Data Dependence Persists

INVESTMENT GRADE TAXABLE

The higher rate trend seen throughout the first quarter carried into the second. The April data cycle kicked off with stronger data releases that brought into question the ability of the U.S. Federal Reserve (Fed) to cut rates at all in 2024. While a fair distance remains between current market rates and the cycle highs seen last fall, "higher for longer" continues to influence trading in Treasuries, even with a central bank that consistently leans into the market's desire for an easier stance on monetary policy.

The totality of inflation data for the first quarter forced the Fed to acknowledge a loss of confidence that core inflation was still on a sustainable path to 2%. This early quarter inflation scare even saw the two-year Treasury briefly trade above 5% again, before moving back down. More constructive data later in the quarter offered the Treasury market a reprieve, such that the April spike in yields, 40 to 50 basis points (bps) across the curve, turned out to be the highs for the quarter. The shift in Treasury yields for 2Q can be seen below:

	03/28/24 (%)	06/28/24 (%)	2Q24 basis points (bps)
2 Year	4.62	4.76	+0.14
5 Year	4.21	4.38	+0.17
10 Year	4.20	4.40	+0.20
30 Year	4.34	4.56	+0.22

Source: Bloomberg.

Having spent the first quarter repricing Fed rate-cut expectations from an early extreme of nearly seven cuts to only three, the market consolidated in the second quarter around expectations for one to two cuts by the end of the year. Bearish sentiment for higher rates permeated April. A new strong employment report released on April 5th was followed by March's Consumer Price Index (CPI) data five days later which cemented the core CPI's third consecutive 0.4% advance. This news resulted in uniformly negative total returns across the investment grade bond market for the month, and carried over to the stock market, where the S&P 500® Index declined 4.1% in April, ending a five consecutive month streak of positive total returns.

Both the rates and risk markets turned friendlier in May, directly following the Fed's meeting and press conference on the first day of the month. Given the disappointing inflation data up to that point, some feared rate hikes could again find their way into the Fed policy discussion. Instead, Chair Powell offered a less hawkish—more market friendly—performance. He indicated during the press conference that it was unlikely the next policy rate move would be a hike, and a collective sigh of relief echoed across the capital markets.

The Fed also formalized its plan to taper the balance sheet reduction (Quantitative tightening, or QT) that has been in place since June 2022. While there had been talk of an eventual taper to the ongoing QT, the timing and size of this announcement was a positive surprise for the market.

Shortly thereafter, the payroll report on May 3rd offered the slowest job gains in six months. Completing the more friendly market backdrop, the April CPI report released on May 15th saw the core CPI finally downtick to 0.3% versus the prior three 0.4% advances. Treasuries rallied into and through the inflation report, before coming under some pressure again throughout the balance of May. Regardless, a friendly Fed offered an opening for the stock market to rebound back to record highs in May, and spread sectors generated positive excess return across the board.

June's primary data releases produced mixed results. Job gains as reflected by the Bureau of Labor Statistics (BLS) establishment survey on June 7th exceeded expectations, keeping pressure on rates to go higher. The BLS' household survey, however, was decidedly weaker—as it has been for the past several years. The disparity of this data cast doubt on just how robust the labor market is at this point in the cycle. Many analysts believe that the household survey could be a better indicator of labor market health at inflection points. Such skepticism contained the market's overall reaction to the establishment survey payroll data, and the May CPI data subsequently released on May 12th showed the slowest monthly core CPI since August 2021. The rise in rates after the payroll data was quickly undone, and the prospect of rate cuts over the balance of the year also improved considerably.

The same day that the CPI report was released, the Fed concluded its fourth meeting of the year, which included an update to their summary of economic projections (SEP). As part of the SEP update, the Fed offered an update to the "dot chart," which includes every Fed participant's estimate of the future path to their target rate. The March iteration of this periodic update anticipated three rate cuts by the end of the year. The June update surprisingly saw the median estimate get reduced to only one.

The market had expected the median dot to get reduced to two rate cuts. The breakout of the dot chart showed that eight participants anticipated two rate cuts, seven assumed one, while four expected none. Knowing that only two participants had to change their view to return to a two rate-cut outcome offered the market an olive branch of sorts, minimizing the impact of this potentially more restrictive policy path over the balance of 2024.

2Q Total/Excess Return Summary

Using Bloomberg index data, 2Q 2024 total returns were fairly muted for the Bloomberg Aggregate Bond Index (Agg) and the primary spread sectors (Corporates and RMBS):

	2Q24 (%)	YTD (%)
Bloomberg Aggregate Bond Index	+0.07	-0.71
Investment Grade (IG) Corporates	-0.09	-0.49
Residential Mortgage-Backed Securities (RMBS)	+0.07	-0.98
Commercial Mortgage-Backed Securities (CMBS)	+0.68	+1.53
Asset-Backed Securities (ABS)	+0.98	+1.66

The Agg saw its total return go very negative in April, given the pressure on rates during that month. May and June returned to moderately lower levels, allowing the investment grade benchmark to recover. Total return year-to-date remains negative for the Agg, as well as for the primary spread sectors.

Excess returns were also very muted, with little outperformance for the primary investment grade spread sectors. The smaller CMBS and ABS sectors were only slight outperformers:

	2Q24 (bps)	YTD (bps)
IG Corporates	-4	+85
RMBS	-9	-23
CMBS	+24	+171
ABS	+17	+71

Within IG corporate credit, lower quality BBB rated risk eked out a small positive excess return against a small negative outcome for higher quality single-A rated risk. The robust supply backdrop in corporate credit persisted over the second quarter, albeit at a modestly lower rate. The first half saw overall investment grade corporate supply outpace the comparable 2023 period by 26% and still produce a respectable +85 bps of excess return for the first half of the year.

> Lower-quality BBB credits modestly outperformed in 2Q with +10 bps of excess return versus single-A credits at -11 bps.

> Long credit underperformed in 2Q with -57 bps of excess return versus intermediate credit outperforming with +23 bps of excess return.

> Financials outperformed again with +23 bps of excess return; industrials and utilities underperformed at -16 bps and -24 bps of excess, respectively.

> At the broad investment grade corporate sector level, spreads were slightly wider with the index option-adjusted spread (OAS) ending at +94 bps versus +90 bps at the end of 1Q.

RMBS was challenged once again. 2Q was the mirror image of 1Q as the lower coupon risk of the sector outperformed, while the higher coupon risk generated negative excess returns. The overall spread change for the production coupon was modestly wider.

> Perfect current coupon (PCC), a generic spread proxy for the "production" coupon, widened +9 bps to +148 bps.

CMBS/ABS both generated positive excess returns in the second quarter, but not as strong as in the first. Similar to the corporate sector, ABS sector performance remains impressive given the robust supply backdrop seen over the first half of 2024.

CMBS performance still seems at odds with the challenged commercial real estate (CRE) market. The slow moving nature of the CRE market, coupled with the ability of many participants to "extend and pretend" upon loan maturity, offers a window for yield-seeking investors to temporarily support the sector. Standard qualifier CMBS and ABS 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 strategies benchmarked to that index.

"Plus" sectors offered another quarter of outperformance in both total and excess returns.

> High yield delivered a 2Q total return of +1.09% and excess return of +36 bps.

> High yield total return year-to-date was +2.58%.

> Emerging markets debt (EMD) delivered a 2Q total return of +0.68% and excess return of +54 bps.

> EMD total return year-to-date was +2.22%.

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Economic Pivot Pending

Economic resilience has been a prominent theme since the Fed embarked on the tightening cycle. Inflation remains front and center, along with labor market data. We expect the totality of the data to inform and drive monetary policy in 2024. Given that the Fed is offering little in the way of more specific forward guidance, the market is hypersensitive to each and every economic data release, leaving capital markets prone to bouts of volatility around the release of critical data points.

Economic surprise indexes offer a crude assessment of just how good or bad the aggregate data releases are relative to the market's consensus expectation. According to the Citigroup Economic Surprise Index, the second quarter took an interesting turn for the worse that warrants ongoing surveillance. Exhibit 1 shows the evolution of this index for 2024.

EXHIBIT 1

Source: Bloomberg. As of 7/8/2024.

After rising over the first quarter, offering evidence of the data outperforming expectations, the index turned down considerably after early April. This level of disappointment relative to expectations hasn't been seen since 2022.

A negative reading is not an indication of negative growth. Rather, it indicates that overall economic releases have been coming in below the market's consensus expectation. Growth can remain positive, just as it did the last time this measure was in negative territory back in 2022. Underperformance relative to expectations is important, however, given the longer time the economy has endured more restrictive monetary policies.

Deficits, Supply, and Term Premium

The spring release from the Congressional Budget Office (CBO) offered another sobering outlook for the federal budget over the coming decade. The very short summary is that deficits—already very high—are not going to improve over the next decade. The following excerpt is directly from the CBO's release:

"In CBO's projections, the federal budget deficit in fiscal year 2024 is $1.9 trillion. Adjusted to exclude the effects of shifts in the timing of certain payments, the deficit amounts to $2.0 trillion in 2024 and grows to $2.8 trillion by 2034. With such adjustments, deficits equal 7.0 percent of gross domestic product (GDP) in 2024 and 6.5 percent of GDP in 2025. By 2027, as revenues increase faster than outlays, they drop to 5.5 percent of GDP. Thereafter, outlays generally increase faster than revenues. By 2034, the adjusted deficit equals 6.9 percent of GDP—significantly more than the 3.7 percent that deficits have averaged over the past 50 years."[1]

Deficits in 2024, as a percentage of GDP, look to be around 7%. And the economy is still on track for growth. Historically, there is no precedent for such a high deficit outside of a deep recession or a world war. Deficits obviously need to be financed, and the Treasury will be very busy over the next decade in doing so. The CBO highlights the challenging backdrop the Treasury will be faced with:

"Relative to the size of the economy, debt swells from 2024 to 2034 as increases in interest costs and mandatory spending outpace decreases in discretionary spending and growth in revenues. Debt held by the public rises from 99 percent of GDP this year to 122 percent in 2034, surpassing its previous high of 106 percent of GDP."[2]

Updates like this from the CBO are not new. Their decades-ahead forward projections are wrought with assumptions. Many like to criticize them, and very few will lose sleep over the conclusions in the short run. However, most agree that this fiscal backdrop is unsustainable over the long term.

At what point over the short to intermediate term will these deficits matter? That question is a growing risk for the Treasury market going forward. Recall that last summer the Treasury made modifications to their borrowing cycle to term out some T-bill borrowing in order to finance the deficit. The increased-term borrowing was spread across the yield curve, the market repriced to adjust to the higher long term borrowing, and the yield curve "steepened" as a result. Over the course of the third quarter of 2023, the two-year to ten-year part of the curve steepened by nearly 60 bps.

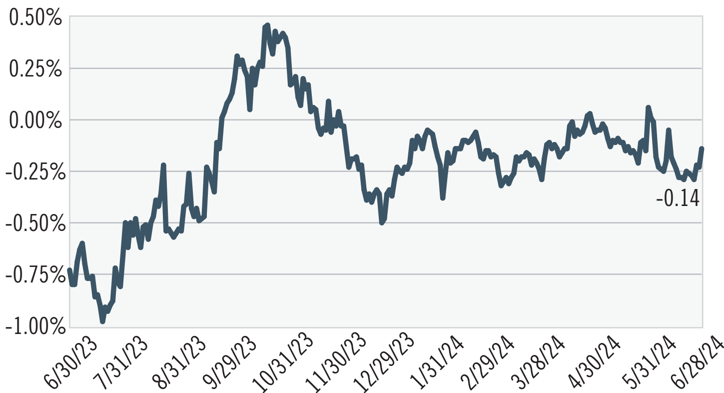
This rise in the term premium is not a directly observable measure, but there are models that attempt to measure this component of long-term Treasury yields. The NY Fed publishes

[1]Congressional Budget Office, June 2024, An Update to the Budget and Economic Outlook: 2024 to 2034 | Congressional Budget Office (cbo.gov).
[2]Ibid.

continued

an estimate of the term premium from the Adrian Crump & Moench (ACM) model it uses. Exhibit 2 shows the estimate of the term premium over the last year from the ACM model:

EXHIBIT 2



Source: Bloomberg. As of 7/8/2024.

The rise in the term premium from the middle of last summer to the end of October was quite significant. It returned the term premium back to positive territory, albeit for only a few months. This backdrop of higher rates and a steeper yield curve was challenging to risk assets, and the stock market suffered its only quarterly decline of 2023 over this time period.

The move was enough to get the Treasury to alter the mix of increased long-term Treasury issuance at the November refunding announcement, thereby helping to contain the rise in term premium. Over the long term, the term premium will eventually return to a more normal positive estimate. Consider that prior to the global financial crisis and the near-permanent presence of Fed intervention in the Treasury market, the term premium per the ACM model averaged +138 bps (2000-2007), well above the closing level of -14 bps on June 28th.

Looking Forward

Soft landing remains a narrow consensus for the markets, as talk of a hard landing comes from a relatively quiet minority. Growth decelerated in the first quarter to 1.4% and economic tracking models for the second quarter currently coalesce near 2%. The Bloomberg mid-June economic survey shows expectations for GDP over the second half of the year around 1.5%. But the crystal ball gets cloudier with each passing month, particularly given the incoming clouds that accompany the election cycle.

The markets' reaction to the June 27th presidential debate reminded everyone that elections have consequences. The post-debate rate increase and steeper yield curve came in response to the higher probability of a Republican sweep in November, potentially ushering in an unprecedented wave of new government spending and/or tax relief.

Preliminary thoughts on Trump 2.0 consistently point to the post-2016 election outcome of higher rates and a steeper yield curve. Truth be told, full-blown policy expectations are a challenge to forecast, absent knowing the balance of power that flows from the Senate and House elections, so the next four months will offer many iterations of what may be forthcoming after the November 5th election.

Overall, risk markets appear resilient in the face of this highly uncertain backdrop. The stock market hit a moderate speed bump in April, amidst higher rates and the relatively brief talk of potential new rate hikes, given the inflation data seen for the first quarter. The May 1st Fed press conference made clear that additional hikes were not on the table, and the stock market spent the balance of the quarter establishing record highs.

Spread markets exhibited a similar resilience. The RMBS market underperformed in April amidst the higher rate move, but recovered in May and June as the rate market settled down. Credit spreads were solid in April and May, but underperformed in June along with the broader economic data, fearing a potential policy error by a Fed that cuts rates too late. Markets will remain hypersensitive to inflation and labor market updates, but as the Fed repeatedly reminds us, the totality of the data will dictate monetary policy.

Valuations across the investment-grade credit spread sectors continue to lean rich across varying historical time periods. Given the degree to which these sectors have performed, and the onset of higher volatility that the election cycle brings, we believe that the incremental spread offered fails to adequately compensate for the risk. The macro backdrop of higher leverage, higher refinancing costs, and a still uncertain inflation backdrop amidst an exceptionally volatile election cycle is a flashing yellow light for taking risk.

Investment Grade Tax-Exempt

In the second quarter, rates continued to move higher across fixed income markets as higher inflation and robust growth prevailed. This affirmed fears that the Fed would need to delay interest rate cuts until later in the year, contrary to earlier expectations. As a result, municipal bonds (munis) finished with negative returns for the quarter and underperformed Treasuries. Municipal/Treasury ratios were significantly higher in the 2-, 5-, and 10-year spots, but slightly lower in the 20- and 30-year, making munis more attractive versus Treasuries in the front end of the curve on a quarter-over-quarter basis.

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The broad market index, as represented by the Bloomberg Municipal Bond Index, returned -0.02% for the quarter. Total return performance was uneven in the second quarter, with the 1-year performing the best, followed by the long bond (22+ years), then the 3-year. The worst performing part of the curve was the 10-year bond followed by the 7-year.

Revenue bonds returned 0.07% and outperformed general obligation (GO) bonds, which returned -0.30%. Broadly, state GOs outperformed local GOs. The best-performing subsectors of the Bloomberg Municipal Revenue Bond Index included housing, hospital, industrial revenue, and tobacco, while the worst performing subsectors were resource recovery, leasing, water/sewer and electric. There was significant dispersion among sectors, with housing returning 0.71% at the high end and resource recovery returning -0.99% at the low end.

Compared to other fixed income markets, municipal bonds outperformed the Bloomberg Corporate Index (-0.09%), but underperformed the Bloomberg U.S. Aggregate Bond Index (0.08%), Bloomberg U.S. Aggregate Gov/Credit Index (0.05%), and the Bloomberg U.S. Treasury Index (0.10%).

Municipal Treasury ratios were higher than in the previous quarter. The 2-year increased by 1.5 percentage points (pp) to 65.9%, the 5-year by 6.1 pp to 66.6%, and the 10- year by 5.4 pp to 65.3%, while the 30-year was down by 2.3 pp to 82.5%.

For the quarter, yields were lower in the 1-year spot of the curve and higher from 2-30 years, resulting in a flatter yield curve. The slope of the 2-year to 30-year tax-exempt curve flattened to 61 basis points (bps) from 71 bps. The 1-year yield decreased by 9 bps, the 2-year yield increased by 14 bps, the 5-year increased by 35 bps, the 10-year increased by 33 bps, and the 30-year increased by 4 bps. The municipal 2-year to 10-year curve inversion persists. It was widest in early April at -48 bps, then tightened through early June, reaching a low of -21 bps and ending at -27 bps for the quarter.

We ended the quarter at $243 billion in year-to-date issuance, up 39% year-over-year—the highest level seen since 2007. Monthly issuance for April, May, and June was also up on a year-over-year basis. In April, volume rose by 31% year-over-year to $45 billion. In May, volume rose by 61% to $47 billion, and in June, volume rose by 31% to $49 billion.

Year to date, municipals have seen inflows of $11.6 billion, with $9.2 billion into funds and $2.4 billion into ETFs. For the quarter, flows were flat with a modest net inflow of $57 million. (April outflows of -$524 million, $754 million in inflows in May, and -$173 million in outflows in June.)

Continuing the trend of the prior quarter, credit spreads tightened during the second quarter. The yield differential between the Bloomberg BBB Municipal Index and the Bloomberg AAA Municipal Index went from 96 bps at the end of March to 81 bps at the end of June. The spread between high yield (HY) munis and high grade (HG) munis was tighter, as well. The differential between HY and HG indexes was at 171 bps at the end of June, down from 201 bps at the end of March.

Credit quality remained strong across most sectors. According to J.P. Morgan on June 14, 2024, rating upgrades by Moody's and S&P for the year-to-date through May exceeded downgrades by a ratio of almost two to one.

Local GO bonds have been a primary driver of the rating agencies' positive actions. With a majority of revenues derived from property taxes (over 80%, according to J.P. Morgan), they benefited greatly from the post-pandemic boom in housing prices.

The transportation sector was also a credit bright spot, particularly for airports, with passenger totals breaking pre-pandemic levels—a trend that is expected to continue.

There was additional positive news for the beleaguered mass transit sector, as Moody's revised its sector outlook to Stable from Negative. Increased office attendance has contributed to ridership growth, as have non-commuter trips. Growing state and local government support was also cited by Moody's. However, the nation's largest mass transit system—New York's Metropolitan Transportation Authority (MTA)—experienced a setback with respect to funding for capital projects, when the state's governor delayed the implementation of "congestion pricing." This planned surcharge on vehicles entering Manhattan's central business district would have raised as much as $1 billion per year for system improvements (Bond Buyer, July 1, 2024). The MTA has now been left with a $16.5 billion capital funding gap.

State GO bonds are a highly rated sector. The vast majority have ratings in the AAA and AA categories and none rated in the BBB category. Most states completed their 2024 fiscal years on June 30, with general fund reserves at or near record levels. According to S&P, a majority of states reported outperforming their budgets, despite slowed revenue growth. Flush with cash, 25 of the 41 states where income taxes are levied cut rates since 2021. This could cause future budgetary pressure for some, as federal COVID-relief funds run out.

The higher education and healthcare sectors remained under credit pressure, with downgrades exceeding upgrades in both. For higher education, negative rating actions were

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biased toward small, private institutions, while in healthcare, stand-alone hospitals were the primary driver. S&P reported increased frequency of covenant violations in both sectors.

According to Bank of America calculations, first-time payment defaults through June across all municipal sectors were down 42% year-over-year, and first-time distressed debt was down 7%.

The municipal bond sector remains well positioned as we head into the third quarter. Credit quality remains high, and yields remain above their five-year average levels. Municipal bonds may provide investors with important diversification due to their historically low correlation with other asset classes. Additionally, munis are typically highly defensive in the case of a recession, and we believe they will 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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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. **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 **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.

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