WASMER SCHROEDER STRATEGIES

Quarterly Bond Market Overview

March 31, 2021

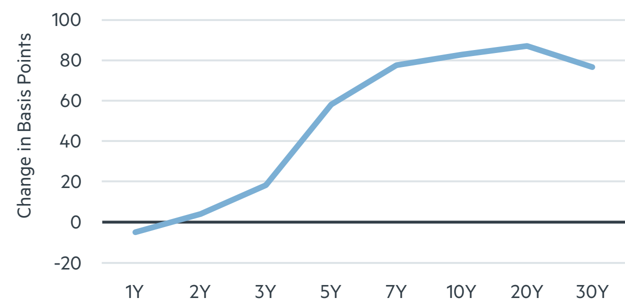
Let the Games Begin

By: Tom Richmond, Co-Head of Wasmer Schroeder Taxable Bond Strategies

The first quarter was not a great one for bond investors broadly, as most sectors of our market, with the exceptions of very short strategies and certain credit-heavy, tax-exempt styles (as you will see further below), had returns that ranged from negative to very negative. This was, of course, the result of heavy selling of bonds, especially Treasuries with maturities past three years. Just how this came to be, however, was, at least to me, a ray of light in an otherwise gloomy quarter, as market participants were treated to the first few innings of what will undoubtedly be a fairly lengthy game, waged between two of the most powerful squads in our business: The U.S. Federal Reserve (Fed) and the combined forces of bond investors.

It would be easy to say that 'the Market' won this early portion of the game, as the drumbeat of calls for stronger, post-pandemic, stimulus-driven growth and inflation concerns eventually lead to higher rates. Treasury Inflation-Protected Security (TIPS) breakevens were also a contributing factor to higher rates. If you believe the narrative that things are steadily returning to normal on the economic and pandemic fronts, and that the Fed remains resolute that they are 'not even thinking about thinking about' tapering or raising the Fed Funds rate, then this bear-steepening made sense. For their parts, the members of the Federal Open Market Committee (FOMC) actually don't seem to mind being down a few runs in the early going, as they continue to telegraph a willingness to let things run hot from inflation and growth perspectives (including rooting for fiscal help). We believe that even the higher breakevens are pleasing to them, as they have had a few decades of little success fostering their targeted inflation rate. After all, the Fed has a playbook for reining in growth and inflation, but we believe not much left in the bag of tricks to fight the opposite effects.

US Treasury Yield Curve Change – 12/31/2020 to 3/31/2021



3/31/2021; Source: Bloomberg

One spectator to all this who might be a little concerned is new Treasury Secretary Janet Yellen. Given the amount of debt already outstanding and the amount that will continue to be needed to fund the last stimulus package and whatever infrastructure law eventually comes out of Congress, Treasury rates certainly matter to her. For her part, Ms. Yellen professes concern not for the size of debt or nominal rates at any given moment, but rather only for the total cost of the debt's service. If that is so, a continuation of the move in rates seen in the first quarter may find Madame Secretary asking for a dugout chat with her successor, Jerome Powell, as Chair of the Fed in the hope of convincing him and the Committee to change their tune and bring their 'dot plots' more in line with the ones implied by the market, which may stop the steepening of the curve.

As the second quarter gets underway, data regarding the end of Q1 is continuing to impress. That said, the market seems like it has finally found a rate regime that it is more comfortable with, at least for now, as the curve has stabilized, and volatility has fallen over the past couple of weeks. While we welcome the calm and wish it would continue, it is likely that volatility will reappear in the coming months as both of these forces play on, armed with data releases and pandemic-related headlines that may bring larger surprises than we are accustomed to seeing in any and all directions. The market may have an edge for now, but the Fed has proven to be a formidable force over time, and we still like their chances of getting what they want.

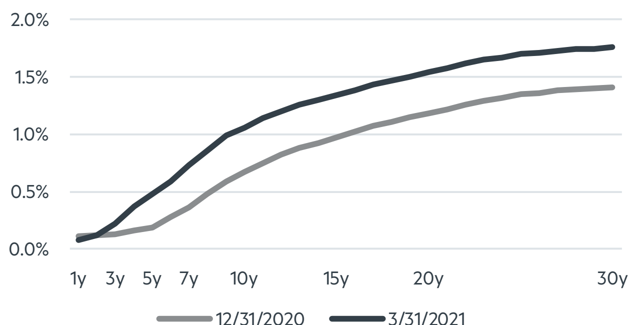
Tax Exempt Market

By: Jason Diefenthaler, Head of Wasmer Schroeder Municipal Bond Strategies

Overview

The municipal bond market saw mixed performance during the first quarter with most sectors and maturity buckets posting slightly negative returns for the three-month period. But the real story was how the muni market performed relative to U.S. Treasuries, which saw significantly worse performance due to higher rates on intermediate and longer maturities. The Bloomberg Barclays 10-Year Municipal Bond Index outperformed the 10-Year U.S. Treasury Index by 645 basis points (bps) during 1Q21, its largest quarter of outperformance since 2Q09 and the 2nd largest since the inception of the Municipal Index in 1981.

Tax- Exempt Municipal Yield Curve



3/31/2021; Source: Bloomberg

The reasons that the municipal market held up so well during a period of rising Treasury yields were readily apparent. As with prior quarterly commentaries, anemic supply meeting elevated demand was again a factor. Yet there were a few new twists this quarter: the accelerating distribution of vaccines and local economies reopening; the introduction of a $1.9 trillion Federal stimulus program with substantial direct aid to state and local governments; the anticipation for changes to Federal tax policy with higher rates for corporations and individuals; and real momentum to a long-awaited Federal infrastructure spending package. All four of these dynamics played key roles in how investor perception of the tax-exempt bond market evolved over the quarter, which we discuss in more detail below.

Supply and Demand

The $102.6 billion of total municipal new issuance during the quarter was the highest first quarter tally since 1Q15 ($102.8 billion). However, the new issue calendar felt like it was a bit lighter than those numbers would suggest, given that 26% of the supply came as taxable. As has been the case for the better part of the last two years, this elevated level of taxable supply has created an element of scarcity demand for tax-exempt paper, which is a theme we saw play out again in 1Q21; it was not uncommon to see new issues see demand that exceeded supply by more than 10x.

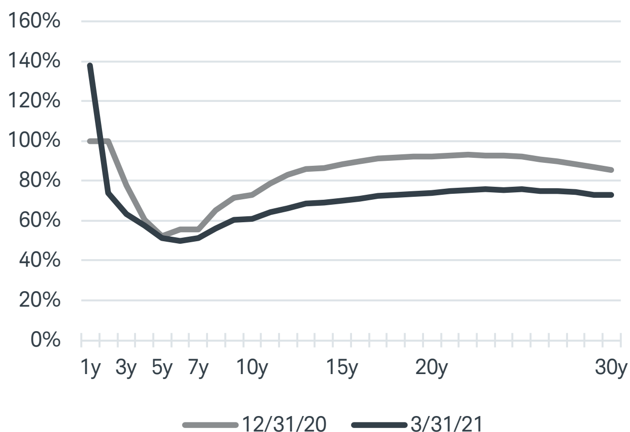
Retail asset flows into munis were extraordinarily strong during the quarter. Municipal funds reported inflows in 11 of the 12 weeks during the quarter; nine of those weeks saw inflows in excess of $1 billion, including a three-week run totaling more than $7.7 billion. Overall, muni funds experienced roughly $17.6 billion in net inflows in 1Q21.

Also on the topic of demand, the Federal Reserve updated its data on municipal bond ownership for 4Q20. The size of the municipal market grew to a par value of $3.95 trillion by the end of 2020, or $4.295 trillion in market value. Individuals, mutual funds, money funds, and ETFs continue to be the primary owners of municipal securities at 72% of all outstanding debt. Banks and insurance companies increased their ownership of municipal securities by 6% in 2020 after declines of -12% and -1% the prior two years respectively. Not surprisingly, the bulk of this increase came during the second half of 2020 as corporations began to assess the likelihood of higher corporate tax rates in 2021. The other holders category saw a 14% year-over-year increase in ownership, due in large part to non-financial corporations buying tax-exempt bonds but also because of borrowings by the State of Illinois and the NY's Metropolitan Transportation Authority from the Fed's Municipal Liquidity Facility.

Muni-to-Treasury Ratios

The record investor inflows during the quarter led to significant tighter muni-to-Treasury yield ratios along the curve. Ratios on the very short end of the yield curve (inside 2 years) remain highly volatile due to extremely low absolute rates. 5-year ratios fell slightly to 51%, while 10-year ratios compressed to 61%. 30-year ratios fell from 86% at the end of 2020 to close out the quarter at 73%.

Muni-to-Treasury Ratio Curve



3/31/2021; Source: Bloomberg

These lower ratios are clear byproducts of the strong technical influences we outlined above. The ultimate impact, if and when these ratios correct to levels considered more historically "normal," will likely be just a period of short-term underperformance for the municipal market versus the Treasury market.

Credit Trends

Revenue bonds outperformed general obligation bonds by 25 bps during the quarter, with the Hospital, Transportation, and Leasing sectors leading the way. The Bloomberg Barclays AAA Muni Index, which posted a loss of -0.90% during the quarter, lagged the performance of the Bloomberg Barclays A and BBB Muni Indices by 96 bps and 228 bps, respectively. This was the third consecutive quarter that the Bloomberg Barclays BBB Muni Index outperformed the Bloomberg Barclays AAA Muni index by more than 200 bps. The Bloomberg Barclays High Yield Municipal Index was higher by 2.11%. States with pension-funding concerns, such as Illinois and New Jersey, were strong performers in this risk-on environment (Illinois was the best performing state with a return of +1.14%).

Federal Initiatives

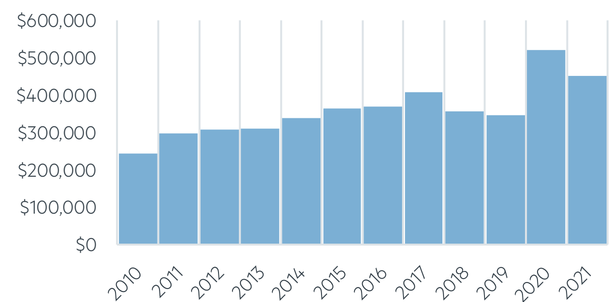
The four key themes mentioned in the introduction will remain important topics for municipal bond investors. The pace of the vaccine rollouts around the country, combined with reopening of local economies, should provide much needed economic relief as business conditions begin their return to normal. The impact of the $1.9 trillion American Rescue Plan Act of 2021 allocates $350 billion in direct aid to state and local governments – a massive influx that should help solve any short-term budgetary issues that governments have struggled with since the pandemic began. The prospects for higher corporate and individual tax rates have also directly led to a marginal increase in demand for tax-exempt income. And the initial discussions around a long-awaited Federal jobs, infrastructure, and green energy proposal — possibly as large as $2 trillion — would also be seen as a potential credit-positive for municipalities by shifting a portion of that maintenance burden away from state and local agencies. We view all of these as positive themes for municipal bonds that should continue to support the market into the second quarter and possibly through the remainder of 2021.

Taxable Market

By: Brian E. Ferry, Senior Portfolio Manager

The influx of cash to American citizens, companies, localities, and states benefited fixed income spread sectors and led to outperformance against their Treasury benchmarks across the board in the first quarter of 2021. Corporate spreads were stable throughout the quarter despite volatility experienced in equity markets. Investment grade companies borrowed $451 billion in the first three months of the year. In terms of borrowing, it was the second largest 1Q of all time, but a 13% drop from the same time period last year. The decline might seem significant; however, it was because of the massive amount of borrowing companies did last year to fund themselves through the pandemic. The option-adjusted spread (OAS) of the Bloomberg Barclays Corporate Index declined to near its lowest level in over a decade and finished the quarter at 91 bps, a 5 bps decline from December. The positive spread return along with carry allowed the Index to outperform Treasury bonds by 95 bps in the first quarter.

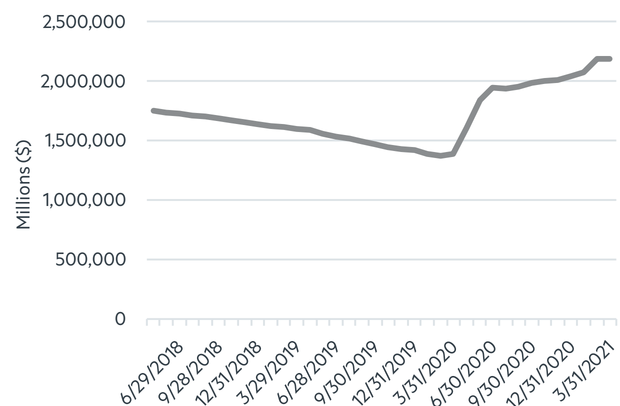
1st Quarter Corporate Issuance



3/31/2010 – 3/31/2021; Source: Bloomberg

Taxable municipal bonds strongly outperformed their corporate counterparts after trailing for much of the previous year. The Bloomberg Barclays Taxable Municipal Index significantly outperformed Treasury bonds by 378 bps, which also outpaced their corporate peers mentioned above. The passage of the $1.9 trillion stimulus bill clearly bolstered investor confidence in the sector along with the vaccine progress and the gradual reopening of the U.S. economy. Taxable municipal issuance continued at a healthy clip and increased 10% from the previous year to total $33 billion in the first quarter of 2021. The "back to normal" issuers mentioned in last quarter's write-up were once again the biggest winners in the sector.

Fed Mortgage Holdings



4/30/2018 – 3/31/2021; Source: Bloomberg

The credit sectors mentioned above most likely benefited more from the fiscal package than from monetary stimulus, but there was no doubt the mortgage market was the biggest beneficiary from the commitment by the Fed to ongoing asset purchases at their March meeting—specifically, the $40 billion a month in Agency Mortgage Backed Securities (MBS). The Fed held over $2 trillion in Agency MBS securities at the end of the quarter. The Bloomberg Barclays US MBS Index was able to squeak out a small outperformance of 15 bps in the first quarter. The contributing components of coupon return and price performance were able to offset the faster prepayments the sector experienced.

The unrelenting liquidity from both fiscal and monetary authorities paved the way for spread sector outperformance in the first quarter. The increased vaccine distribution along with the gradual reopening only added to investor optimism. Bond investors paid a small price in the form of negative total returns in the first quarter for the benefit of U.S. citizens, companies, and localities to receive both cash payments and refinancing opportunities. The questions going forward are what is the true cost of the stimulus and will it have long-term positive or negative effects. In the near term, interest rates and credit seem to be in a goldilocks scenario, but as we learned in the first quarter of last year, markets can change abruptly. It is incumbent on us, as your fixed income managers, to know both sides of the coin; to know when markets have run too fast and when they have sold off too low— both of which we have experienced over the past 12 months.

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