WASMER SCHROEDER STRATEGIES

Quarterly Bond Market Overview

March 31, 2023

Never a Dull Moment

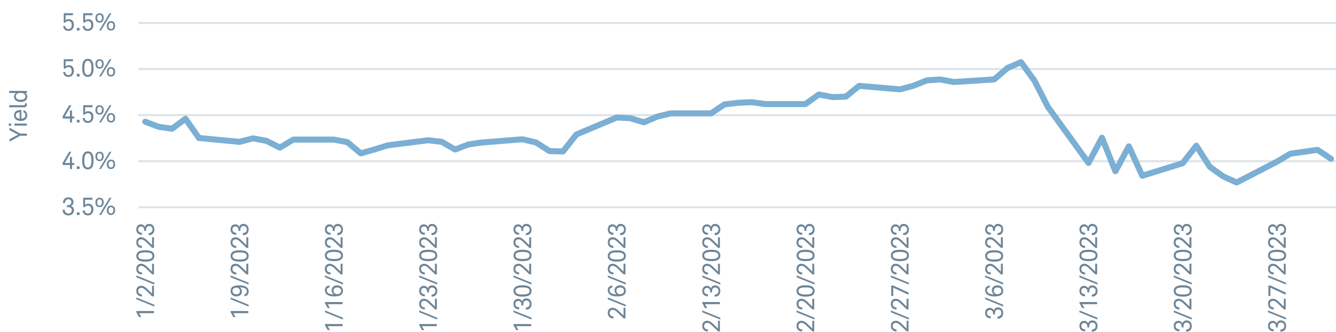
By: Thomas N. Richmond Jr., Co-Head of Taxable SMA Strategies, Senior Portfolio Manager

The first quarter of 2023 was certainly an interesting and action-packed time in the bond markets. With COVID more or less relegated to the back pages and no new, attention-grabbing political or geopolitical headlines to preoccupy market participants, investors were left to focus on the macroeconomic picture and how it might influence future monetary policy. Inflation in most of the developed world continued to run well above levels targeted by these countries' central banks. This, combined with a still-tight labor market in the US, for instance, led the Federal Open Market Committee (FOMC) to tighten policy rates twice more, for a total of 50 basis points (bps), bringing the top of the target range to 5%. This was not a surprise; Federal Reserve officials had spent virtually all of 2022 trying to convince the markets that they would keep raising rates until inflation began to fall meaningfully, which it had thus far failed to do.

What changed, at least for the first ten weeks of 2023, was that investors finally bought into the Federal Reserve's rhetoric. Into early March, Treasury yields had moved up smartly, and the yield curve had inverted to historic levels, with 2-year yields hitting 5.07%, their highest level since 2006, and the spread between 2- and 10-year maturities hitting a closing high of -109 bps, the curve's deepest inversion in decades. Fed Funds futures, which were predicting a peak rate of around 4.7% at year end, well below the Federal Reserve's own guess of 5.1%, rose as high as 5.6% as inflation remained high and unemployment remained low. Then, of course, came March 9, 2023.

That morning, Silicon Valley Bank (SVB) announced an ill-conceived plan to raise capital and the deposit run was on. By Friday afternoon, the Federal Deposit Insurance Company (FDIC) had stepped in and taken over SVB, and by Monday morning they had taken over Signature Bank in New York as well. As rumors swirled around other names in the banking sector, markets reacted violently; 2-year notes fell from that 5.07% level to 3.98% in the space of just three trading days, and as noted below, risk was repriced across all asset classes. The Federal Reserve, for its part, while still wanting to tighten monetary policy with one hand, announced several new liquidity measures and programs with the other. The big question moving forward will be whether this somewhat dissonant set of moves will eventually have the desired effects of lowering inflation and providing stability to the banking sector without dramatically slowing the economy.

Two-Year Note Yield



Source: Bloomberg; 3/31/2023

ICE BofA MOVE Index

This is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the CT2, CT5, CT10, and CT30. (weighted average of 1m2y, 1m5y, 1m10y and 1m30y Treasury implied vols with weights 0.2/0.2/0.4/0.2, respectively).
Source: Bloomberg; 3/31/2023

For now, the word of the hour has been and continues to be volatility. The two charts here show this in detail, as rates continue to whipsaw with large intra- and inter-day moves, and mathematical measures of market volatility remain just off their highest levels since the Great Financial Crisis. We expect this volatility to continue in the quarter ahead. The questions that all investors will have to contemplate, like the one above, are difficult to answer, and are made more complicated by the fact that it feels like the economy, the Fed, and the markets are all at or near pivots of some sort. This will likely have implications for rates and credit, and will undoubtedly involve challenges; it will also undoubtedly provide opportunities as markets reassess value. It is going to be a bumpy ride, but it should be quite interesting.

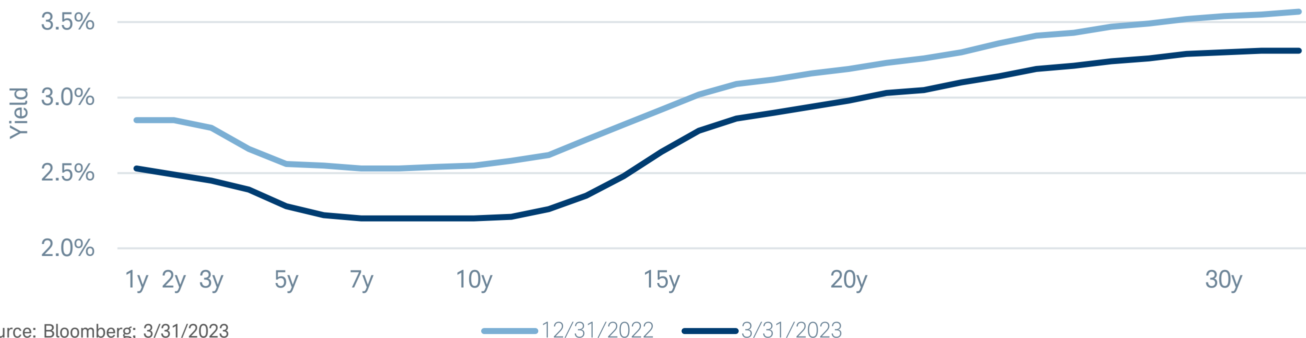
Tax Exempt Market

By: Jason D. Diefenthaler, Managing Director and Head of Tax-Exempt Strategies

The municipal bond market has experienced a period of strong investment performance over the first three months of 2023 as Treasury yields fell due to a variety of factors. Investors grappled with signs of a slowing global economy, uncertainty about additional Federal Reserve rate hikes, tighter financial conditions, and turmoil in the banking sector. These factors contributed to a fairly abrupt decline in Treasury yields, particularly during March's bank-run induced flight-to-quality rally. These same factors were also the primary drivers of the positive returns seen across the municipal bond market during the quarter, with tax exempt yields lower by 20-40 basis points (bps) across the yield curve.

The Bloomberg Municipal Bond Index produced its second straight quarter of positive performance with a total return of 2.78%, which brought the Muni Index's return since 10/31/22 to 7.89%. Longer duration securities outperformed short and intermediate duration bonds during the first quarter. The Bloomberg Long Municipal Bond Index was up 4.27% over the period, compared with a positive total return of 1.93% for the 5-Year Muni Index.

Bloomberg AAA Municipal Yield Curve



Source: Bloomberg; 3/31/2023

Lower quality, A and BBB rated investment grade municipal bonds outperformed AAA rated municipals during the quarter as investors were seemingly taking on more credit risk in their search for yield. Municipal credit quality continues to benefit from prior rounds of Federal COVID-related stimulus payments, which provided much-needed support to state and local governments struggling with the economic fallout from the pandemic. Additionally, the State of Illinois had its credit rating upgraded by Moody's and S&P to the A rating category, which boosted investor confidence in the state's financial health and caused Illinois to be one of the strongest performing states during the period.

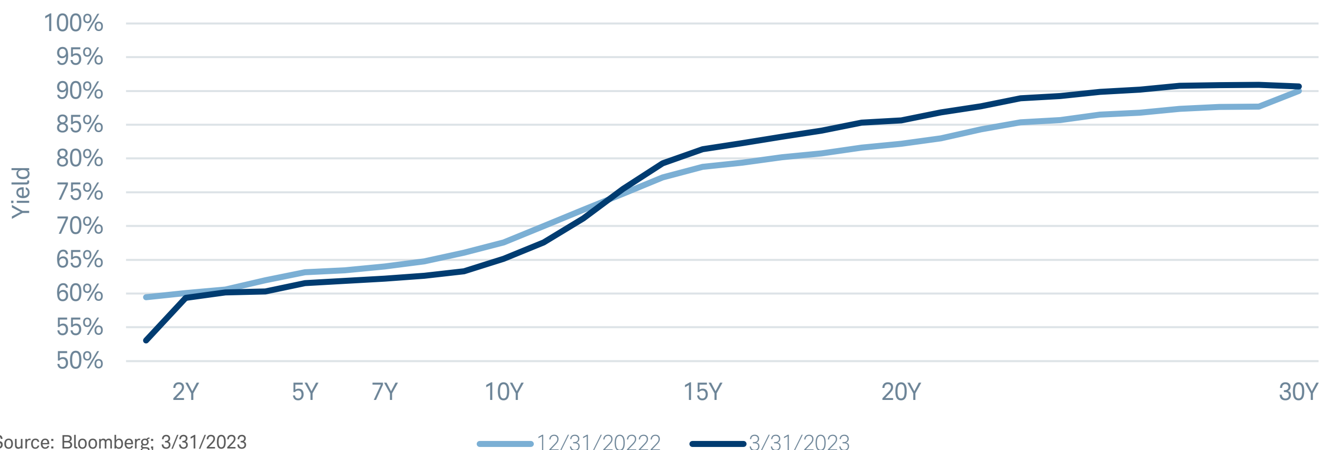
It is worth noting that the impact of Silicon Valley Bank's failure on the municipal bond market was relatively muted. While the bank's collapse did create some volatility in the broader financial markets, the impact on the municipal bond market was limited, as the vast majority of municipal bonds are issued by state and local governments with strong credit ratings. That said, there are certain sectors and bond structures in the municipal market where banks serve as bond obligors, typically referred to as "gas pre-pay" bonds. We did see a degree of spread widening in this sector; however, the impact across the broader market was minimal.

One additional factor that contributed to the strong performance of municipal bonds over the past three months was the technical backdrop across the market. There was a distinct moderation of retail investor outflows from municipal bond funds during the quarter, particularly compared to the record pace of outflows during 2022. Fewer investor redemptions meant mutual funds were making fewer bonds available for sale, creating an element of scarcity demand during a period in which the issuance of bonds was much lighter than expected. This constructive supply and demand backdrop, combined with cash reinvestment needs from coupon and maturity payments, created favorable technical conditions across the market and was an additional contributor to the positive performance during the quarter.

The strong technical conditions left municipal-to-Treasury yield ratios trading within a fairly narrow range during the quarter. 2-year ratios were generally in the range of 50-60%, while 5- and 10-year ratios stayed mostly within the 60-70% band. These ratios inside of 10-years do appear relatively tight when compared to their longer term averages, which is a nod to the strong technical conditions described in the prior paragraph. 30-year ratios appear somewhat attractive on a historical basis in the low-90% range, however, investors looking to take advantage of this area of the curve should understand the risk vs. reward tradeoffs involved with owning long duration bonds in a volatile yield environment.

The value proposition within the market continues to be clouded by the inversion of the municipal yield curve from 2-year yields (2.39%) to 10-year yields (2.26%). An inverted yield curve has been historically seen as a sign of an impending recession, as it may indicate that investors are willing to accept lower yields on longer-term investments because they expect rates to fall in the future. While the current inverted yield curve does not necessarily indicate an imminent recession, it does suggest that the outlook for future economic growth is uncertain. Meanwhile, the slope of the curve beyond 10 years remains quite steep, which suggests some value can be had by investors with a longer-term investment horizon and a higher tolerance for the volatility that can come from longer duration bonds. The spread between 10-year and 30-year maturities (10s30s) ended the quarter at +105 bps, which is the steepest reading since early 2016 and significant wider than the +17 bps spread exhibited in the 10s30s Treasury market slope.

Municipal-to-Treasury Yield Ratios



Source: Bloomberg; 3/31/2023

Looking ahead, there are several factors we are monitoring that have potential performance implications for municipal bond portfolios. The inverted yield curve described above suggests that there is some uncertainty about future economic growth, which could lead to increased volatility in the market. This led us to make slight adjustments to certain strategy targets that amounted to a tilt towards a barbell structure, essentially reducing allocations to the 5-10 year area and reallocating those exposures to 1-5 year bonds and +10 year bonds. Additionally, tighter financial conditions could lead to certain revenue sectors, like industrial revenue (corporate-backed), healthcare, and private higher education, exhibiting weaker credit quality metrics. This scenario could potentially create a degree of bifurcation across the market where we see the performance of higher quality, more traditional municipal bond structures (like general obligation and essential service revenue sectors) outperform the more economically sensitive sectors described above. This latter scenario will be heavily dependent on the economic picture over the coming months and quarters, and whether the Fed is able to successfully engineer a soft landing and avoid a deeper, longer lasting economic downturn.

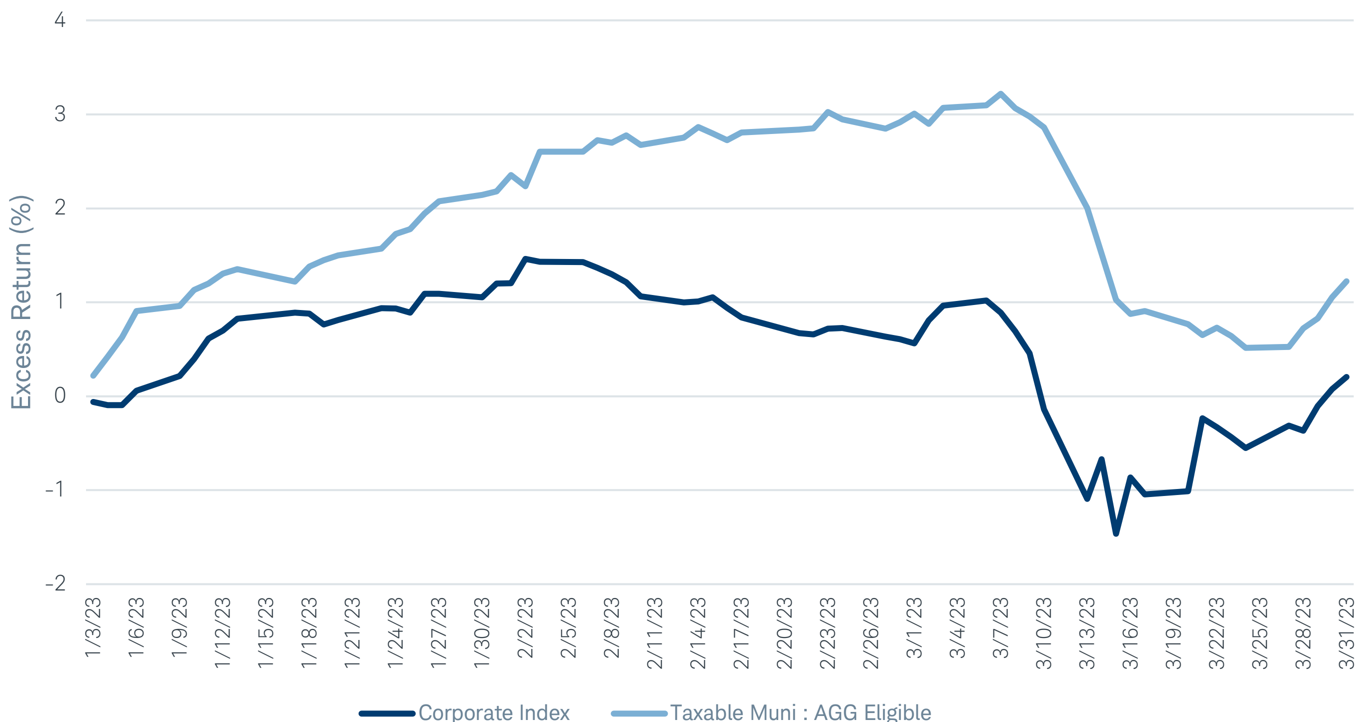
Despite the renewed uncertainty about the path of Fed monetary policy, the environment for fixed income remains volatile. However, even though relative valuations of municipal bonds to other taxable fixed income asset classes looks less favorable than historical measures, absolute and taxable-equivalent municipal yields still look attractive for investors in high tax brackets, particularly considering the strong credit characteristics of munis as we approach a potentially slower economic growth backdrop.

Taxable Market

By: Brian Ferry, Senior Portfolio Manager

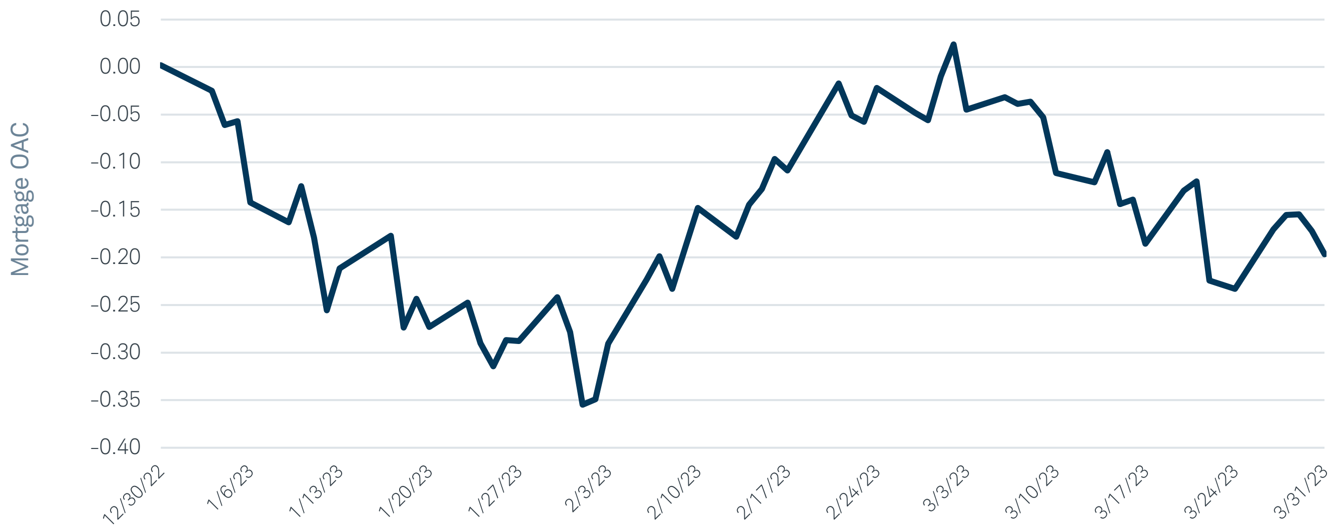
The collapse of Silicon Valley Bank (SVB) and Signature Bank negatively impacted returns for the corporate bond market on what would have otherwise been a very impressive start to the year. The week before the failure of SVB the corporate bond market, as measured by the Bloomberg Corporate Index, was outperforming like duration Treasuries by over 100 bps. The outperformance quickly dissipated as investors de-risked and sold credit in favor of risk-free securities after the bankruptcy announcement. Fears of contagion risk did ease somewhat in the last week of March and the corporate index was able to squeak out a slight positive outperformance for the first quarter of 20 bps. The volatility in the market did impact supply and made issuance very choppy. Total issuance of investment grade corporate bonds in the first quarter was $403 billion, a 15% drop off from the previous year.

Year-to-Date Bloomberg Excess Returns Over Like Duration Treasury Bonds



Source: Bloomberg; 3/31/2023

The "risk-off" credit tone in March also impacted the taxable municipal market but was not enough to offset the strong gains notched in the first two months of the year. In fact, the Bloomberg Taxable Municipal: AGG Eligible Index never experienced a trailing year-to-date underperformance against similar duration Treasury bonds in the first quarter. At quarter end, the index outperformed by 122 bps. The higher rate environment slowed new issuance more than the volatility in the quarter. Municipalities borrowed just under $12 billion in the taxable market in the first three months of the year, a 48% decrease from the same quarter last year.



Source: Bloomberg; 3/31/2023

The mortgage market traded much like the corporate market to start the year but couldn't recapture the positive outperformance it once had. The failure of the two banks left many unanswered questions for mortgage investors. The FDIC absorbed the mortgage holdings of each bank and eventually will have to liquidate them which created uncertainty and supply headwinds for the mortgage bond buyers. The Bloomberg U.S. MBS index underperformed like duration Treasury securities by 50 bps in the first quarter. In addition to the eventual supply headwinds, the index was also hurt by its negatively convex nature in a Treasury rally.

In summary, March was the pivotal month of the quarter no doubt. Investors at the very start of the month debated how high the Fed might hike rates to get inflation back to target and soften the labor market...6%, 7% or even 8%? What investors and the Fed came to realize only a few days later was the speed and magnitude of previous rate hikes were already being felt in specific parts of the economy. The bond market quickly reversed course and priced in multiple rate cuts by the end of the year. The abrupt U-turn by fixed income investors was at odds with the Fed and their higher for longer outlook (no rate cuts in 2023). The diverging outlooks illustrate how much uncertainty the regional banking crisis has thrown into forecasts which could lead to elevated volatility in the fixed income markets.

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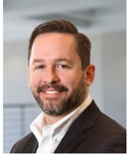

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Source: Bloomberg.

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About the Wasmer Schroeder Strategies: More than 30 years ago, the Wasmer Schroeder philosophy was founded on the principles of an unwavering commitment to service and a dedication to managing fixed income. Originally founded by Martin Wasmer and Michael Schroeder, and now managed by Schwab Asset Management, the Wasmer Schroeder Strategies have grown significantly. From the beginning, management of the Wasmer Schroeder Strategies has held steadfast in its spirit of collaboration—doing what's right for the advisors, investors, and institutions invested in the Strategies. Schwab Asset Management does right by doing right by them—knowing their businesses, understanding their goals, and consistently finding strategies to help meet their needs. We remain dedicated to uncovering opportunities and delivering results for our clients by working together every step of the way. The Wasmer Schroeder Strategies portfolio management team takes a dependable, collaborative, and insightful approach in the management of active fixed income tax exempt and taxable strategies.

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