

Powering the Q4 returns were significant declines in Treasury yields across the curve, as reflected below:

	09/29/23	12/29/23	Q423	2023
2 Year	5.05	4.25	-0.80	-0.18
5 Year	4.61	3.85	-0.76	-0.16
10 Year	4.57	3.88	-0.69	0.00
30 Year	4.70	4.03	-0.67	+0.06

Source: Bloomberg.

The first quarter of the year saw recession fears compounded by a regional banking crisis; rates declined and returns across the bond market were uniformly positive. The second and third quarters witnessed a complete reversal of that initial rate decline, pushing Treasury yields higher and driving total returns negative again. Economic resilience and no material effects from the banking crisis offered hope that expectations of imminent recession were misplaced. The economy saw gross domestic product (GDP) expand by 2.1% annualized over the first half of the year and Q3 upped the ante with a robust 4.9% annualized growth rate. This newfound optimism, in tandem with the

Treasury announcing increased coupon issuance (as opposed to just increased T-bill issuance) at the August refunding announcement, pressured Treasury yields higher in Q3, with yields across the curve reaching calendar year highs in mid-October. The 10-year Treasury yield topped out just over 5% intraday on October 19, 2023, before closing that trading session at 4.99%.

The initial catalyst for the rate reversal came on November 1, 2023, the Treasury’s latest quarterly refunding announcement. The rise in the term premium seen over Q3, where the yield curve steepened, elicited a response from the Treasury, with the distribution of increased auction sizes altered to limit the impact on the longer end of the yield curve. The overall change was hardly monumental, with the auction increases for 10-, 20-, and 30-year Treasuries each only one billion less than their respective August increases. More impactful, the Treasury intimated that only one additional quarter of increases to coupon auction sizes would be necessary beyond the increases announced that day. Market consensus anticipated two, if not three, more quarters of increased coupon auctions in 2024. With persistent deficits of 6+% of GDP, the Treasury’s expectation for only one additional quarter of larger coupon auctions could prove to be overly optimistic, but that debate will continue well into 2024 and beyond.

The morning refunding announcement lit the fuse for a move lower in yields and the Federal Open Market Committee (FOMC) meeting in the afternoon of November 1, 2023, further supported the rally in Treasuries. The meeting was perceived as “dovish” by the market, with the FOMC offering the assessment that they have little confidence that policy is too tight or not tight enough, thereby leading the committee to do nothing. The market takeaway was that the FOMC wants to end the hiking cycle without admitting as much. Bonds and stocks reacted gleefully, and the 10-year Treasury yield declined ~20 basis points (bps) that day alone. Two days later saw a solid, but unspectacular, payroll report extend the move lower in yield, followed by a mid-month Consumer Price Index (CPI) report where the core rate came in at 0.2% month-over-month against a 0.3% consensus expectation. That 0.1% (0.07% unrounded) improvement for the core rate elicited another one day 20 bps move lower in the 10-year Treasury yield. By the close on November 14, 2023, the 10-year Treasury yield was 4.45%, a 54 bps decline from that October 19, 2023 closing high.

Treasury yields continued to decline over the balance of November and December. The activity in December around key economic releases failed to alter the bullish sentiment in Treasuries. The employment report released on December 8, 2023, was strong, with the unemployment declining to 3.7% from 3.9%, causing a modest uptick in Treasury yields. Shortly thereafter, on December 12, a consensus CPI report set the stage for the final FOMC meeting of the year on the following day.

When overall financial conditions were tightening in Q3, as rates rose and risk assets underperformed, the FOMC made note of it and acknowledged that the market was in fact doing some of the work for them, meaning that additional rate hikes may not be necessary. However, when the market actually reversed—with lower rates and risk asset outperformance, the consensus expected the FOMC to push back on the markets' premature easing of financial conditions, which was counter to the restrictive policy setting the FOMC desired. In fact, on Friday December 1, just before the Fed's normal blackout period (no speeches for the twelve days leading up to an FOMC meeting), Chair Powell expressed modest concern about the easier financial condition the markets were generating. The chart below illustrates the tightening over Q3 and the consequent loosening over Q4 of broad financial conditions as represented by the Goldman Sachs Financial Conditions Index (GSUSFCI).

**GOLDMAN SACHS FCI**

Broad Financial Conditions Eased Aggressively in Q4



GSUSFCI Index (GS US Financial Conditions Index) GS FCI. Daily 12/31/22-12/31/23. Source: Bloomberg Finance L.P.

Consensus expectations were for the FOMC to use this final meeting to push back more aggressively on the ebullience in markets and counter the easier conditions seen since mid-October. However, there was no such push back, and Chair Powell essentially poured fuel on the fire by pivoting and saying it was time to talk about rate cuts. The “Powell

Pivot” was official as the Chair took a victory lap for defeating the inflation dragon, of course while claiming to not be declaring victory. Risk assets soared and rates declined with another ~20 bps move lower in the 10-year Treasury yield. Easier conditions got even easier, and the goldilocks scenario of a soft/no landing was cemented as the consensus for 2024.

**Total/Excess Return Summary**

Using Bloomberg Index data, Q4 and 2023 total returns were uniformly positive:

	Q4	YTD
Aggregate	+6.82%	+5.53%
Investment Grade (IG) Corporate	+8.50%	+8.52%
Residential Mortgage-Backed Securities (RMBS)	+7.48%	+5.05%
Commercial Mortgage-Backed Securities (CMBS)	+5.25%	+5.42%
Asset-Backed Securities (ABS)	+3.48%	+5.54%

Those quarterly returns were incredibly robust, to say the least. For context, while not as impressive as the aforementioned two-month total return of November and December 2023, the +6.82% quarterly return for the Agg was the eleventh best calendar quarter return since the inception (1976). Again, all the stronger quarters date back to the 1980s.

Excess returns were also uniformly positive for the investment grade spread sectors in Q4 and 2023:

	Q4	YTD
IG Corporate	+203 bps	+455 bps
RMBS	+133 bps	+68 bps
CMBS	+67 bps	+114 bps
ABS	+37 bps	+124 bps

Within IG Corporate credit, the bulk of the gains for Q4 came in November (+205 bps) while October was modestly negative, and December was modestly positive.

- > Lower quality BBB credits outperformed in Q4 with +248 bps of excess return versus single-A credits at +175 bps; for the full year, it was BBBs winning again at +551 bps against single-A at 376 bps.
- > Long credit outperformed in Q4 with +303 bps of excess return versus intermediate credit at +159 bps; for the full year, it was long credit again at +763 bps against intermediate credit at +303 bps.
- > Little differentiation amongst the sectors in Q4 with each generating approximately +200 bps of excess return; for the full year, industrials outperformed with +498 bps of excess, followed by utilities with +406 bps, and financials with +392 bps.

> Spreads tightened with the corporate option-adjusted spread (OAS) ending at +99 bps versus +121 bps at the end of Q3 and +130 bps at the end of 2022.

RMBS had its best performance in Q4, bringing the full year excess return back into positive territory.

> PCC (perfect current coupon)—a generic spread proxy for the “production” coupon—tightened to +137 bps; that was a 42 bps tightening in Q4 but a more modest 12 bps tightening for 2023.

CMBS/ABS both generated more muted excess in Q4; for the full year 2023, they generated similar excess at +114/+124 bps. These are small sectors within the Agg (only ~2% total in market value terms) and as such, are typically smaller contributors to overall excess returns for Agg-benched strategies.

“Plus” sectors offered robust total and excess returns in Q4 and for the full year.

> High Yield delivered a Q4 total return of +7.16% and excess return of +331 bps; for the full year that breakout was +13.44% and +886 bps of excess.

> Emerging Markets Debt (EMD) delivered a Q4 total return of +8.10% and excess return of +256 bps; for the full year that breakout was +9.09% and +532 bps of excess.

### Higher for a Little Longer?

Given the formal policy pivot seen in December, the mantra of “higher for longer” suddenly has a shorter shelf life. As often as it was referenced by Powell and the FOMC through the middle of this year, it died an unceremonious death over the second half of the year. Along with the signal from Powell that discussing rate cuts was now on the table, the FOMC’s updated “dot chart” included a median expectation for three rate cuts in 2024. Given that the additional rate hike the committee had implied in the September “dot chart” was never delivered (which would have brought the midpoint of the target rate range to 5.625% vs. 5.375% currently), the new 2024 median is 100 bps lower than that implied terminal rate from September.

Declining inflation drove the improved sentiment in Q4, with short-term annualized metrics for core inflation returning to levels more consistent with the Fed’s price stability objective. The Fed’s favored inflation metric, the core-PCE (Personal Consumption Expenditures) deflator, saw its six-month annualized rate fall to 1.9% through November against a 3.7% rate as recently as August. That was good enough for the Fed to pivot. The emphasis on the super core measure that tracks core services ex-housing—a specific measure of the Fed’s own creation this cycle—was no longer a focus of

the discussion. Whether looking at the super core measures from the CPI data series or the PCE deflator series, the shorter-term annualized measures fail to reflect as much improvement. The six-month annualized rate for the CPI super core series through November actually rose and stands at 3.7% against 2.6% in August. The same rate for the PCE super core series saw only modest improvement and stands at 2.6% against 2.9% in August. But in September, with that August data in hand, the FOMC was still preparing the market for one more rate hike. By December, the FOMC chose to look through this mixed message from the super core measures and shifted the discussion to pending rate cuts in 2024.

Inflation outcomes in 2024 may prove the FOMC was prescient in their decision to pivot already. But the record of the Fed’s inflation forecasting might have argued for a more cautious approach to changing the policy narrative so quickly. Clearly the move higher in rates in Q3 was alarming to many, particularly given that the shift higher saw the yield curve steepen. The end of cycle dynamics for the yield curve is normally a steeper curve, but the path is typically through lower short-term rates, not higher long-term rates. Given the higher levels of aggregate debt across the economy, with the amount of Treasury debt outstanding being exhibit A for that growth in debt, there is immense pressure on the Fed to do what they can to keep a lid on rates after having normalized the policy rate after 15 years of a near zero interest rate policy backdrop.

The Treasury was quick to respond to the higher term premium seen in Q3 when they altered the mix of coupon auction increases in November. Having worked together at the Fed for several years, Treasury Secretary Yellen and Chair Powell are in close contact as it relates to markets and policy. Having seen the level of coordination between the Treasury and the Fed since the global financial crisis, it is not hard to envision the Fed coming under significant pressure to restrain from additional rate hikes and consider a less restrictive policy setting in the near future.

### 2024 and Beyond

The economy and markets have come a long way since the early days of 2023, when fears of recession cast a pall over expectations. Growth expectations (per the Bloomberg monthly economic survey) anticipated little, or even negative growth in GDP terms for the first three quarters of 2023 and then only a modest pick-up in Q4. The formal accounting for that 2023 GDP consensus was approximately 0.5%. Quarter by quarter, the economy exhibited a resilience no one expected, delivering GDP of approximately 2.5%, with Q4 currently tracking around 2%. It’s this resilience that has

convinced the market consensus that the soft landing is now the higher probability outcome. Growth will moderate in 2024, but the pall of imminent recession is gone.

Given the Fed pivot and the expectation of a lower policy rate, risk markets and the Treasury market have rallied nearly uninterrupted since mid-October. While the Fed's updated "dot chart" offered a median target rate in 2024 that implied three rate cuts, market pricing has moved well beyond that. As 2024 gets underway, short-term interest rate markets are oscillating between five or six rate cuts for the full year, with those cuts starting as early as the Fed's March 20, 2024, meeting. Given the evolution of Fed policy in Q4, it's difficult to place a high probability on whether the Fed will deliver the first rate cut that soon. Given the degree to which sentiment and pricing have moved in a noticeably short period of time, there is little room for disappointment as it relates to the fundamental data the Fed will need to see between now and March 20. Should an inflation update, wage data, or labor market data—just to name a few—offer evidence that the pivot was premature, market pricing across rates and risk will be challenged.

Recession or not, economic growth over the next few quarters is likely to slow down as a result of the tighter monetary conditions set by the Fed and the challenged pace of expansion seen globally. The U.S. economy has outperformed in the post-pandemic period, given the aggressive fiscal and monetary policy response seen to date. Remnants of that policy stimulus were a significant component of the resilience seen in 2023, but it would seem overly optimistic to extrapolate that into 2024. Long and variable lags from tighter monetary policy are exactly the element that could surprise going forward. The ability of the economy to navigate this first wave of restrictive policy offers a level of complacency of which all investors need to be cognizant.

Valuations across the investment grade spread sectors are fair-to-rich across varying historical time periods. Given the degree to which these sectors have outperformed in 2023, initially in response to the economy's resilience and consequently in response to the Fed's surprise pivot in Q4, there is little margin for error. The broad macro backdrop of higher leverage, higher refinancing costs, and an uncertain inflation backdrop that may not offer the Fed an easy path for modest policy easing remains front and center. The massive returns of November and December have proven intoxicating; but expecting no hangover seems highly unrealistic.

#### **INVESTMENT GRADE TAX-EXEMPT**

The fourth quarter saw a significant move lower in rates across fixed income markets as fears of runaway inflation faded and data was supportive of a soft landing scenario.

Following the large move lower in rates, municipals finished with a strong positive return for the quarter and dramatically outperformed Treasuries. With this move, municipal/treasury ratios were markedly lower making munis less attractive versus Treasuries on a historic basis.

The broad market index, as represented by the Bloomberg Municipal Bond Index, returned 7.89% for the quarter, bringing the year-to-date return to 6.40%. Total return performance for the quarter was strongly correlated with duration with the long end performing the best, returning 11.61%, while the one-year return was the weakest at 2.32%.

The strong performance was seen across the board with the Bloomberg Municipal GO Bond Index up 7.79% for the quarter and the Bloomberg Municipal Revenue Bond Index up 8.15%. Broadly, local general obligation (GO) bonds outperformed state GOs. The best performing subsectors of the Revenue index included hospitals, housing, leasing, and special tax, while the worst performing subsectors were industry development revenue (IDR)/pollution control revenue (PCR) and electric. Notably, even the lowest performing revenue sectors returned more than 6.8% for the quarter.

Relative to other fixed income markets, municipals underperformed the Bloomberg Corporate Index (8.5%), but outperformed the Bloomberg US Aggregate Gov/Credit Index (6.63%) and the Bloomberg US Treasury Index (5.66%). Municipal Treasury ratios were lower than in the previous quarter. The 2-year decreased by 13.3 percentage points (pp) to 59.3%, the 5-year by 14.5 pp to 59.6%, the 10-year by 16.4 pp to 59.1%, and the 30-year by 7.1 pp to 85.1%. With the significant adjustment, ratios are now below their 1-, 3-, 5- and 10-year average levels.

Yields were significantly lower by the end of the quarter, declining more in the short end and resulting in a steeper yield curve. The slope of the 2-year to 30-year tax-exempt curve steepened to 90 bps from 69 bps. The 2-year yield decreased by 113 bps, the 5-year by 113 bps, the 10-year by 117 bps, and the 30-year by 92 bps. The municipal 2-year to 10-year curve inversion persists with no indication of a reversal. It reached a wide of -26 basis points in late December and a tight of -6 basis points in mid-October but settled at -24 basis points by year end.

We ended the year at \$364 billion in issuance—some 2% less than the previous year. Monthly issuance for October, November, and December was up on a year-over-year basis. In October, volume rose by 42% year-over-year to \$39 billion; in November, volume rose by 29% to \$35 billion; and in December, volume rose by 36% to \$23 billion. The five states with the highest volume of municipal issuance



in 2023 were Texas (\$59.0 billion), California (\$53.9 billion), New York (\$42.3 billion), Illinois (\$14.3 billion) and Florida (\$13.4 billion).

Issuance projections for 2024 show a wide range of potential outcomes, varying from \$330 billion on the low end to \$450 billion on the high end. Despite the variability in projections, most sell side firms are projecting an increase in issuance versus 2023 levels, with many projecting over \$400 billion in issuance.

January is historically a strong seasonal month, fueled by low supply and strong investor demand. February and March are typically more difficult months, with March showing the lowest monthly returns on average over the last 22 years.

For the quarter, investors largely remained on the sidelines and fund flows remained negative. For the year, mutual funds saw \$29.4 billion in outflows, according to Lipper. It is interesting to note that more than \$12.4 billion came into municipal ETFs during the year.

Reversing the trend for the prior three quarters, credit spreads began to widen during the third quarter. The yield differential between the Bloomberg BBB Municipal Index and the Bloomberg AAA Municipal Index went from 104 bps at the end of September to 126 bps at the end of December. The spread between high yield (HY) muni and high grade (HG) muni was wider as well, with the differential between HY and HG indices at 235 bps, up from 189 bps at the end of September.

One of the stories of 2023 in the municipal sector was credit stability. Upgrades continued to outpace downgrades. According to JP Morgan, year-to-date through October 2023, the municipal upgrade-to-downgrade ratios for Moody's and S&P combined was 3.5 times (x), versus 2.9x for Moody's for the whole of 2022, and 3.3x for S&P. On the tax-backed side, in the fourth quarter, Fitch raised Illinois' general obligation rating to A- from BBB+, and both Moody's and S&P boosted the ratings on Ohio's GOs to AAA. Fitch also upgraded Chicago's GO rating to BBB+ from BBB.

However, in the state and local government sectors, credit may have reached a peak for now. This is because federal COVID relief funds, which helped state and local governments to bolster reserves to record levels over the last several years, must be obligated by December 31, 2024, and spent by the end of 2026. Based on JP Morgan's review of data released by the U.S. Treasury, as of June 30, 2023, states had already allocated 69% of their State and Local Fiscal Recovery Funds and spent about 50%. For localities, these figures are 46% and 34%, respectively.

To be clear, solid revenue growth also contributed to strong financial performance, although at a lower rate in 2023 than in the two prior years. With widespread expectations for slower economic growth rather than a recession, state and local government revenues may face additional softening in 2024. In fact, California (GOs rated Aa2 by Moody's, AA- by S&P, and AA by Fitch) is already projecting a \$68 million deficit in the upcoming budget process due to a large shortfall in income tax collections. On the other hand, Illinois (Moody's A3, S&P and Fitch A-) reports that for the first half of fiscal 2024 (i.e., through December 2023), its general fund revenues rose by 3.1%.

On the revenue-backed side, the transportation sector stood out for its credit resilience last year. Airports benefited from generally strong passenger demand with a particularly strong second half. For December, the passenger total was 72.5 million, representing a 10.5% increase from December 2022 and equal to 103.3% of December 2019 levels. For the entirety of 2023, the total about 1.5% higher than in 2019.

The toll road sub-sector has demonstrated resilience—both during and subsequent to the COVID pandemic, particularly those with large commercial traffic components amid robust consumer spending. In fact, to our knowledge, no S&P rating downgrade has occurred since the start of the pandemic in March 2020.

Air and road travel—and shipping activity at America's seaports, for that matter—tend to move in tandem with GDP growth. In the event the U.S. economy does indeed cool, major transportation issuers are well-positioned financially to weather declines in traffic and throughput growth, like their tax-backed counterparts. This is particularly true for airports, which also benefited from large infusions of federal pandemic relief.

In the hospital sector, metrics appeared to have bottomed out, with modest improvement occurring for some in 2023. In general, systems were able to achieve breakeven operating results while slowly adding to their balance sheets. We expect continued slow improvement in 2024, though this will be dependent on economic activity remaining solid with inflation under control. Mergers and acquisitions in this sector continue to be prevalent, including most recently Novant Health and Tenet Healthcare (which is expected to close in first quarter of 2024).

First time payment defaults totaled \$2.8 billion for 2023, down 32.9% versus 2022 according to Municipal Market Advisors. Defaults remain concentrated in the nursing home, hospital, student housing and industrial development sectors.

The municipal bond sector remains well positioned as we head into 2024. Credit quality remains high, and yields remain above their five-year average levels. Municipal bonds provide investors with important diversification given their low correlation with other asset classes. Additionally, they

are highly defensive in the case of a recession and should maintain high credit quality given the current strong positioning of many credits. With these benefits in mind, we believe investors should maintain an allocation to the sector.

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