WASMER SCHROEDER STRATEGIES

Quarterly Bond Market Overview

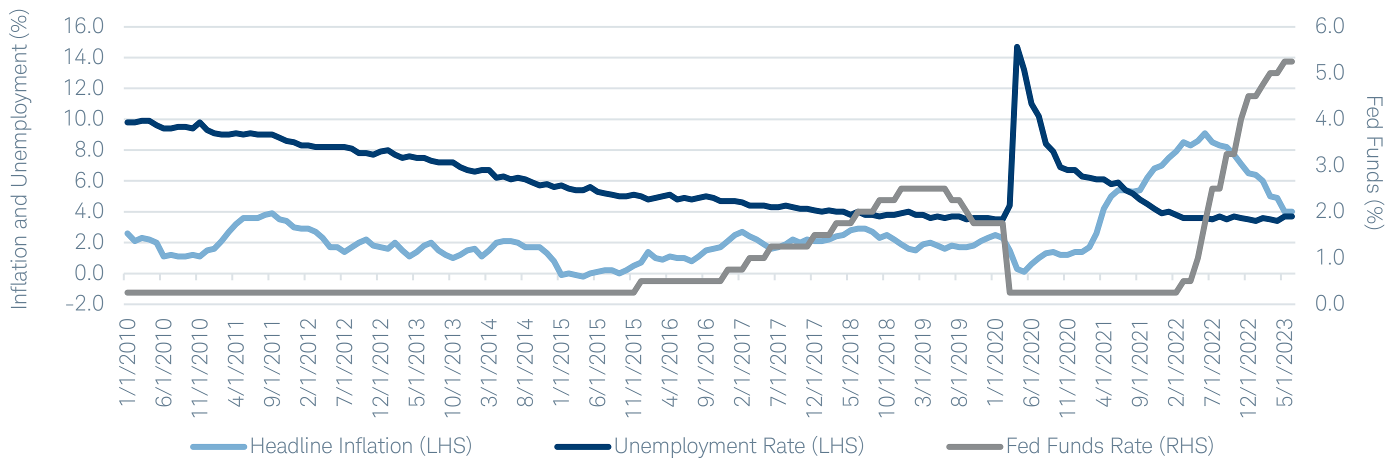
June 30, 2023

For the Fed and the Economy, So Far, So Good

Tom Richmond, Co-Head of Taxable SMA Strategies, Senior Portfolio Manager

In the quarter just ended, with few market-moving headlines or geopolitical dustups to muddy the market waters, bond investors were left to contemplate macroeconomic data and central bank monetary policy actions and rhetoric when deciding how to position themselves in the various market sectors. Once it became clear that, for the time being, the bank failures and stresses seen late in the first quarter had been possible anomalies, the markets, and especially the US Treasury complex, resumed the process of aligning themselves with what the Federal Reserve was telling them was in the cards: continued policy rate hikes to further combat falling but sticky core measures of inflation. Interest rates rose across the maturity spectrum during the quarter, and noticeably more in the short end of the curve where Fed policy rates play a much more important role; this, in turn, pushed market-derived estimates of the eventual peak in the Fed Funds rate to new highs, near 5.5%. Moreover, the market's expectation for the length of time that will pass before the Fed begins to cut rates extended significantly, into the early parts of 2024.

The Fed's Dual Mandate

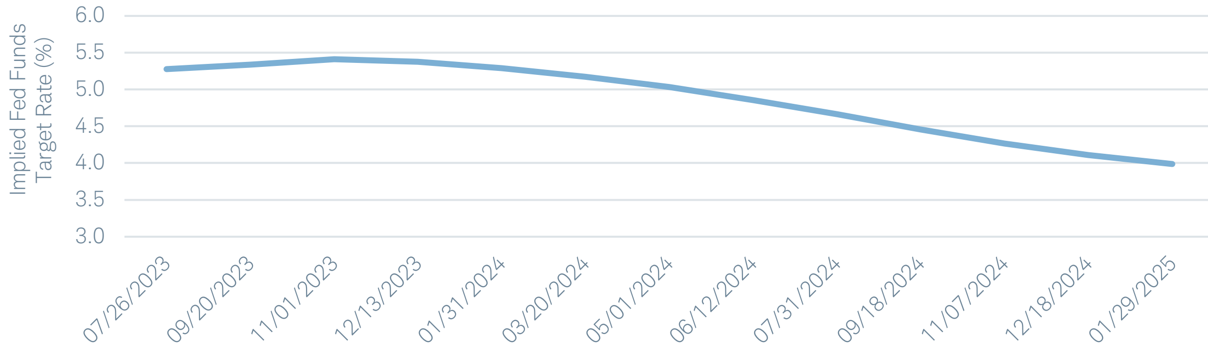


Source: Bloomberg; 6/30/2023

Perhaps more interesting than these market reactions, however, was the performance of the US economy. Inflation remains elevated but maintained a slow decline that may persist as the effects of Fed actions continue to work, albeit with lags. As announced in April, growth, as measured by real GDP, posted decent gains in the first quarter, and most estimates for Q2 show continued modest positive growth. Some survey measures of economic activity indicated mild contraction, especially in manufacturing, although services activity remains healthy. The housing market in the US continues to impress, despite much higher mortgage rates and lower affordability as measures of activity in the sector continue to beat estimates and home prices remain steady. Finally, the US labor market remains very strong with unemployment below 4%, ongoing monthly job creation averaging nearly 300,000, and only slightly elevated levels of initial jobless claims. Against this backdrop and despite higher base rates and still-elevated volatility, perhaps it's not surprising that, as you will read below, risk assets enjoyed a solid quarter of relative outperformance.

As the third quarter begins, the markets may likely resume 'Recession Watch' as the Fed likely continues its process of removing policy accommodation from the system by raising the Fed Funds target once, if not twice more, and also continues to reduce its holdings of Treasuries and Agency mortgage-backed securities. As shown in the chart below, market estimates of the path of policy rates show an agreement that this target will remain elevated for the next several months, but will then fall rather quickly beginning next spring, and throughout the remainder of next year. In our view, this is a probabilistic path; some investors may believe that the Funds rate will remain 'higher-for-even-longer' while others believe that rates will have to come down even more quickly as the current policy regime finally 'breaks' something and the 'inevitable' economic downturn sets in. Which view is correct? Of course it's impossible to know the answer at this point, but Q2 data may reveal clues and offer investing opportunities.

Fed Funds Futures Implied Rate



Source: Bloomberg; 6/30/2023

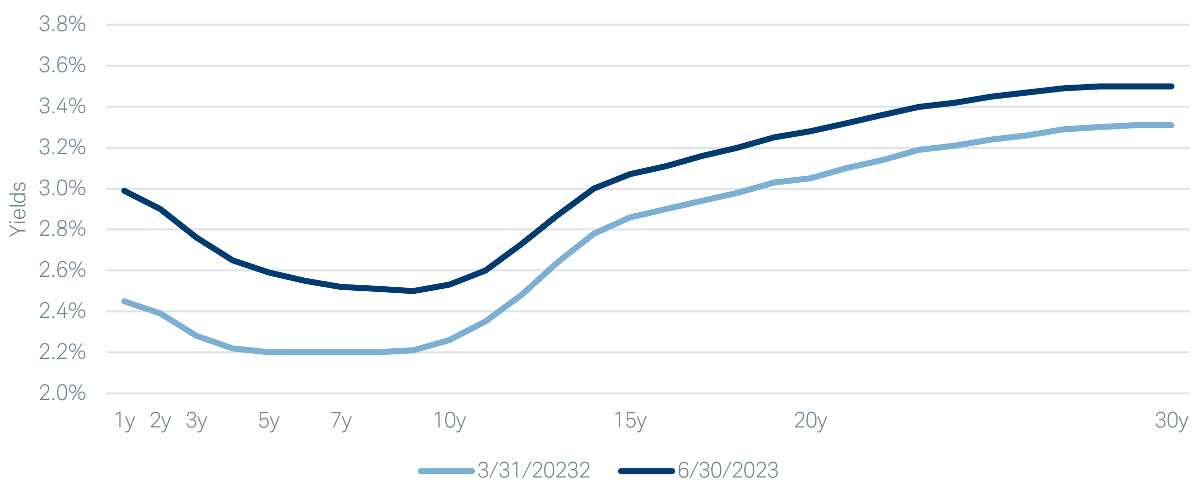
Fed Funds Futures Implied Rate is based on market expectations of the future rate based on the pricing of fed funds futures contracts.

Tax Exempt Market

Jason Diefenthaler, Managing Director and Head of Tax-Exempt Strategies

It was a quiet quarter of performance for the municipal bond market. Yields were higher by 20-50 basis points (bps) across the curve, in sympathy with the more pronounced move in Treasuries, yet the Bloomberg Municipal Bond Index was only down -0.10% during the three-month period. Bond investors were seemingly focused on shifting perspectives around future monetary policy changes given the stubborn inflation backdrop and persistent strength in the labor markets. As a result, the short-end of the curve saw the most movement with 2-year tax-exempt yields hitting a 2023 high of 3.05% in late May.

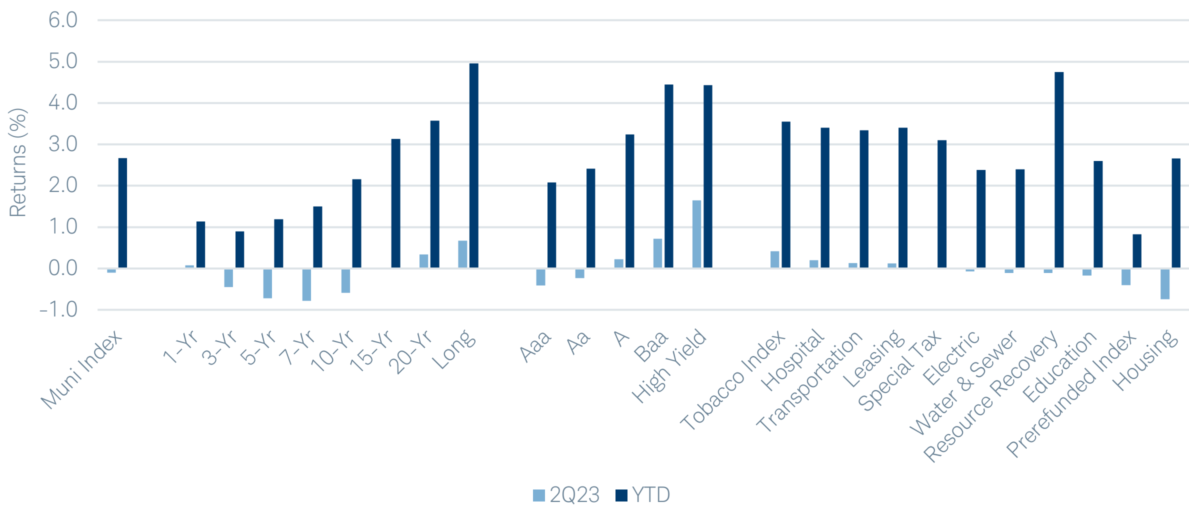
Bloomberg AAA Municipal Yield Curve



Source: Bloomberg; 6/30/2023

Longer duration bonds witnessed the best performance during the quarter, with the Bloomberg Long (22+) Index up +0.67% compared to a decline of the -0.72% for the Bloomberg 5-Year Municipal Index. This has been a consistent trend throughout the year with the Long (22+) Index outperforming the overall Muni Index by 229 bps year-to-date. Lower rated credits also held their own as a positive source of total return for investors, with revenue bonds outperforming general obligation bonds for the third consecutive quarter, and the BBB Muni Index outperforming the AAA Muni Index by 113 bps. Riskier sectors, including Industrial Revenue, Tobacco, and Healthcare, posted the strongest returns during the quarter, while more stable essential service sectors like Electric, Water & Sewer and Education tended to underperform.

Bloomberg Index Returns

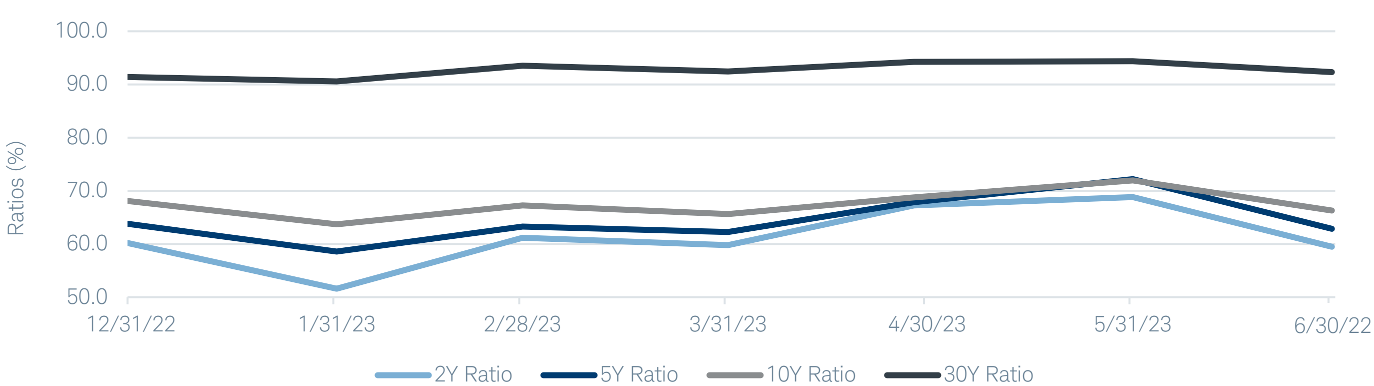


Source: Bloomberg; 6/30/2023

The slope of the tax-exempt yield curve from 2-year to 10-year maturities ("2s10s") has been inverted since early February and closed out June at -37 bp. While the muni market has historically avoided yield curve inversions in the past, the sheer gravity of the 2s10s inversion in Treasuries (-106 bp as of June 30) has been too great not to have an effect on the muni market. Meanwhile, the slope of the muni curve from 10-years to 30-years ("10s30s") ended the quarter at +102 bp, which is significantly steeper than +2 bp 10s30s slope in the Treasury market. This suggests there are potential relative value opportunities for investors willing to venture into longer duration muni bonds.

Municipal bonds outperformed Treasuries during the quarter, which led municipal-to-Treasury yield ratios to become more expensive across most of the market. Two-year ratios reached a 2023 high of 70% in early May, only to end June at 59%. Ten-year ratios also reached their YTD high in May, to finish the quarter 66%. The 30-year area of the curve wrapped up the quarter at 92%, which is right on the top of the trailing 2-year average.

Municipal Curve Ratios



Source: Bloomberg; 6/30/2023

Technicals remained constructive for the market during the 2nd quarter. Following an anemic calendar of new issuance during the 1st quarter, the primary market finally started to show signs of life with June's issuance representing the healthiest month of new deals since April 2022. Total 2Q23 tax-exempt supply of $92 billion represented an encouraging year-over-year increase from the $88 billion that came to market in 2Q22. And while YTD flows continue to be negative in 2023, with Lipper Refinitiv reporting $8 billion in outflows from municipal bond mutual funds through June, that total pales in comparison to the record $150 billion of outflows last year. As a result, trading conditions have been orderly, and the reinvestment needs from coupons and maturities being put back to work in the muni market helps promote these positive technicals, and the overall relative outperformance produced by munis during a period in which Treasuries were distinctly higher in yield.

Credit conditions across the muni market remain favorable. State and local governments continue to exhibit budget stability and replenished reserves, while many essential service revenue sector credits including electric utilities, water/sewer systems and transportation authorities have been able to partially offset rising expenses with higher revenues. Certain risk sectors of the market are showing signs of trouble, however, with healthcare continuing to struggle and higher education issuers (particularly smaller, private, niche colleges) having a difficult time with enrollments and profitability. We are entering a period in the economic cycle where diligent surveillance of issuer credit quality will become increasingly important.

Looking ahead, we are monitoring several factors 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; this could lead to increased volatility in the market. This prompted 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 result in certain revenue sectors, including 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 (such as general obligation and essential service revenue sectors) outperform the more economically sensitive sectors described above. This latter scenario will be largely 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.

Amid 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 compared with 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

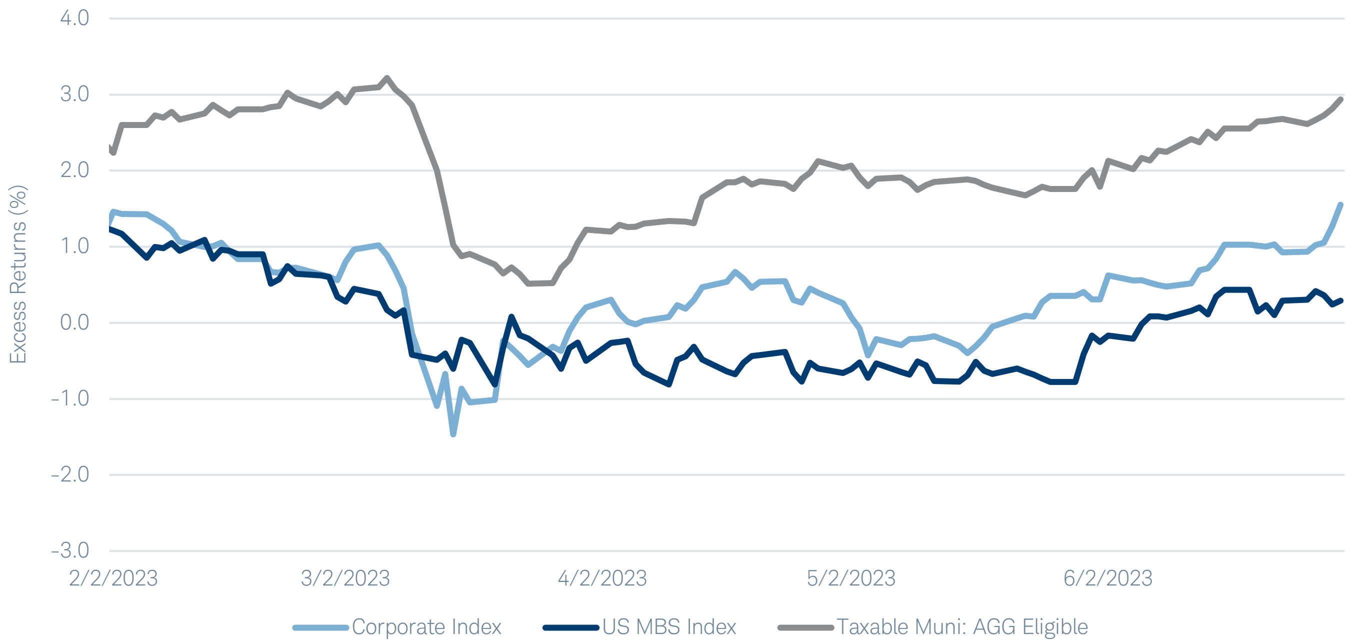
Brian Ferry, Senior Portfolio Manager

The corporate bond market finished the second quarter on much better footing than it ended the previous quarter. June was the best month of relative performance for the corporate bond market in 2023, which led to strong outperformance for the quarter. The Bloomberg Corporate Index outperformed similar duration Treasury bonds by 132 bps, of which 122 bps were notched in June. The total return for the Bloomberg Corporate Index in the first half of the year was 3.21%. Issuance regained steam after a lull towards the end of the first quarter, and companies priced over $325 billion worth of deals. Second quarter issuance brought the year-to-date total to $751 billion, or 3.5% below last year's pace.

The taxable municipal market had a strong showing throughout the second quarter. The Taxable Municipal component of the Bloomberg Aggregate Index outperformed similar duration Treasury bonds by 168 bps in the quarter. June, like for corporate bonds, was the strongest month of performance for the sector with 90 bps of excess return. The significant drop in issuance continued into the second quarter for taxable municipal investors. New issuance in the first half of the year fell 51% from the previous year. The primary culprit was lack of refinance opportunities out of tax-exempt bonds into new taxable municipal bonds due to vastly higher risk-free rates.

The Agency MBS market was the one spread sector that needed the June "risk-on" rally to turn relative performance positive for the year. The Bloomberg US MBS Index outperformed similar duration Treasury bonds by 77 bps in the second quarter, of which 45 bps came in June. For the first half of the year, the index outperformed by 29 bps. The further the sector has moved away from of the regional banking crisis and the associated volatility, the better it has been able to perform.

Excess Returns Over Treasuries



Source: Bloomberg; 6/30/2023

In summary, the fading headwinds from rate hikes, regional bank liquidity concerns, coupled with the resolution of the debt ceiling, and a resilient US economy (1Q GDP revised up to 2.00% from 1.40%), had fixed income investors in positive spirits as they closed out the first half of the year. Every major sub-sector (Agency MBS, Corporates, Taxable Municipals, High Yield, ABS) outperformed similar duration Treasuries in the second quarter, which in turn pushed them all into positive relative performance for the year.

Tom Richmond
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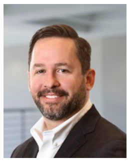

Jason Diefenthaler
Head of Tax-Exempt Strategies

Jason Diefenthaler is the Head of Tax-Exempt Strategies for Schwab Asset Management. In this role, he is responsible for developing, managing, and implementing Schwab Asset Management's tax-exempt fixed income investment strategies, including separately managed accounts, actively managed mutual funds, and exchange-traded funds (ETFs).

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