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Peak Growth, Peak Inflation, Rates Rally

> As a result of a modestly "less dovish" stance by the Federal Reserve (Fed), long Treasuries were up almost 6.5% in the second quarter after being down 13.5% in the first quarter. Long TIPS (Treasury Inflation-Protected Securities) were up over 8% compared to an 8.8% decline in the first quarter, as they benefited from the upside surprises seen in the consumer price index over the quarter.

> In a remarkable turnabout, AAA rated nominal returns led the investment grade corporate market, primarily a function of AAA's longer duration. BBBs led on an excess return basis, which is duration adjusted. In the high yield market, CCC's continued to lead the way.

> The tax-exempt side saw a continuation of the positive trends from the first quarter: phenomenal retail demand and relatively limited supply—all of which culminated in extraordinarily expensive Muni-Treasury ratios, extraordinarily low yields, and incredibly tight credit spreads.

> As a result of such extraordinary demand, the Bloomberg Barclays Municipal Index, a broad measure of the municipal market, returned 1.42% for the second quarter. Continuing its strong run, the long end outperformed dramatically, as did lesser-quality paper and high yield funds.

INVESTMENT GRADE-TAXABLE

Curve Flattens, Reflation Trade Pauses as Fed Turns "Less Dovish"

The second-quarter narrative was the exact opposite of the first quarter. Whereas long Treasuries sold off on the reflation/inflation trade in the first quarter, the second quarter witnessed an unexpected rally in longer term Treasuries as the reflation trade/reopening trade paused. At the start of the quarter, the certainty of a 2% 10-year Treasury yield was the consensus, with only the timing being left to debate. A counter trend rally consequently ensued, as the extreme positioning for higher rates seen in Q1 finally began to crack, triggering short duration and curve steepening trades to unwind. By the end of the quarter, signals from the Fed regarding a tapering of bond purchases as well as a shift in the median "dot" in 2023 to reflect the potential for an earlier rate lift-off further induced the move away from the reflation theme.

In its most recent meeting on June 15-16, the Federal Open Market Committee (FOMC) moved its median "dot" for the first rate hike into 2023 from 2024, which brought it closer to where the market was as represented by the Eurodollar futures curve. The Fed often downplays the importance of the "dots" as they only represent the aggregation of individual assessments of where the Fed target rate will go over time, not a formal committee forecast. These assessments are updated quarterly and extend through 2023 currently. History would support the Fed's dismissive approach to the "dots" as they've been a poor predictor since their 2012 introduction. Consider just one example, where the December 2014 "dots" produced a median target rate of 2.5% in 2016, implying nine rate hikes over that two-year period. The target rate at the end of 2016 turned out to be 0.75% (upper band of the target range), meaning that only two rate hikes actually came to pass. The last cycle saw the "dots" consistently overestimate the magnitude of tightening ultimately delivered by the Fed, and this cycle will be no different.

As a result of this modestly "less dovish" stance by the Fed, long Treasuries were up almost 6.5% in the second quarter after being down 13.5% in the first quarter. Long TIPS were up over 8% compared to an 8.8% decline in the first quarter, as they benefited from the upside surprises seen in the consumer price index over the quarter.

In a remarkable turnabout, AAA rated nominal returns led the investment grade corporate market, primarily a function of AAA's longer duration. We haven't seen AAA's lead the way on a nominal basis in quite a long time. BBBs led on an excess return basis, which is duration adjusted. In the high yield market, CCC's continued to lead the way, in both nominal and excess return terms.

Taper Talk, But No Tantrum

Although there was no talk of the Fed reversing its quantitative easing strategy in the first quarter, the financial markets had somewhat of a tantrum anyway. The second quarter had some taper talk, but none of the tantrum that usually goes with it. What changed? Recall the surprising April CPI report that came out on May 12. Suddenly there was a real challenge to the FOMC narrative that inflation would be transitory. That debate is going to be with us the rest of the year.

The second critical event was the release of the FOMC's April meeting minutes on May 19, which revealed that some participants wanted to start the taper discussion despite Chairman Jay Powell's prior insistence that it really wasn't time for that discussion yet and despite a disappointing April employment report.

Weighing the risks of roiling the markets with taper talk, the FOMC decided to go forward with such discussions anyway, setting the stage for the June FOMC meeting where the Fed's Summary of Economic Projections (see below) included the updated dot chart that brought two rate hikes into 2023 versus no hikes in the March iteration of the dots. Up to that point, no one in the market was anticipating median projections would change to reflect two hikes in 2023. But the Fed couldn't ignore the upside surprise from the latest inflation data, and there was enough acknowledgment from several vocal regional Fed presidents that the rate hike timetable would have to shift modestly given the faster-than-expected pace of the economic recovery.

Even so, a closer look at the Fed's Summary of Projections lends credence to the view the economy has hit peak growth and peak inflation and the second half could see some deceleration.

THE FED'S SUMMARY OF ECONOMIC PROJECTIONS JUNE 16, 2021 (%)

	Median[1]			
Variable	**2021**	**2022**	**2023**	**Longer Run**
Change in real GDP	7.0	3.3	2.4	1.8
March projection	6.5	3.3	2.2	1.8
Unemployment rate	4.5	3.8	3.5	4.0
March projection	4.5	3.9	3.5	4.0
PCE inflation	3.4	2.1	2.2	2.0
March projection	2.4	2.0	2.1	2.0
Core PCE inflation[2]	3.0	2.1	2.1	
March projection	2.2	2.0	2.1	
Memo: Projected appropriate policy path				
Federal funds rate	0.1	0.1	0.6	2.5
March projection	0.1	0.1	0.1	2.5

Source: Federal Reserve

Note: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The projections for the federal funds rate are the value of the midpoint of the projected appropriate target range for the federal funds rate or the projected appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. The March projections were made in conjunction with the meeting of the Federal Open Market Committee on March 16–17, 2021. One participant did not submit longer-run projections for the change in real GDP, the unemployment rate, or the federal funds rate in conjunction with the March 16–17, 2021, meeting, and one participant did not submit such projections in conjunction with the June 15–16, 2021, meeting.

[1]For each period, the median is the middle projection when the projections are arranged from lowest to highest. When the number of projections is even, the median is the average of the two middle projections.

[2]Longer-run projections for core PCE inflation are not collected.

Fund Flows and Excess Returns

Interestingly enough, negative total returns in the first quarter really didn't deter cashflows into the IG space, and positive total returns in the second quarter helped drive further interest as the demand for income remained very strong. For the first half of the year, taxable bond inflows into mutual funds as well as ETF creation totaled about $330 billion (preliminary ICI data). For the full year 2020, that number was $392 billion.

Suffice it to say, fund flows and ETF creation have been exceptionally supportive of all portions of the IG market. As a result, there have been good excess returns almost across the board. The corporate market's nominal return in the second quarter was about 3.5%—112 basis points (bps) of excess, slightly above the 95 bps of excess generated in the first quarter. Excess return for the first half totaled just over 200 bps for the IG credit sector.

Lower quality BBBs had 136 bps of excess in the second quarter, exactly what had happened in the first quarter. Single As had 90 bps of excess in the second quarter, which is better than the first quarter's 45 bps.

Still Underweight RMBS

In contrast, the residential mortgage-backed securities (RMBS) market had 61 bps of negative excess return in the first quarter, and year-to-date performance is also negative—all of which helps to explain why we are very underweight the sector.

The RMBS market remains under the thumb of the Fed. The Fed is still adding $40 billion net a month to its balance sheet. And the reality is with spreads as tight as they are, in tandem with elevated prepayments, the likelihood of generating any excess return in RMBS is a low probability outcome. If tapering were to start, some have argued that the Fed should go to the mortgage market first given the strength in the housing market and the view that the sector does not need any additional support. Amongst those making this case include several regional Fed bank presidents.

Commercial mortgage-backed securities, on the other hand, performed well with 82 bps of excess return, while asset-backed securities generated a more modest 24 bps points of excess.

Outlook

Regardless of the level of rates or even indications that rates can only go higher, money continues to flow in as investors seek income.

The Bloomberg consensus for the end of the year still points to a 10-year Treasury rising to nearly 1.90%, quite a distance from 1.35% as of July 8. However, the bond market appears to be rejecting the hawkish outlook of former Treasury

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Secretary Larry Summers, among others. What matters more to the market is the sustainable rate of inflation, and it's just a matter of time before the effects of supply chain bottlenecks and shutdowns from the pandemic run their course and the secular deflationary forces become dominant again.

The Fed will continue trying to convince the market that it is now looking for a modest overshoot on inflation and will be driven by outcomes, not forecasts. By definition that suggests the Fed would be late to the inflation fight, a less than popular position amongst many policymakers (current and former alike). The fear is that the Fed might have to act much more aggressively when it finally decides to tighten and in doing so will do damage to the economy and risk assets.

WHY THE FED IS JUST LESS DOVISH Goldman Sachs Financial Conditions Index Hits Another Record Low, 1/1/16-7/7/21

Source: Goldman Sachs. The Goldman Sachs Financial Conditions Index 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.

This is not to suggest that the Fed is acting hawkish with its latest economic projections, including the dot chart; it's just less dovish. After all, the degree to which financial conditions remain accommodative is in plain sight. For instance, the Goldman Sachs Financial Conditions Index closed the second quarter at another record low.

While the fiscal transfer payments that have been deployed support the economy, they don't stimulate the economy, which underscores the risk that the economy will eventually hit a fiscal cliff absent any further policy support. Given the magnitude of support already enacted since the pandemic ensued, budgetary imbalances would argue that multiple trillion-dollar packages are not sustainable after reopening the economy. That being said, legislation for infrastructure spending and "green" initiatives are already under negotiation; the total spending and timetable are but guesses at this point.

Looking ahead, we are not likely to get a clear picture on how the underlying economy is trending (or what the sustainable rate of inflation is) until the August/September timeframe, at the earliest, and more likely later.

However, in line with our peak growth/peak inflation thesis, the Russell 2000® Index peaked in the middle of March and is down a little over 3% since then. The Russell 1000® Value Index peaked on June 4. The economically sensitive Dow Jones Transportation Index is down 6.4% from its peak in the beginning of May. Copper, which tends to outperform in times of high growth and inflation, peaked on May 11th and was down 10% through quarter-end.

As for the yield curve, spreads on both 2/10-year Treasuries and 5/30-year Treasuries flattened more than 40 bps as of early July since peaking in mid to late March. Likewise, real yields peaked in March and declined about 40 bps by early July.

Against that backdrop, money supply growth has decelerated from growing at 27% on a year-over-year basis as recently as February 2021 to just under 14% in May. Now, inflation hawks (a/k/a "inflationistas") will argue that such money supply growth must indicate higher inflation, but they leave out the second variable of that inflation equation: velocity of money must go up. The velocity of money remains near record lows. And with approximately seven million fewer jobs than existed pre-lockdown, we are not seeing the kind of wage pressures that would spark concern about a big and sustainable jump in inflation.

INVESTMENT GRADE-TAX EXEMPT

Extraordinarily Expensive Ratios, Low Yields, and Tight Spreads

The second quarter of 2021 saw a continuation of the positive trends of the first quarter: phenomenal retail demand (with some institutional interest) and relatively limited supply—all of which culminated in extraordinarily expensive Muni-Treasury ratios, extraordinarily low yields, and incredibly tight credit spreads.

While we expect supply will probably be more than $500 billion for the year, so far, some 25-30% of that has been in taxable munis, meaning there has not been enough tax-exempt issuance to meet robust demand.

In June, as is typical of the summer months, a large amount of cash was returned to muni investors' hands from maturities, coupon payments, and bond calls, but issuance once again could not keep pace, helping municipals post strong performance for the first half.

Performance

As a result of such extraordinary demand, the Bloomberg Barclays Municipal Index, a broad measure of the municipal market, returned 1.42% for the second quarter.

Continuing its strong run, the long end outperformed dramatically, as did lesser-quality paper and high yield

continued

funds. Total return for the 5-year segment of the municipal market was 0.48%; for the 10-year, it was 1.14%, and for the long bond it was 2.82%—all in all, quite a difference.

In terms of quality, AAAs saw a total return of 0.97% for the quarter; AAs gained 1.17%; As advanced 1.78%; and the Baa cohort jumped 2.6%. For the year to date, the 5-year was up 0.17%; the 10-year was up 0.57%, and the long bond, much to some investors' surprise, was up 2.33%. Year to date, however, AAAs were up 0.06%; AAs gained 0.51%; the A cohort advanced 1.84%; and the Baa segment increased 3.91%.

Such market dynamics proved difficult for our high-quality, intermediate approach, but that is understandable. Last year, we outperformed and did remarkably well. This year so far, there was no way we could keep up with the remarkable strength of lesser-quality paper and the long end.

For historical perspective, consider the performance of two types of municipal bonds between 2017 and 2020: a 30-year, A-rated revenue bond versus a AAA-rated general obligation bond. The average spread was 65 bps. Today, it is at about 32 bps and there does not seem to be any motivation for the spreads to widen out.

Limited liquidity is still an issue, especially in lesser-quality paper. Dealers simply are not stocking bonds like they used to, even in a bull market. They are only buying when they know they have a seller or vice versa. Cash flows to investors will continue to be strong through August, but then decline in September.

Little Concern About Credit

If the market environment feels like it does not make sense, you are not alone, but that is the reality of it. From a credit perspective, there does not appear to be any worry. So much federal money has been given to states and municipalities, and revenue declines were not as bad as anticipated. Should a federal infrastructure bill go through, states and municipalities will receive even more money.

Against that backdrop, there should be no wonder Standard & Poor's has raised its outlook on about $403 billion of municipal bonds this year and upgraded nearly $38 billion worth, according to data compiled by Bloomberg. That translates to 145 outlook increases this year through June 25, nearly six times more than in the first half of 2020. Last year, S&P lowered its outlook on $434 billion of municipal debt and downgraded $79 billion.

The current lack of concern about credit even extends to tobacco bonds, convention bonds, and hotel bonds, which might give some investors pause given the healthy living movement and residual Covid concerns about the Delta variant. Hospital bonds have also rallied significantly, but smaller credits like nursing homes are still under pressure.

Outlook

After an impressive second quarter, 2021 is shaping up as another strong year for municipal bonds. Individuals still feel very comfortable going into the asset class, as evidenced by $2 billion a week in mutual fund flows. There has even been some interest from banks for their portfolios.

Issuance should remain strong—maybe not as strong as the first half, but with the recent downswing in rates, it could pick up quite a bit. However, for the time being the overall municipal market is shrinking, thanks in part to higher than anticipated revenues during the re-opening and all the money municipalities have received from the Federal government.

Of course, much depends on future fiscal and monetary policies, especially if the Fed decides to taper quantitative easing sooner than it last signaled. The yield curve is very flat now, but when will it steepen? With the economy continuing to recover, albeit with significant questions about pandemic trends, the market doesn't seem very concerned that the Fed will have to raise rates any time soon to fight inflation.

If an infrastructure deal goes through, there is a good chance Congress will also authorize a new sort of Build America Bond (BAB), like we had after the 2008 financial crisis, where the U.S. Government will pay part of the interest and the municipality will pay part of the interest. Such a hybrid would open the market to a totally different issuer and investor because the BAB would be partly taxable and partly tax exempt.

In any case, we will be sticking to our high-quality investment strategy as we have always done. That is what our investors know us as, and that is what they expect from our funds and from our management. We will not be trying to tweak the portfolio by going heavily into lesser quality like BBB paper, and we will maintain our focus on the intermediate maturity range of the yield curve.

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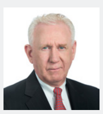
Investment Grade – Taxable



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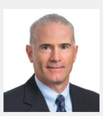

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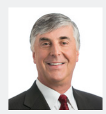
Investment Grade – Tax-Exempt



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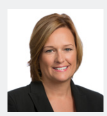

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The **Municipal/Treasury Ratio**, M/T ratio or muni-Treasury ratio, as it is more commonly known, is a comparison of the current yield of municipal bonds to U.S. Treasuries. It aims to ascertain whether or not municipal bonds are an attractive buy in comparison. The ratio uses indices from the Thomson-Reuters Municipal Market Data (MMD) series.

The **Bloomberg Barclays 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 index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. **Bloomberg Barclays Long U.S. Treasury Index** includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have $250 million or more of outstanding face value. **Bloomberg Barclays 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 Barclays U.S. Corporate High Yield Bond Index** measures fixed rate non-investment grade debt securities of U.S. corporations, calculated on a total return basis. **Bloomberg Barclays 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 **Russell 2000® Index** is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. The **Russell 1000® Value Index** is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. The **Dow Jones Transportation Average™** is a 20-stock, price-weighted index that represents the stock performance of large, well-known U.S. companies within the transportation industry.

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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