WASMER SCHROEDER STRATEGIES

Quarterly Bond Market Overview

December 31, 2021

Step Away from the Punch Bowl

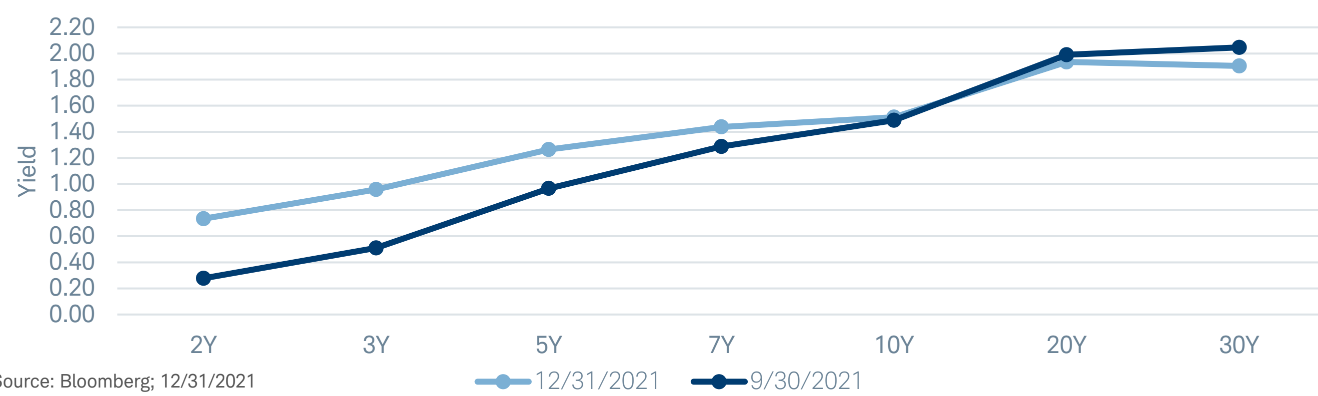
By: Thomas N. Richmond Jr., Co-Head of Wasmer Schroeder Taxable Bond Strategies

The economic backdrop in the fourth quarter of 2021 was somewhat uneven. Domestic GDP growth reaccelerated in October and November (it had dropped to 2.3% in Q3 but is estimated to have grown close to 7% in Q4), as holiday shoppers, hearing dire predictions for shortages of many potential presents, got busy much earlier in the season than usual, and the pandemic, still somewhat in charge after almost two years, allowed for near normal economic activity for a time. As we all know, the emergence of the Omicron variant in late November put a damper on activity into the end of the year, especially in sectors like travel and entertainment. Nonetheless overall economic performance remained strong, driven by consumers and businesses with cash to spend.

The word of the quarter in the U.S. was inflation. Data reports on the level of prices for almost everything throughout the quarter showed year-over-year increases not seen in decades. The Core Personal Consumption Expenditures (PCE) deflator, the time-tested and preferred measure of the U.S. Federal Open Market Committee (FOMC), hit 4.7% on an annualized basis in December, a level last seen briefly in 1989 and not seen on a sustained basis since 1983. The headline Consumer Price Index was last reported at 6.8%, and the Producer Price Index sits at 9.6%. It turns out that the Federal Reserve was now admittedly wrong on both the magnitude and the persistence of this supply-chain-bottleneck and worker-shortage inspired phenomenon.

Perhaps the members of the FOMC and its newly reappointed Chairman Jerome Powell deserve some amount of credit. By the standards of decades of slow-moving policy stance and communication changes, the Federal Reserve not only recognized and voiced its mistake, but they also took quick action in response. As speaker after speaker and statement after statement rolled out over the quarter (and into 2022), the FOMC talked time to taper, tapered, and tapered even faster their asset purchases. This drew the markets into thinking there will be a much faster liftoff from the effective lower bound of the Fed Funds rate. Even now, they are discussing ways to shrink their balance sheet – all in the space of three months.

US Treasury Curve



Source: Bloomberg; 12/31/2021

The markets listened and seem to be taking the Federal Reserve at its word. Treasury rates have risen, especially in the short end of the yield curve. Futures now see hikes in the Fed Funds rate beginning in a few months and continuing a steady cadence through 2023. Inflation breakevens have fallen recently on the thought that the FOMC is finally on the inflation-fighting case. Will this be how things play out in 2022? No one knows for sure of course, but for now it all seems fairly logical. On a final note, the yield on the 10-year note rose 20 basis points (bps) in the first trading week of 2021, on its way to an 82 basis point rise in 1Q21. The same yield rose 25 bps in the first week of 2022. Does this mean anything? Probably not. The economy is in a much better spot this year and it appears that more fiscal stimulus is off the table for now. However, given the very quiet December trading in the past two years, it does seem like some investors are going from the same playbook. We shall see.

Tax Exempt Market

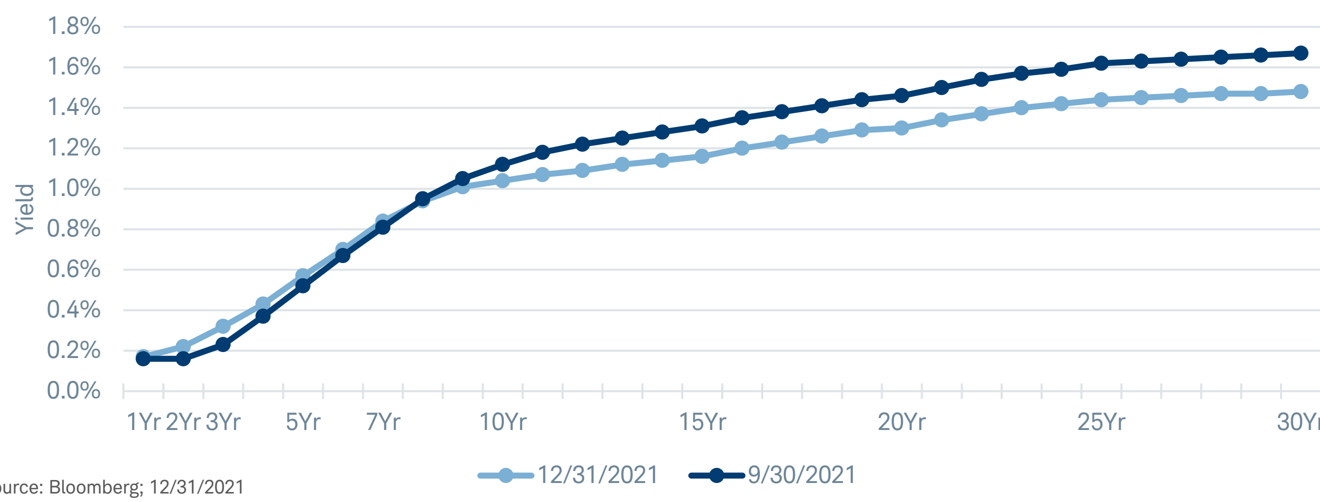
By: Jason D. Diefenthaler, Head of Wasmer Schroeder Municipal Bond Strategies

The municipal bond market got back on track during the 4th quarter with the Bloomberg Municipal Bond Index posting a total return of 0.72%. It was the muni market's 11th positive quarter of performance out of the last 13, and it brought the Muni Index's full year return up to 1.52%.

Tax exempt yields in the front end of the yield curve were roughly 5-10 bps higher during the quarter, reflecting some of the changing sentiment in the Treasury market around the timing of future Federal Reserve rate hikes. To add context to the relatively muted move in municipal yields, 2-year Treasury yields were higher by more than 45 bps during the quarter. 10-year tax exempt yields were lower by approximately 8 bps to end the year at 1.04%, while yields on the long end of the curve were lower by almost 20 bps. Ultimately, the municipal yield curve saw a fairly significant bull flattening move during the quarter with the difference between 2-year and 30-year tax exempt yields declining by 25 bps to +126 bps.

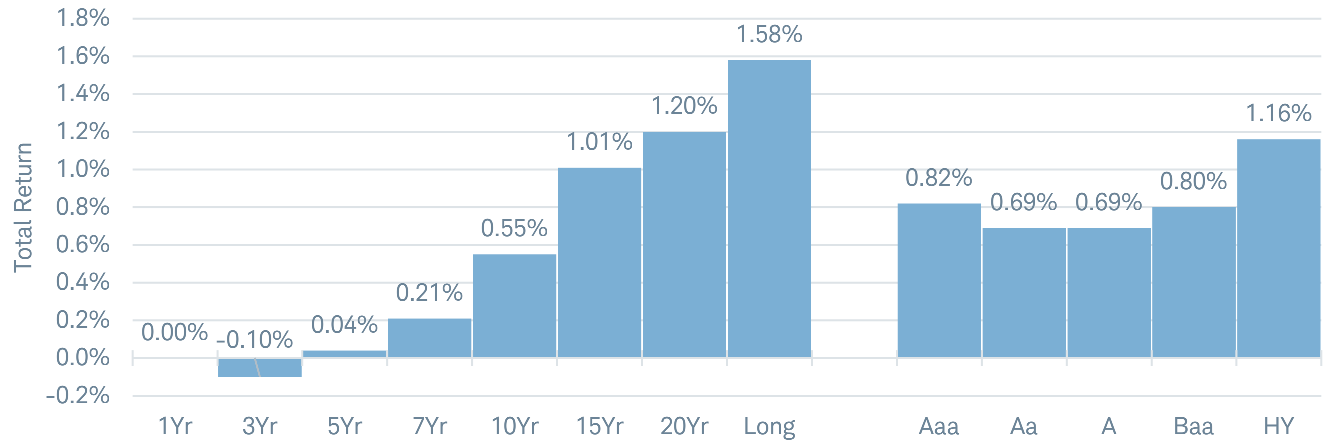
The primary themes for the municipal market during 4Q21 were remarkably consistent with what we have seen throughout most of 2021. Municipal bond funds saw a record year of inflows with investors adding more than $102 billion to funds during 2021, including every week of the quarter. While supply of new debt has remained at healthy levels, the large percentage of taxable issuance plus the elevated demand has provided strong technical support to the market and liquidity conditions. Relative valuations of tax exempt bonds versus other fixed income asset classes remains stubbornly expensive, reflecting those supply vs. demand imbalances. Even growing concerns throughout the quarter around the inability of Congress to pass the Build Back Better spending bill – and what that might mean for tax exempt demand if the risk of higher taxes are off the table – ended up being far less of a headwind for munis than expected. And credit conditions across the market remained highly supportive of owning lower-rated bonds, although the current historically tight credit spread environment, plus uncertainty around the impact of COVID-19 variants, could limit total return opportunities in the near-term.

Bloomberg AAA Municipal Yield Curve



Source: Bloomberg; 12/31/2021

4Q 2021 Bloomberg Municipal Index Returns



Source: Bloomberg; 12/31/2021

Supply and Demand

The $129 billion of total municipal new issuance during the 4th quarter was roughly 11% higher than 3Q21, although taxable muni issuance – which was roughly 23% of all issuance in the 3rd quarter – saw a sizeable increase to 30%. As previously noted, investor demand remained consistently strong as Lipper reported positive net inflows to municipal bond funds in every week during the quarter and ended December on a 43-week net inflow streak.

Muni-to-Treasury Ratios

Municipal-to-Treasury yield ratios were generally lower across the entire yield curve during the quarter. The short end of the curve continues to see the most volatility given the low absolute rates and the outsized impact of just a few basis point shift in either muni or Treasury yields. 2-year ratios plummeted during the quarter to end the year around 30%. 5-year ratios fell to 45%, while 10-year ratios fell to 69%. 30-year ratios saw the least movement but still ended the quarter at a historically tight 78%.

Credit Trends

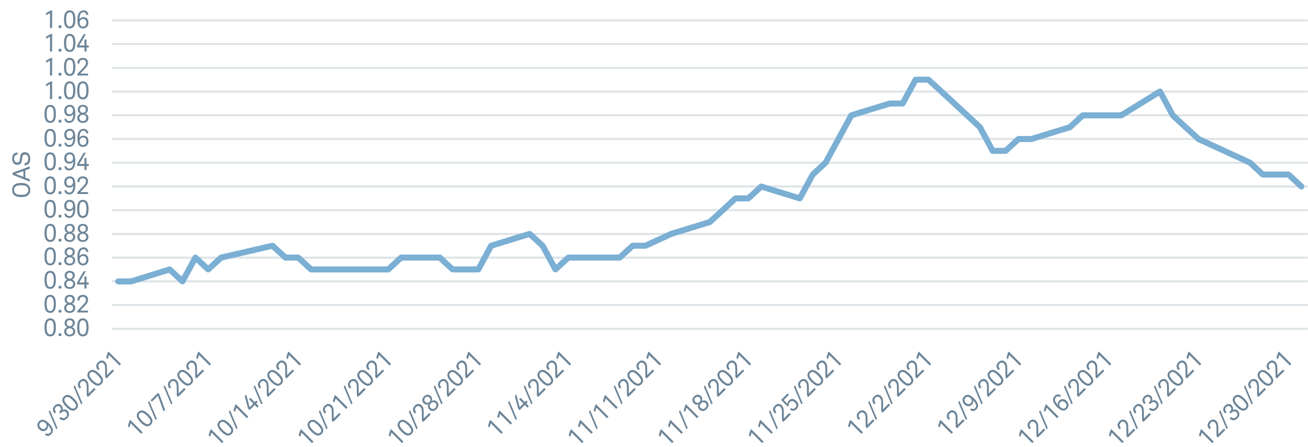
Although the Bloomberg BBB Municipal Index underperformed the AAA Index for the first time in 5 quarters (by just 2 bps), credit spreads across much of the market remain near or below all-time tights. Below investment grade rated credits were again the place to be as high yield municipals outperformed investment grade bonds by 34 bps; this was the 7th consecutive quarter where high yield outperformed and the 18th out of the last 20 quarters. Credit quality trends remain supportive of owning lower rated bonds, although the outperformace of BBB and high yield during 2021 has greatly limited those areas of the market for additional material outperformance. In the current environment, A rated bonds, particularly dedicated tax, general obligation and essential service sectors, still appear attractive on a spread basis. Looking forward, there will continue to be heightened oversight around COVID-sensitive sectors such as airports, stadium/convention centers, and healthcare credits. While the Bloomberg Hospital Muni Index was the best performing investment grade muni sector in 2021, the ongoing pandemic continues to cause operations challenges, including restrictions on profitable elective surgeries as well as higher operating expenses from persistent labor shortages.

Taxable Market

By: Brian Ferry, Senior Portfolio Manager

The beginning of a pullback in monetary support by the Federal Reserve led to the most volatile quarter of the year. In historic terms, volatility in the fourth quarter across taxable fixed income sectors remained very low, but the first three quarters were quiet at times. The demand for yield was still present which kept a cap on how far spreads could move out. In fact, companies were confident enough in market conditions that corporate bonds had their biggest December issuance of all time. The OAS of Bloomberg Corporate Index widened only 8 bps in the quarter and still finished the year below where it started. The Index outperformed by 161 bps on the year. The corporate market slightly underperformed in the quarter, although the tone was very constructive given the backdrop.

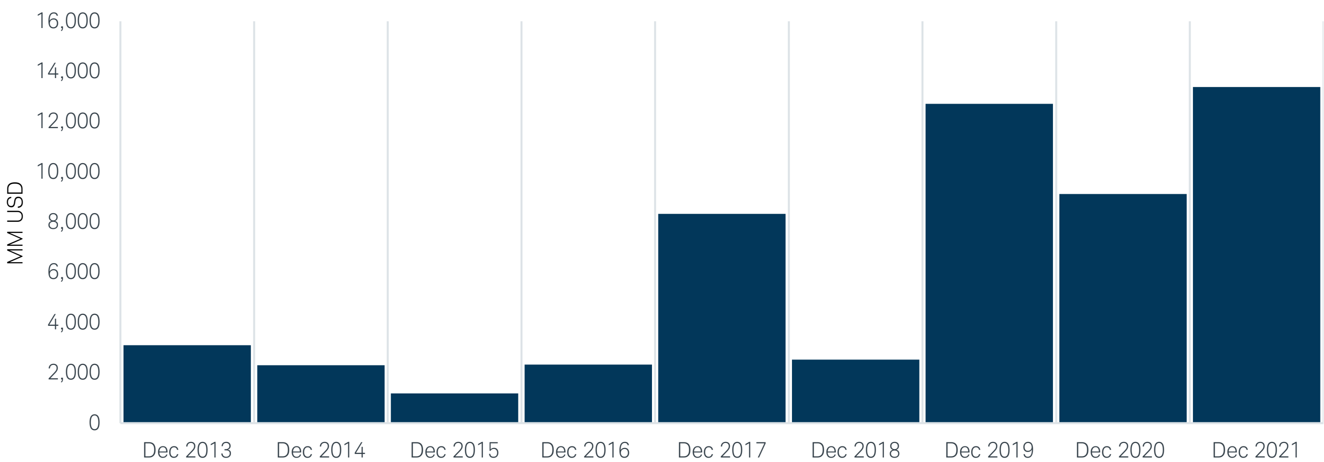
Bloomberg US Corporate Index Option-Adjusted Spread (OAS)



Source: Bloomberg; 12/31/2021

Record issuance did not just take place in the corporate market. Taxable municipals also shared in a record month of issuance in December. For the quarter, the market priced $38 billion of new deals and $138 billion for the year. Supply dropped by 24% from the record pace of 2020, but 2021 was still the second largest year of issuance by over $50 billion. The number of issuers coming to the taxable municipal market continued to grow as well. Investors easily absorbed the heavy supply. The Bloomberg Taxable Municipal: AGG Eligible Index widened slightly on the quarter like its corporate counterparts, although it put in a stellar year of performance by beating Treasury bonds by over 5%.

December Taxable Municipal Issuance



Source: Bloomberg; 12/31/2021

The tough sledding continued in the fourth quarter for the Agency Mortgage Backed Securities market. It got hit not once, but twice by the Federal Reserve. The initial reduction in asset purchases was announced at their November meeting, but the Federal Reserve followed this up by increasing the pace of tapering at the December meeting. Much of the pain was taken in previous quarters leading up to the announcement. The sector underperformed by 26 bps in the fourth quarter. It was not meant to be in 2021 for the mortgage market. Elevated prepayments and the pullback of price support by the Federal Reserve exceeded the minimal return investors received from coupon payments.

There were a few curveballs thrown at fixed income markets throughout the fourth quarter– the swift onset of the Omicron variant and the abrupt change to a more hawkish Federal Reserve to name a few. All things considered the markets absorbed them well. The 10-year Treasury note was only 3 bps higher on the quarter; there were no disruptions to supply trends, credit spreads remained steady, and investors continued to deploy money into the market.

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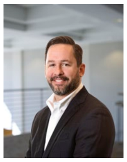

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