WASMER SCHROEDER STRATEGIES

Quarterly Bond Market Overview

March 31, 2022

Fortunately, We've Still Got Seven and a Half More Years…

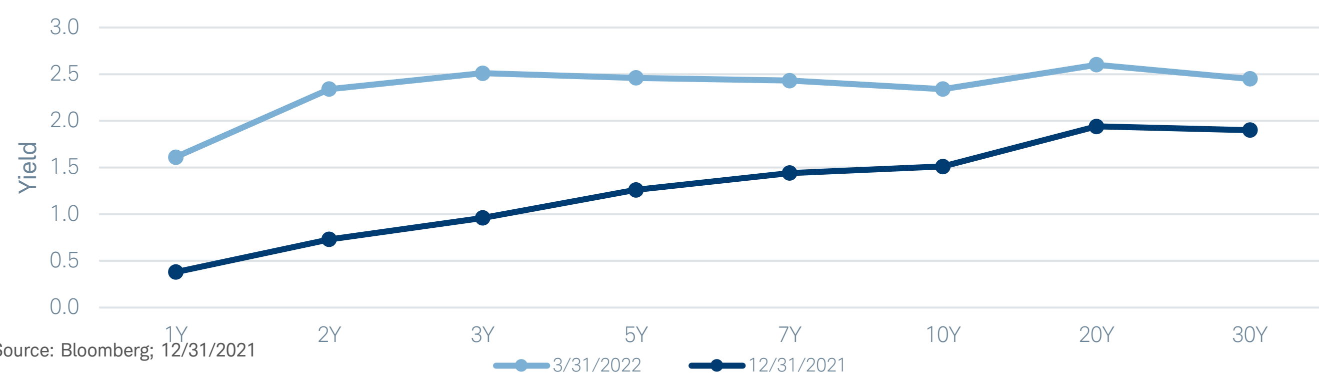
By: Thomas N. Richmond Jr., Co-Head of Wasmer Schroeder Taxable Bond Strategies

As human beings we like to categorize things neatly, and we certainly like to sum up specific periods of time, like decades, in a word or two for ease of memory and historical relevance. Think the Roaring '20s, or the Excessive '80s. When it comes to establishing its legacy, however, the 2020s – let's face it – are off to a miserable start. Sure, January and February of 2020 weren't bad, until a few headlines about a heretofore unknown virus caught everyone's attention as March rolled around. We all know what followed; two years of various levels of pandemic and lockdowns left an indelible mark on society, mental well-being, and the global economy. As if that wasn't enough, just as COVID slowly made a shift from pandemic to endemic, the world got its first taste of war in Europe in over 75 years – adding to already elevated levels of human suffering and mental anguish.

While not wanting to minimize the human toll of the current environment, we are in the business of focusing on the effects of these events on the economy and our financial markets. Here we have a much more uneven story with a few key takeaways. Propelled by unprecedented levels of monetary and fiscal stimulus, economic growth, especially in the US, has been remarkably resilient and the employment situation looks quite strong; wages are rising as more workers return to the workforce, although job openings continue to outpace the number of workers either looking for a job or having the necessary skill set to fill them. These forces have teamed up to create the perfect backdrop for the highest inflation readings in a generation, as supply chain bottlenecks and massive logistical challenges have run headlong into consumers and businesses flush with cash and feeling good about their financial conditions looking to buy very tight quantities of virtually all goods and services. Events in eastern Europe have only exacerbated this situation, making commodity goods like oil and wheat, which are large outputs of those economies, even scarcer.

Central bankers around the world have reacted to this scenario with almost unanimous hawkishness. Years of zero-bound or negative policy rates and massive waves of quantitative easing are starting to be unwound, in some cases quite quickly. This in turn led the world's bond markets to reprice significantly over the course of the first quarter, including in the US. As you will read in the following paragraphs, and as you already know if you are a bond investor, the performance of fixed income assets across virtually all sectors was among the worst in history, as rates all along the maturity spectrum struggled to divine where policy rates might end up once the process of removing monetary accommodation is complete. If there were any silver linings in all of this, liquidity remained healthy despite the added volatility, risk assets held their own especially late in the quarter, and the yields now available in the market are the highest they have been in several years.

US Treasury Curve



Source: Bloomberg; 12/31/2021

Will this decade be able to regain its footing and eventually take its place among other fondly remembered periods of history? Only time will tell. Maybe global peace will regain a foothold, or perhaps the world will find a cure for cancer in the coming years. More importantly for those of us in this business, perhaps the problems outlined here will be solved, this bout of inflation will recede as some experts expect, and the fixed income markets will get back to something more resembling 'normal'. In the meantime, we can only hope for such an outcome and a much touted 'soft landing' for the world's economy, as we continue to look for the opportunities that these 'abnormal' times may present. We are all rooting for you 2020s...don't let us down.

Tax Exempt Market

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

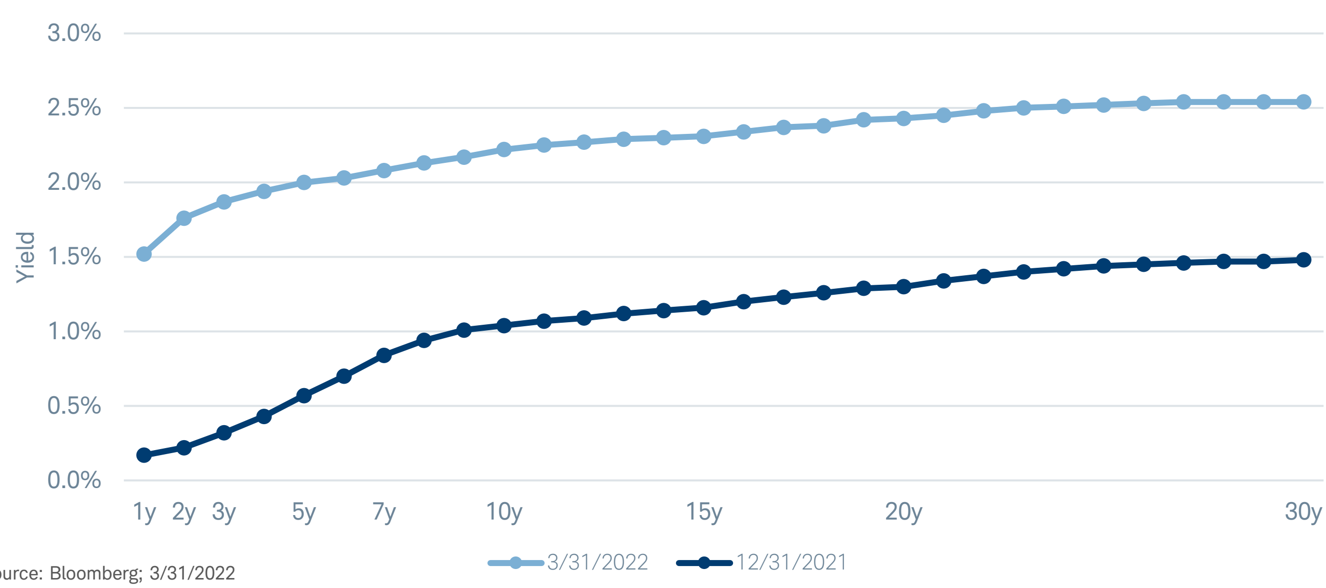
The Bloomberg Municipal Bond Index posted a total return of -6.23% during the first quarter, representing its worst quarter of calendar performance since 1980. The muni market dealt with two primary influences to start the year: higher Treasury yields and softening investor demand. The Treasury market was forced to grapple with a combination of conflicting inputs, including continued supply chain issues, multi-decade highs in inflation, a hawkish Federal Reserve eyeing as many as 8 rate hikes through year-end, and the Russian invasion of Ukraine. Rather than a flight to quality move into Treasuries, concerns over inflation and monetary policy captured the minds of investors as Treasury yields rose by 120 to 160 basis points ("bps") on the short end, 83 bps on 10-year notes, and 55 bps on 30-year bonds. This move wasn't just felt in Treasuries, as the dollar amount of global negative yielding debt fell by 74% during the quarter from $11.3 trillion to $3.0 trillion.

Tax exempt yields exhibited strong links to the move in Treasuries during the quarter, with the correlation of changes in muni yields to Treasury yields at 90% compared to just 30% over the course of 2020 and 2021. Given the tighter correlations, municipal bonds were tethered to the volatility we saw across the broader interest rate market and experienced a significant increase in yields to start the year. According to Bloomberg, 2-year tax exempt yields were 154 bps higher, while 10-year and 30-year yields were 118 bps and 106 bps higher, respectively. For investors in the top federal tax bracket, the taxable equivalent yields on AAA rated municipal bonds ended the quarter 20 to 50 bps higher than A rated corporate bond yields, suggesting an attractive relative value environment for municipal bond investors.

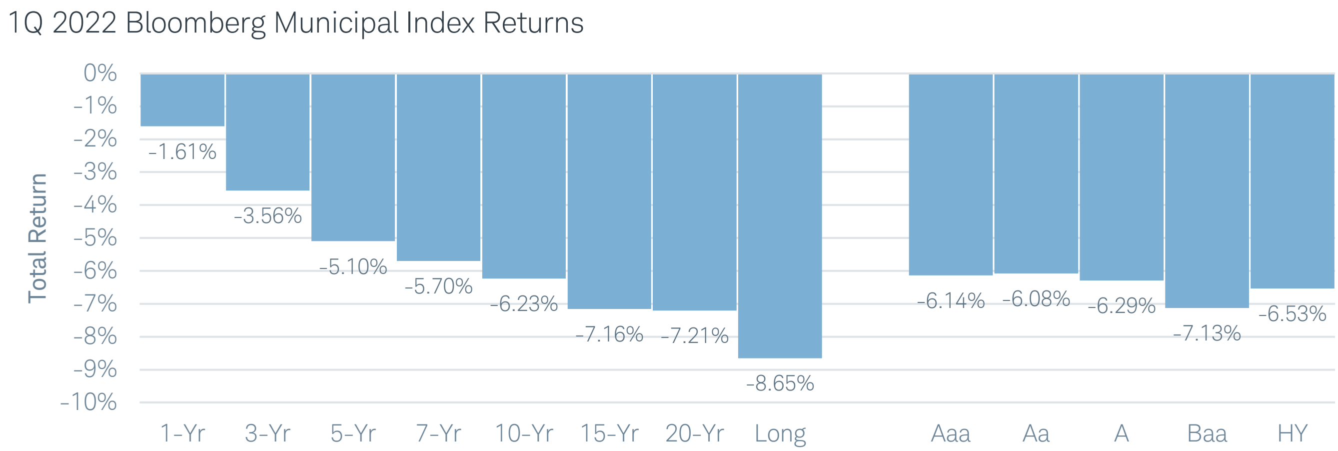
Supply and Demand

The $92 billion of total municipal new issuance during the quarter was roughly 10% lower than the first quarter of 2021, however, issuance was roughly 9% higher than the average first quarter supply environment over the last ten years.

Bloomberg AAA Municipal Yield Curve



Source: Bloomberg; 3/31/2022



Source: Bloomberg; 3/31/2022

The other side of the supply story was faltering investor demand, with the muni market experiencing a remarkable increase in muni mutual fund outflows following a record year of inflows during 2021. Citigroup noted that municipal bond funds ended the quarter riding an 11-week outflow cycle totaling more than -$23 billion; to put that in context, the outflow cycle in March/April of 2020 at the outset of the pandemic was 10 weeks and -$30 billion. However, unlike the 2020 experience where liquidity quickly became challenging, the muni market was well behaved during the first quarter of 2022. While bid/ask spreads widened throughout the quarter, portfolio managers were able to trade efficiently despite the higher yields and investor outflows.

Muni-to-Treasury Ratios

As a result of the investor outflows and softening technicals, municipal-to-Treasury yield ratios were significantly higher across the entire yield curve during the quarter. The short end of the curve continued to see the most volatility given the low ratios and absolute yields entering the year. 2-year ratios began the year at 33% and ended March at 76%. 5-year ratios rose from 45% to 82%, while 10-year ratios increased to 95% from 69%. 30-year ratios saw the least amount of movement but still rose to 106%. These ratios are more in-line with historical averages and indicate increased relative value opportunities for cross-over buyers that alternate investments in either taxable or tax exempt securities depending upon market conditions.

Credit Trends

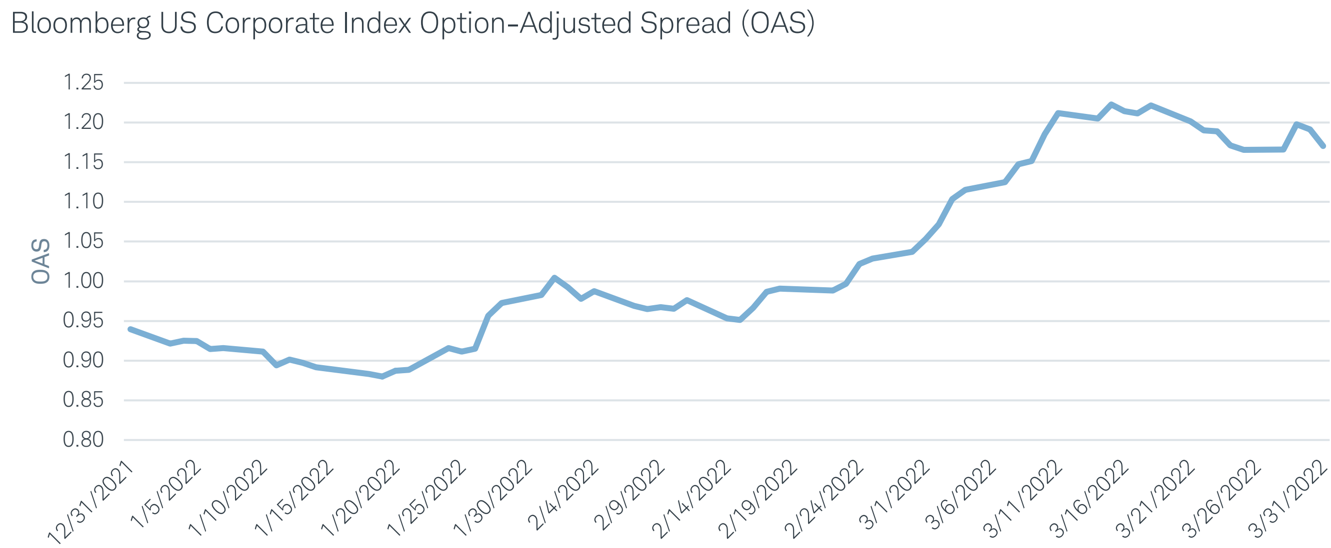
The Bloomberg BBB Municipal Index underperformed the AAA Index for the second consecutive quarter, trailing the Bloomberg AAA Muni Index by 99 bps. However, most of that underperformance was driven by the higher average duration of the BBB Muni Index (6.3 years vs. 5.6 years) rather than by widening risk premiums. According to Municipal Market Data (MMD), credit spreads on A rated bonds widened by just 21 bps during the quarter while BBB rated bonds widened by 23 bps.

The relative firmness of credit was somewhat remarkable given the price action across the broader municipal market during the quarter. Sharp sell-offs in municipal bonds have traditionally correlated with notable spread widening. The stability in credit spreads during the quarter highlighted not only the strong credit quality back-drop across the municipal market, but also reinforced the nature of the Treasury-driven sell-off that tax exempt bonds experienced. That said, the rise in absolute yields outpaced the increase in credit spreads, making the relative value of owning A and AA rated bonds potentially more attractive on a risk-adjusted basis as we look forward.

Taxable Market

By: Brian Ferry, Senior Portfolio Manager

The corporate bond market had one of its more memorable quarters. The cost to borrow for issuers elevated as new issue concessions blew out, which caused secondary spreads to weaken. The positive; companies were not deterred and continued to borrow. In fact, it was the third busiest quarter of all time for the primary corporate market with $471 billion in new issuance. The market started to mount a comeback late in March, but it was too little too late. The Bloomberg Corporate Index underperformed Treasuries by 145 bps for the quarter and ended 23 bps wider at an option-adjusted spread (OAS) of 115 bps.

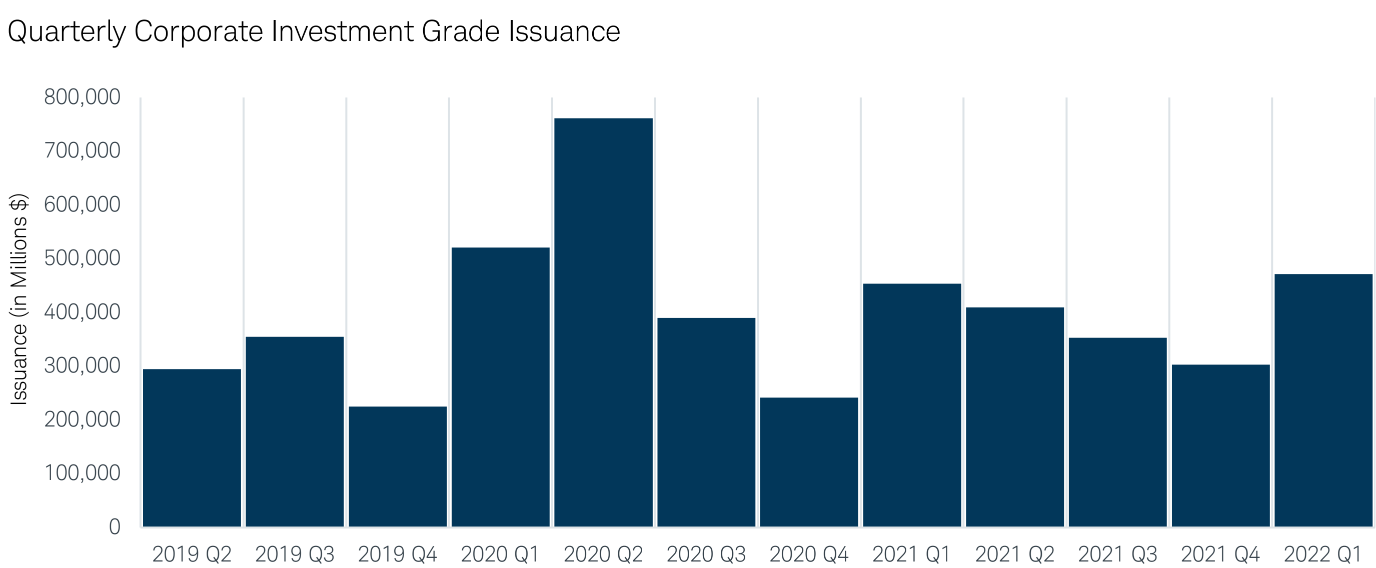


Source: Bloomberg; 3/31/2022

It was a tale of two quarters for the taxable municipal market. The first two months of the year supply was light, and spreads were able to hold firm relative to the poor performance in other credit sectors. January and February each had $5 billion in issuance, whereas March logged $12 billion in new issue supply. The sharp pickup allowed investors to demand higher spreads to more align with the widening that had occurred in other credit sectors. The OAS of the Bloomberg Taxable Municipal: AGG Eligible Index also widened exactly 23 bps in the first quarter like corporates. However, the longer duration of the index resulted in a larger underperformance of 1.99% against like duration Treasuries.

The mortgage market underperformed in each of the first three months of 2022. The Bloomberg U.S. MBS Index lagged similar duration Treasuries by 71 bps in the first quarter. The one bright spot for the sector was the drastic slowdown in prepayments and the associated negative returns. The sharp rise in Treasury yields elevated mortgage rates to levels not seen in many years. However, higher interest rates are a double-edged sword for the mortgage market. The backup in rates extended the duration of the mortgage basis and led to poor price performance against their benchmark securities.

Market participants might not be pleased with first quarter performance but when you factor in the recent experience of March/April 2020 when the new issue market was essentially closed, and secondary liquidity was scarce for a short period, both borrowers and investors might be happy with the somewhat orderly nature of this past quarter. It could have been worse if credit markets didn't hold it together.



Source: Bloomberg; 3/31/2022

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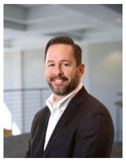

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