Quarterly Bond Market Overview

June 30, 2022

We Wish We Had Better News

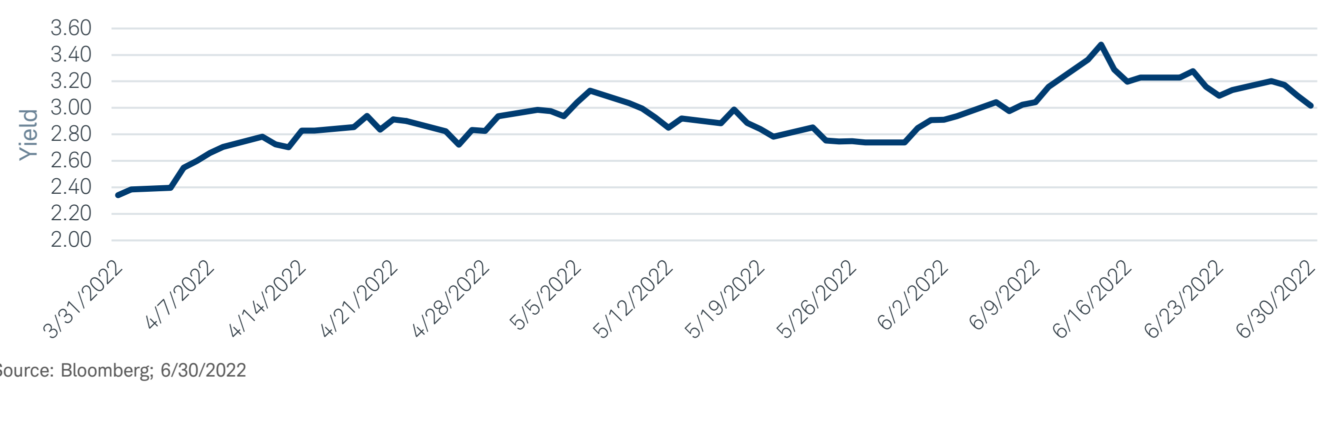
By: Thomas N. Richmond Jr., Co-Head of Wasmer Schroeder Taxable Bond Strategies

When the best thing to be said about the second quarter of this year is that it wasn't as bad as the same period in 2020, when lockdowns due to COVID-19 were in full effect and the global economy collapsed, it tells you a bit about how things went. While death rates and cases of serious illness remained low by pandemic standards, COVID-19 cases remained stubbornly high and on the minds of many wanting to 'return to normal'. The war in Ukraine dragged on, and the human toll remained shocking; further, the shortages of many commodities native to that region of the world remained difficult to overcome. To make things worse, cases of seemingly random violence, including well publicized school shootings, seemed to increase as well. Not a good set of themes for an already weary public, and that doesn't even consider the punishing levels of global inflation hitting these same weary consumers across broad product and service swaths, including in the US where the headline Consumer Price Index sits at 8.6% year-over-year. Not a pretty picture.

One thing the awful second quarter of 2020 had going for it, however, was a seemingly endless stream of both monetary and fiscal policy relief that, as we all know, eventually got the US economy back up and running, and helped many businesses and citizens stay above water in difficult circumstances. This is not the case, of course, in 2022; in fact, in some ways the opposite dynamic is in play. Global central bankers, including our Federal Open Market Committee, are tightening financial conditions – despite the dreary geopolitical and macroeconomic backdrop – in order to control current inflation levels, making an already tough situation, at the margin, tougher. This in turn has caused interest rates to rise and risk assets to stutter, leading to further losses for both bond and stock investors, generally, during Q2.

A good news/bad news situation did develop late in the quarter, at least as far as the bond markets were concerned, and this dynamic has continued into Q3. Market-based levels of future inflation expectations, derived from the yields on both nominal and inflation-protected Treasury bonds, began to fall and, for all but the shortest maturities, now stand in reasonable proximity to the Federal Reserve's stated 2% target. That's good news, as the Federal Reserve's credibility seems to remain intact. Yields on Treasuries began to fall across the yield curve but most strongly in longer maturities. However, fears of inflation seemed to quickly shift to fears of slowing or even negative growth, following reports that GDP in the US fell, in real terms, at a -1.7% annualized rate in the first quarter.[1] Good news, finally, for bond investors, but bad news for the future of the US economy.

10-Year US Treasury Yield



Source: Bloomberg; 6/30/2022

From a market perspective, the best thing we can say about the quarter was that it wasn't as bad for bonds as the first quarter, thanks in no small part to the late-June rally. Most styles did, however, post nominally negative returns, as you will read in the coming pages. Credit spreads were reasonably well behaved although wider, but liquidity remained sufficient, and the pain caused by the widening was far less than that felt in most corners of the equity markets. Volatility was again a very prevalent component of trading, and we suspect that will continue in the coming months as the messiness described above plays out and the mid-term election cycle in the US nears conclusion. Until then, we will continue to hunt for exploitable inefficiencies in our markets, and we certainly hope to have better news to report on all fronts in three months' time.

Tax Exempt Market

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

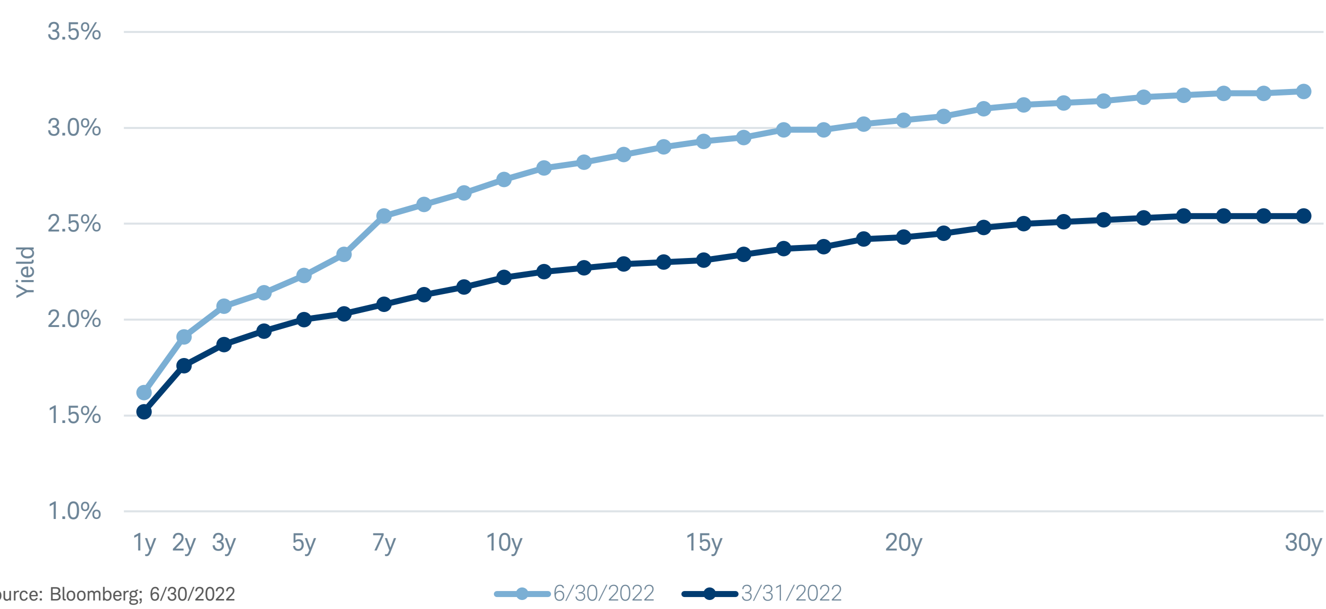
Higher Treasury yields and continued investor outflows from municipal bond funds led the tax exempt bond market to its second consecutive quarter of negative performance. The Bloomberg Municipal Bond Index posted a loss of -2.94% for the three months ending June, bringing the year-to-date return to -8.98%. Many of the same themes that presented headwinds to the market during the first quarter of this year persisted throughout the second quarter. Inflation continues to challenge the Federal Reserve, and the bond market struggled to balance expectations around the path of future rate hikes and what those hikes might mean for an economy that is already showing signs of slowing.

Municipal bond yields continued to exhibit a high correlation to Treasuries during the quarter. 10-year Treasury yields rose by 68 basis points during the quarter while 10-year tax exempt municipal bond yields were higher by 51 basis points to end June at 2.73%. The municipal yield curve steepened quite dramatically, with the spread between 2-year and 10-year yields almost doubling to +82 basis points. Consistent with the first quarter, performance across the market was primarily determined by duration. The Bloomberg Long Muni Index returned -6.59% during the quarter, underperforming the 5-year Muni Index by 617 basis points. Revenue bonds underperformed general obligation debt during the quarter as credit spreads widened.

Supply and Demand

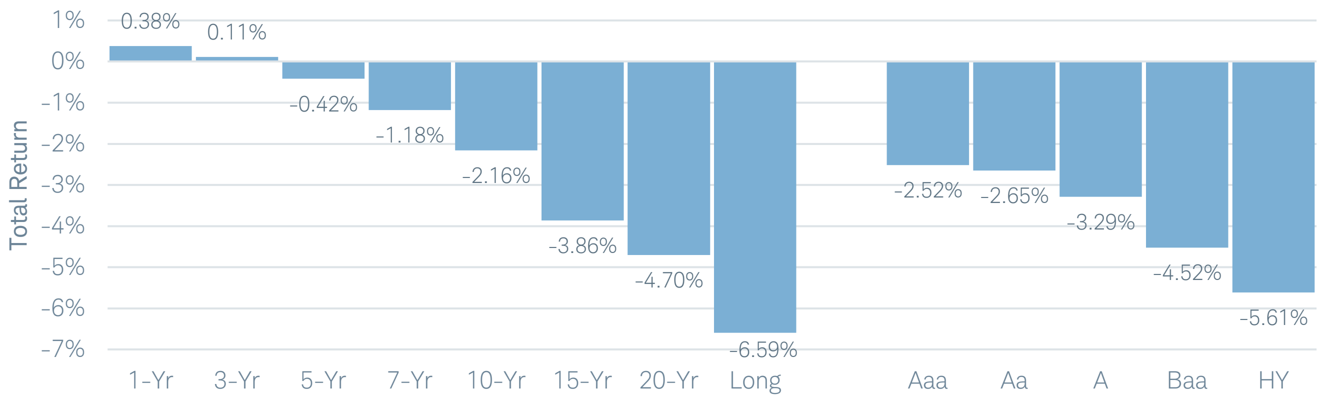
Issuance patterns across the municipal market have remained healthy, although slightly below last year's pace and well below the average estimates from the underwriting community as we entered 2022. Total new issuance through June was approximately $206 billion compared with $226 billion at this time last year. Higher interest rates have certainly had an impact on the pace of new issuance, particularly given the less attractive economics around refunding activity.

Bloomberg AAA Municipal Yield Curve



Source: Bloomberg; 6/30/2022

2Q 2022 Bloomberg Municipal Index Returns



Source: Bloomberg; 6/30/2022

Demand continued to be a wildcard for the market. Refinitiv Lipper reported outflows in all but one week during the quarter, with June experiencing the 3rd largest weekly outflow on record – with $5.6 billion being pulled from municipal bond funds in just one week. For the full year, investors have yanked approximately $74 billion from municipal funds, which is on pace for a record annual outflow after setting the record for largest annual inflow only last year.

Trading conditions in the market remained orderly despite the outflows. June marked the beginning of a three-month seasonal window where reinvestment needs from coupon and maturity payments tend to create significant competition for bonds. For example, July 1st was expected to see roughly $47 billion returned to muni investors, most of which will presumably be targeted for reinvestment back into the market. Given the relatively light supply pattern plus some moderation in outflows during the last few weeks of June, these seasonal technicals might provide decent support for municipal bonds throughout the summer.

Muni-to-Treasury Ratios

Municipal-to-Treasury yield ratios ended the quarter well below the highs they reached in May but still remarkably higher than where they started the year. Ratios on the short end of the curve saw a rather dramatic decline with 2-year ratios falling from 76% to 65%; yields on 2-year munis were only off by approximately 15 basis points during the quarter (compared to an increase of 62 basis points for 2-year Treasuries) which is an indication of just how much demand there is for shorter duration. 5-year ratios rose fell from 82% to 75%, while 10-year ratios fell to 91% from 95%. 30-year ratios fell from 106% to 102%.[2] These ratios suggest that there continues to be value on the intermediate and long end of the tax exempt yield curve, although valuations inside of 5-year maturities are beginning to look somewhat stretched.

Credit Trends

The Bloomberg BBB Municipal Index underperformed the AAA Index for the third consecutive quarter, trailing the Bloomberg AAA Muni Index by 200 bps. This brought the year-to-date underperformance of the BBB Index to 282 basis points. The Bloomberg Municipal High Yield underperformed by 326 basis points. While some of the credit underperformance earlier this year was derived from structural characteristics, like duration and coupon, there has been a clear risk-off component to the recent spread widening as recession concerns have started to mount. Healthcare credits have been notably weaker, with the Bloomberg Hospital Index posting the worst performance across all muni sectors during June at -2.60%.

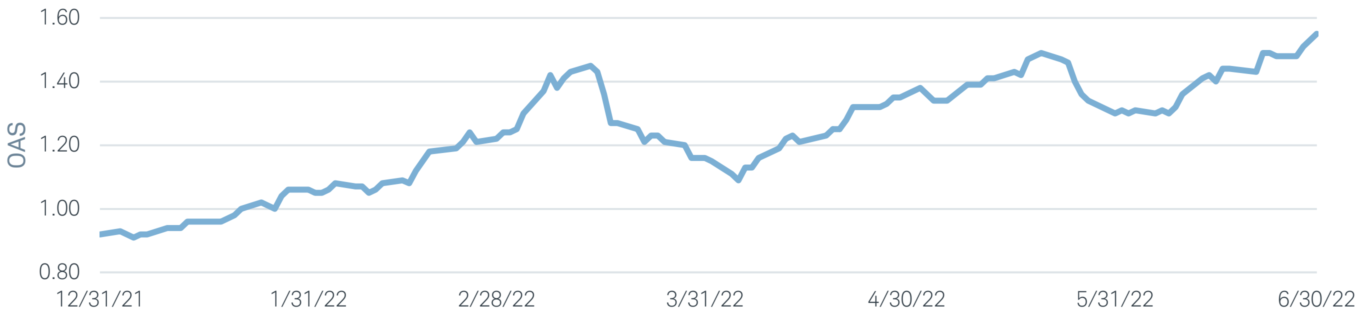
The last two weeks of the second quarter exhibited a more positive tone for bonds, with yields dropping significantly across most fixed income asset classes, including municipal bonds. This renewed demand for yield amidst continued uncertainty around the direction of forward monetary policy, declining inflation expectations (US Breakeven 5 Year inflation expectations fell by 0.34% during June to 2.62%) and a broad slowdown in the domestic economic growth outlook suggests that the bond market may continue to see interest as a flight-to-quality haven. Summer technicals will likely remain a key theme, but as we've been saying, in order for munis to truly stabilize we will likely need to see a decline in Treasury market volatility.

Taxable Market

By: Brian Ferry, Senior Portfolio Manager

The corporate bond market had a tough start and end to the second quarter. April was the worst month of the year for total return (down -5.47%) and June saw the worst relative return to similar duration Treasuries (-1.68% in excess return).[3] May had a slight reprieve with a positive total return, but it couldn't build on its gains into quarter-end. The option-adjusted spread (OAS) of Bloomberg U.S. Corporate Index closed the quarter at 155 bps – its widest level of the year. The escalated volatility not only increased borrowing costs, but also impacted the primary market. Issuance of investment grade corporate bonds fell 15% from the same period last year. In fact, there was one week in June where no deals were issued due to heightened uncertainty.[4]

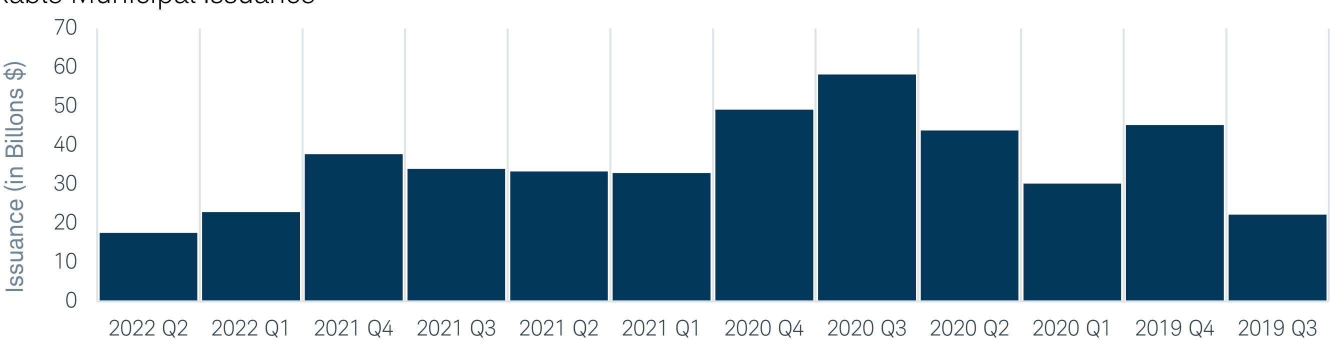
Bloomberg US Corporate Index Option-Adjusted Spread (OAS)



Source: Bloomberg; 6/30/2022

The taxable municipal market had a similar experience to that of the corporate market in the second quarter. The one difference was that outperformance came in June for taxable municipal bonds instead of May, and like corporates the sector suffered a very tough April. The rise in borrowing costs, both due to wider spreads and higher risk-free rates, has reduced supply. Issuance for taxable municipal bonds was down 47% in the second quarter and dropped 40% year-to-date. The drop-off in supply has kept the secondary market firm, but the few new deals that get done reflect a wider, more risk-off environment.

Taxable Municipal Issuance



Source: Bloomberg; 6/30/2022

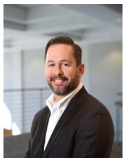
The mortgage market also went one for three in terms of positive monthly performance in the second quarter. The two bad months significantly outweighed the one positive month which resulted in the Bloomberg U.S. MBS Index to have negative 98 bps of excess return for the quarter. In an unusual turn of events, mortgage performance in the second quarter benefited from both coupon and paydown return! Unfortunately, those two combined positive effects couldn't offset the negative price effect due to wider spreads. On a positive note, Jay Powell stated at the June FOMC press conference the Fed would not be selling MBS securities anytime soon which was a temporary relief for MBS investors.

In summary, the trend of higher interest rates and wider credit spreads continued into the second quarter and negatively impacted performance across all spread sectors. Investors have been trying to price in just how high and fast the Fed is willing to raise rates. The almost limitless number of unknowns – from China Covid lockdowns, the Ukraine war and global supply chain issues – has made it a messy process. In June, it was also made clear by policymakers that the fight against inflation was underway and would continue even if there are negative consequences in the near-term.

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

Thomas Richmond is a Senior Portfolio Manager and Co-Head of Taxable Bond Strategies supporting the Wasmer Schroeder Strategies at Schwab Asset Management.

Tom earned his B.S in Computer Science and his M.S. in Applied Mathematics from Rensselaer Polytechnic Institute, where he also minored in Economics and Management.



Jason D. Diefenthaler
Head of Wasmer Schroeder Municipal Bond Strategies

Jason Diefenthaler is a Senior Portfolio Manager and the Head of Municipal Bond Strategies supporting the Wasmer Schroeder Strategies at Schwab Asset Management.

Jason earned his B.S. in Finance from Florida State University.

Brian Ferry, CFA
Senior Portfolio Manager

Brian Ferry is a Senior Portfolio Manager, and he is responsible for co-managing taxable Wasmer Schroeder Strategies at Schwab Asset Management.

Brian earned his BS in Finance from Miami University. He was awarded the CFA Charter in 2016 and is a member of both the CFA Institute and the CFA Society of Cleveland.

1-4 Source: Bloomberg; 6/30/2022.

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