WASMER SCHROEDER STRATEGIES

Quarterly Bond Market Overview

September 30, 2022

It Ain't Easy Being Jay Powell

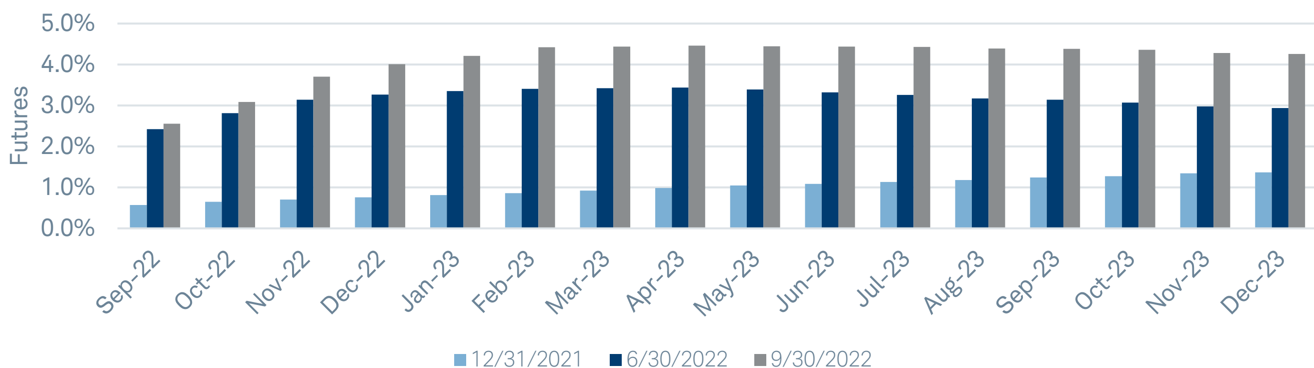
By: Thomas N. Richmond Jr., Co-Head of Wasmer Schroeder Taxable Bond Strategies

If professional athletes carry the weight of the fans and the cities on their shoulders while playing their chosen sports, earning both high praise and abject derision based on their actions on the court or the field, imagine the pressure that comes with being a Governor of the US Federal Reserve, or more pointedly, being the Chair of the Open Market Committee (FOMC). Every word you utter publicly, every policy action you undertake, every dot you plot leaves you potentially open to both praise and derision and, at extreme points in economic history, a legacy of either adoration and admiration or scorn and loathing. This fact is neither unexpected nor unjustified as the Fed's actions, as opposed to a strike out or a dropped pass, can alter lives and livelihoods around the world.

One certain parallel between sports and Central Banking is undeniable: Monday Morning Quarterbacking. It seems every fan has a better idea of how a game should have been played — than the coaches paid and entrusted to make in-game decisions. And, in times like these, every armchair pundit and closet economist seems to know better than the FOMC on how to set monetary policy, despite the massive amount of academic input and data mining available to the members of the Committee. Often the noise is either sour grapes or envy or some other very human response; then again, sometimes the post-game analysis is spot on. In our opinion, this was the case last winter as the Fed was slow to grasp the nature of the inflation that would quickly embed itself in the world's economy, and those calling for a swift and strong policy response were both right and, in the end, heeded by the Fed.

Many armchair Fed governors are now seeming to lean the other way. As we see it, the Chair finally has many (at least bond investors) believing that the Committee will likely continue to tighten policy until the back of the current inflation wave is broken. At the same time, there seem to be a growing number of observers openly opining that the Fed has either already gone, or will go too far, causing pain judged to be too costly in terms of forgone growth and lost jobs — and mostly avoidable. We will not know if that is the case for some time, as both policy reaction and data gathering are subject to significant lags; for now, we only know that, like last fall, the Fed doesn't seem to be listening at the moment.

Fed Funds Futures



Source: Bloomberg; 9/30/2022

The Fed isn't always right, to be sure — look back at the past several years of 'dot plots' and see where the members saw the Fed Funds rate at the end of 2022 for a quick chuckle. However, the Fed oversees monetary policy and remains seemingly quite resolute in their mission to bring inflation down. It is somewhat surprising to us that the market seems to act surprised after each rate hike this year, and it won't be the least bit surprising if this trend continues following the two meetings that remain on the calendar. The Committee will, of course, eventually have to 'pivot' away from the current series of tightening actions, but until they signal such an intention we would expect volatility to remain the main characteristic of bond trading as the markets continue to try to discern the ultimate peak in policy rates, and what that peak will mean into the future.

Tax Exempt Market

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

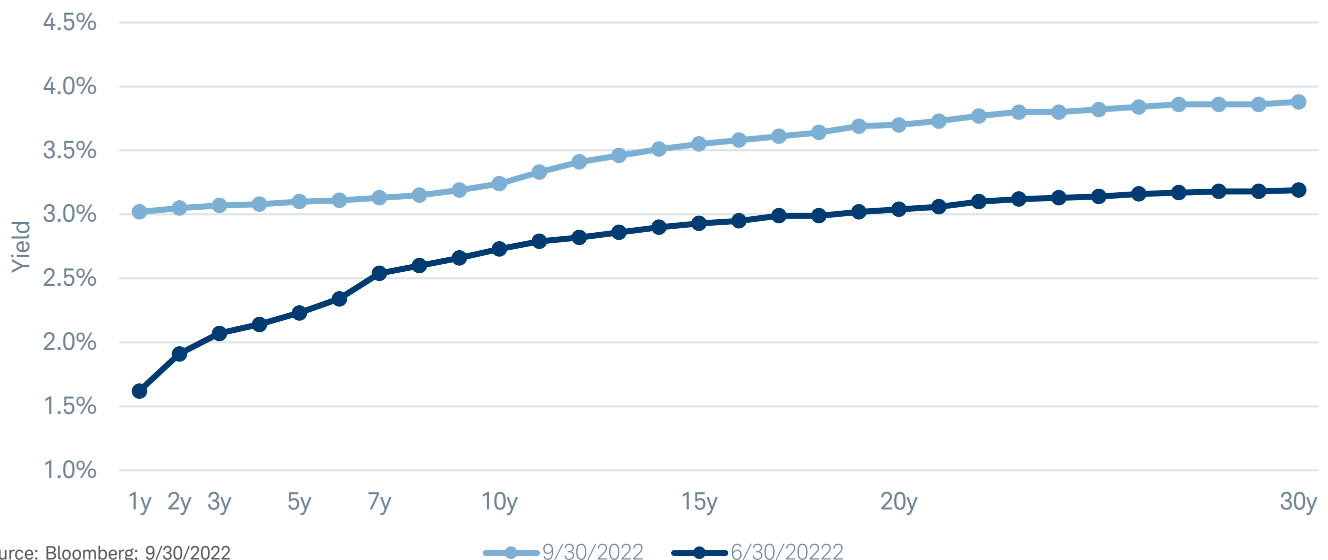
Higher Treasury yields and continued investor outflows from municipal bond funds led the tax exempt bond market to its third consecutive quarter of negative performance. The Bloomberg Municipal Bond Index was down -3.84% for the three months ending September, bringing the year-to-date return to -12.13%. The key narratives that challenged the market during the first half of this year pressed on throughout the third quarter, as the bond market continued to digest the path of the Federal Reserve amidst persistent inflation headwinds and emerging signs of a slowing economy.

Municipal bond yields remained highly volatile during the quarter and were heavily influenced by the higher yields emanating from the Treasury market. 10-year Treasury yields rose by 82 basis points (bps) during the quarter while 10-year tax exempt municipal bond yields were higher by 51 bps, to end September — a near decade high at 3.24%. However, the real action for tax exempt yields was on the short-end of the yield curve, with yields inside of 3-years higher by as much as 140 bps. The dramatic increase in short yields led the municipal yield curve to flatten quite dramatically, with the spread between 2-year and 10-year yields plummeting to just 19 bps. Consistent with the action we've seen throughout 2022, performance across the market was primarily determined by duration. The Bloomberg Long Muni Index returned -5.95% during the quarter and -6.06% just for the month of September; for comparison the Bloomberg 3-Year Muni Index was down only -1.98% during the quarter.

Supply and Demand

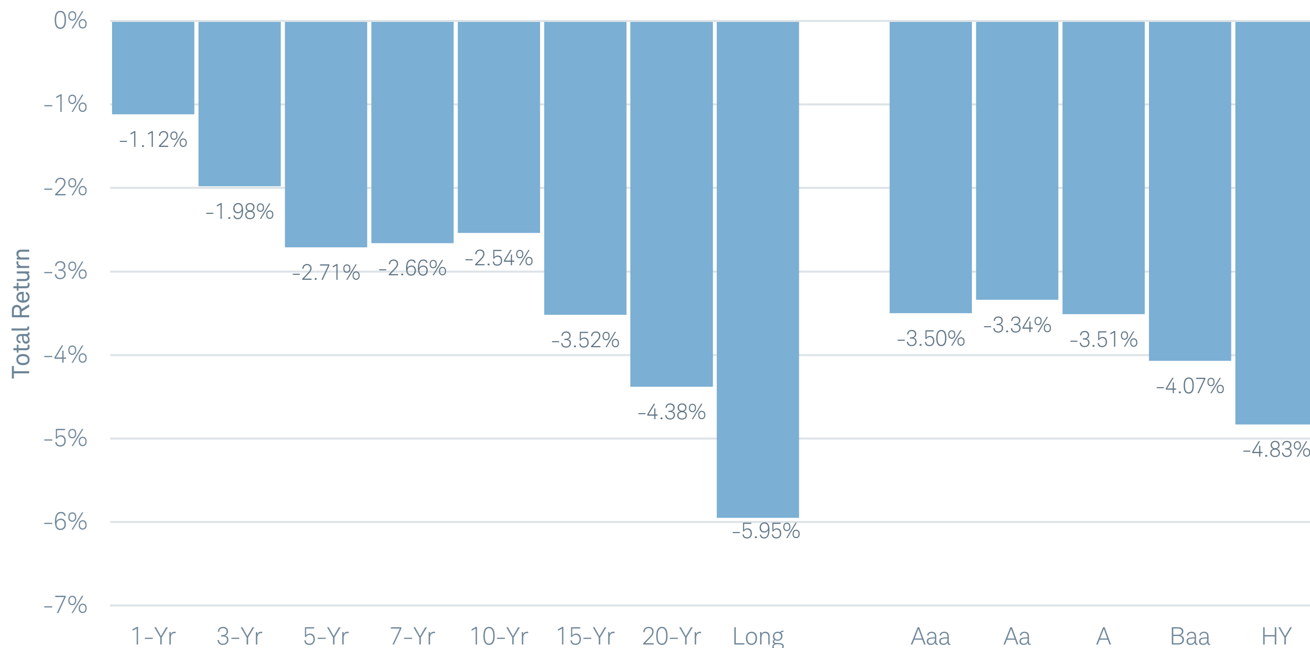
Issuance activity across the municipal market slowed substantially as the quarter wore on and interest rates moved higher. Long term issuance of municipal bonds during the 3rd quarter fell by 24% when compared to the 3rd quarter of 2021, reflecting more hesitancy for issuers to tap the bond market given the higher borrowing costs this year.[1] Total year-to-date new issuance through September was approximately $292 billion compared with $344 billion over the same period last year.[2]

Bloomberg AAA Municipal Yield Curve



Source: Bloomberg; 9/30/2022

Q3 2022 Bloomberg Municipal Index Returns



Source: Bloomberg; 9/30/2022

Demand continued to be a headwind for the market. The Investment Company Institute (ICI) reported weekly outflows from municipal bond funds and ETFs in 9 of the 13 weeks during the 3rd quarter. In total, $14.3 billion in assets exited the municipal market during the quarter, with $8.9 billion leaving in the last two weeks of September alone. For the full year, ICI reports approximately $89 billion in total outflows which is on pace for a record annual outflow after setting the record for the largest annual inflow only last year.

Despite the heightened volatility in yields and fund outflows, trading conditions in the market continue to be orderly. The lower supply backdrop plus reinvestment needs from coupon and maturity payments have helped firm up the soft demand technicals we've seen over the course of this year. New bond deals that came to market remained well subscribed, and dealers have remained active in the secondary market when investors are seeking liquidity.

Muni-to-Treasury Ratios

Relative valuations have improved substantially as absolute rates have risen this year. Municipal-to-Treasury yield ratios ended the quarter at significantly higher levels than where we began 2022, and are now looking attractive across the curve on a historical basis. Ratios on the short-end of the curve saw a considerably dramatic increase with 1-year ratios jumping from 58% on 6/30 to end September at 76%.[3] 5-year ratios rose to 76% after starting the year at 45%, while 10-year ratios declined slightly to 85%. 30-year ratios rose slightly to 103%.[4]

Credit Trends

The Bloomberg BBB Municipal Index underperformed the AAA Index for the fourth consecutive quarter, trailing the Bloomberg AAA Muni Index by 57 bps. This brought the year-to-date underperformance of the BBB Index to 322 bps. The Bloomberg Municipal High Yield underperformed the AAA Index by 133 bps during the quarter, leaving its year-to-date underperformance at 432 bps. As we've previously noted, much of the credit underperformance this year at the index level has been derived from structural characteristics. Investors have been favoring cleaner structures within the market as absolute rates have increased and the need to reach down for sub-optimal call structures or lower coupons to pick up yield has diminished. Nonetheless, we continue to see more economic and cost sensitive sectors – specifically Healthcare – struggle in recent quarters. 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 2nd worst performance across all muni sectors this year, behind only the Housing sector.

Regardless of the weakness in lower rated credits, there were bright spots for municipal credit during the quarter. During September, two of the largest BBB rated issuers in the market were upgraded into the A rated category. The State of New Jersey's appropriation-backed debt was upgraded by Fitch to A- from BBB+, and while the rating agency noted the state's still-significant unfunded pension liability, more sustainable funding practices have gained momentum over the last 2 years as the state's financial profile has improved. And despite the headwinds facing the hospital industry, CommonSpirit Health – one of the largest healthcare borrowers in the muni market – saw its credit rating raised to A- based on operational synergies and significant improvements in balance sheet liquidity.

Looking Forward

The last few weeks of the quarter saw a notable increase in Treasury market volatility, with the ICE BofA MOVE Index reaching levels last seen during the Financial Crisis and the onset of the pandemic in early 2020. While absolute yields in the municipal market are hovering around 10-year highs, and taxable equivalent yields on short duration munis are now in excess of 5% for high tax bracket investors, we anticipate that investor outflows and wide ratios will persist until the Treasury market sees calmer waters. Investors looking to sell bonds in order to harvest unrealized tax losses in their portfolios could also add to choppiness in the muni market over the coming months. However, as we look out the final 6-8 weeks of the year, it is reasonable to anticipate that supply will dimmish (as it often does late in the 4th quarter) which should present tailwinds for a market looking to wrap up a difficult year of performance.

Taxable Market

By: Christopher Sheehan, Senior Portfolio Manager

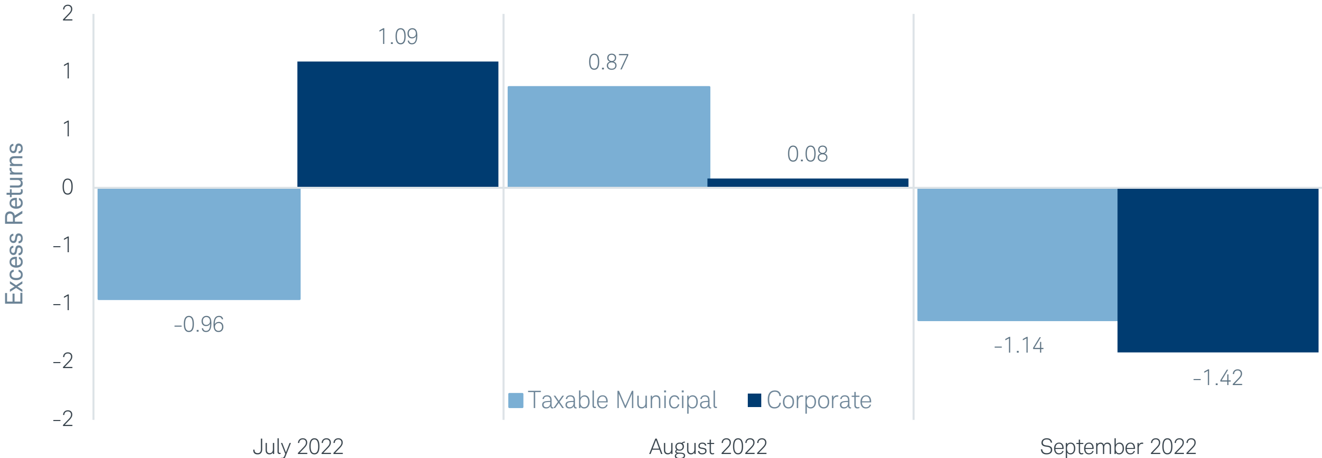
What was a quarter chronologically, felt like a decade in the corporate market, and while the end results felt relatively modest, the ride was definitely not for the faint of heart. Corporates had a very strong July with the Bloomberg US Corporate Index generating 109 bps of excess return and tightening by 13 bps. August saw a boom in issuance with $115.9 billion coming to market, and despite the increased issuance the index was still able to generate 8 bps of excess return.[4] Then September hit and volatility returned in a big way; during the last week of September the index widened 13 bps alone.[5] Issuance decreased drastically from $116.9 billion in August to $82.4 billion in September amid the increased market volatility.[5] When the dust settled the index generated -142 bps of excess return in September and widened 19 bps on the month.[6] The Bloomberg US corporate index finished the quarter 3 bps wider to close at +158 option-adjusted spread (OAS) and generated -33 bps in excess return.[7]

Bloomberg US Corporate Index Option-Adjusted Spread (OAS)

Source: Bloomberg; 9/30/2022

Taxable municipals demonstrated similar themes to corporates but were held back by a weak July. In July taxable municipals had negative excess returns of -96 bps, which was a significant underperformance relative to corporates. The Bloomberg Taxable Muni: Agg Eligible Index widened 12 bps during the quarter to finish at +139 OAS – the widest level of 2022. Issuance in taxable municipals has decreased to about $50 billion thru the end of the third quarter compared to over $100 billion during the first three quarters of 2021.[8]

Excess Monthly Returns – Corporate Bonds vs. Taxable Municipals



Source: Bloomberg; 9/30/2022

Despite having the best month of the year in July, with the Bloomberg U.S. MBS index posting 129 bps of excess return during the month, it turned out to be a tough quarter for the mortgage market. Investors responded positively to Jay Powell not mentioning selling MBS at his July press conference before the headwinds that we have seen for most of the year returned into focus. Market volatility, extension dynamics, uncertainty over the Fed's quantitative tightening program and the health of the US housing market all weighed heavily on investors. During August and September, MBS had a two-month excess return of -292 bps to end the quarter. September was the worst month for the sector in decades. The index finished the quarter with an excess return of -169 bps.

In summary, the themes we expressed that were weighing on the market at the end of last quarter still ring true and even with a significant amount of volatility and the passage of time, there has not been any meaningful clarity for market participants about when these concerns may start to dissipate. The war in Ukraine is still ongoing, supply chains are still having issues, and Central Bankers across the globe continue to raise rates in an effort to fight inflation; this has proven to be a very difficult backdrop for risk assets.

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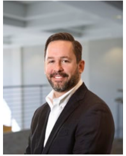

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Sources 1-8: Bloomberg.

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