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Quarterly Bond Market Overview

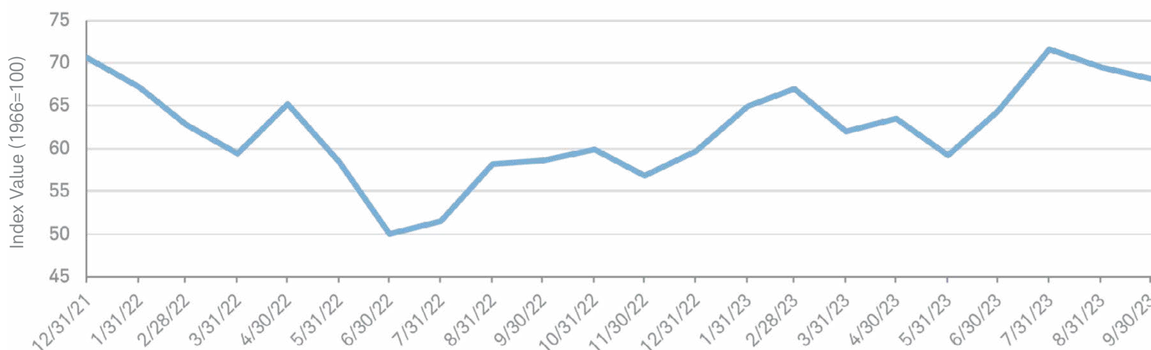
September 30, 2023

How soft is your landing?

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

If you ask a stranger how the U.S. economy is doing, you will undoubtedly get responses that run the gamut from "great" to "lousy", depending on the circumstances of the individual. We can, however, venture a guess as to what an 'average' response might sound like, given current economic and anecdotal information. Gas prices are rising again–always a hot button topic–which might be especially painful given the rise in the price of just about everything over the past few years, so inflation would feature prominently among responses. Broadly speaking, we believe that most folks would still be working and may have seen their wages rise, even in real terms, over the past few quarters, which may mitigate some of that pain. The respondent might still be spending on 'stuff' and 'experiences', although any excess cash they may have amassed during the pandemic may just about be gone, and their credit card balances may be growing or even a bit delinquent. Homeowners might be happier or at least wealthier, on balance, as would most owners of stocks, although many former college students might bemoan the restart of loan payments. It feels like the short answer to the question of the economy's health would be something like "OK".

University of Michigan Consumer Sentiment Index



Source: University of Michigan, Survey Research Center, Surveys of Consumers

If you ask the Federal Open Market Committee, on the other hand, you might get something that sounds much more like "too good". Inflation, by most measures, has moderated in the face of the actions already taken by the Fed, but to hear them tell it, remains too high for their comfort. The domestic job market has remained quite strong as unemployment has remained at historically low levels, which has been keeping upward pressure on wages. GDP growth has remained well above most estimates, even in real terms. Consumer spending has remained robust, business investment does as well, and home prices and rents have kept rising, albeit at a much slower pace than over the past couple of years, despite much higher mortgage rates. It stands to reason that the members of the Committee may well be wondering why their words and actions have not had a more chilling effect on the economy, but it also stands to reason that this fact gives them room to raise rates further, keep policy rates 'higher-for-longer', and to continue to shrink the Fed's balance sheet.

As we begin the fourth quarter, the bond markets have reacted to this environment. Interest rates have continued to rise meaningfully, especially those on longer-dated bonds. This increase may be a by-product of the Fed's actions and rhetoric but could also reflect higher levels of Treasury issuance (and no new Fed purchases) leading to a supply/demand imbalance. It also seems to indicate the markets see continued growth ahead; any thoughts of future problems or recession would likely lead to lower, not higher, rates. It does not appear to reflect larger inflationary fears, as breakevens have risen only slightly, but does reflect what we refer to as a higher 'term premium' or extra yield necessary to entice buyers to take on the uncertainties of the Fed and the economy over a longer period. Given the Fed might be near the end of its tightening cycle, longer rates catching up to short rates makes sense as the economy continues to run well; the question looking forward becomes–is there any type of landing on the horizon? We will get more answers from the data in the 4th quarter.

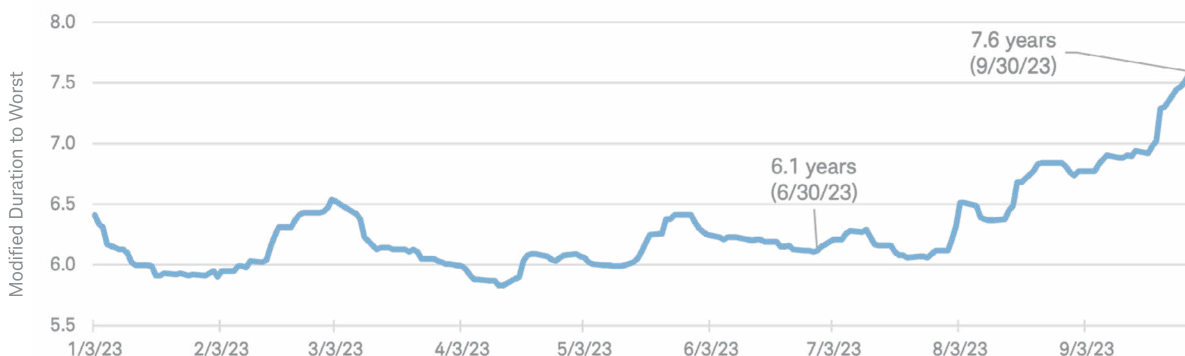
Tax-Exempt Market

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

The municipal market witnessed notable fluctuations during the third quarter, particularly in August and September, marked by a rise of 70-90 basis points (bps) in tax-exempt yields over the three-month period. The primary driver behind this shift was the Treasury market's performance, resulting in the most challenging two-month period for municipal bonds since early 2022. September, in particular, exhibited a persistent upward trajectory in yields, with only one trading day seeing lower yields during the month. The last two weeks of September were particularly volatile and reinforced the strong momentum toward higher yields felt throughout the quarter. The Bloomberg Municipal Bond Index reported a 3.95% loss for the third quarter, lowering the year-to-date return to -1.38%. 10-year AAA municipal yields (Bloomberg BVAL Muni AAA Yield Curve) ended the period at 3.44%, their highest levels in over a decade.

The long end of the municipal market saw significant underperformance during the period. The Bloomberg Long Municipal Index (22+) returned -6.7% during the quarter, underperforming the Bloomberg 5-Year Municipal Index by 463 bps. This was an abrupt reversal from the momentum heading into the quarter, as the Long Index had outperformed the 5-Year Index by 377 bps during the first six months of the year. The performance of longer-duration bonds was additionally impacted by duration extension, with higher yields causing lower-coupon bonds to trade to their longer maturity dates instead of shorter call dates. As we can see in the chart, the modified duration-to-worst of the Bloomberg 15-Year Municipal Bond Index extended from 6.1 years to 7.6 years during the quarter. This type of duration volatility highlights the importance of proper coupon selection and call option management for actively managed portfolios.

Bloomberg 15-Year Municipal Index Modified Duration to Worst



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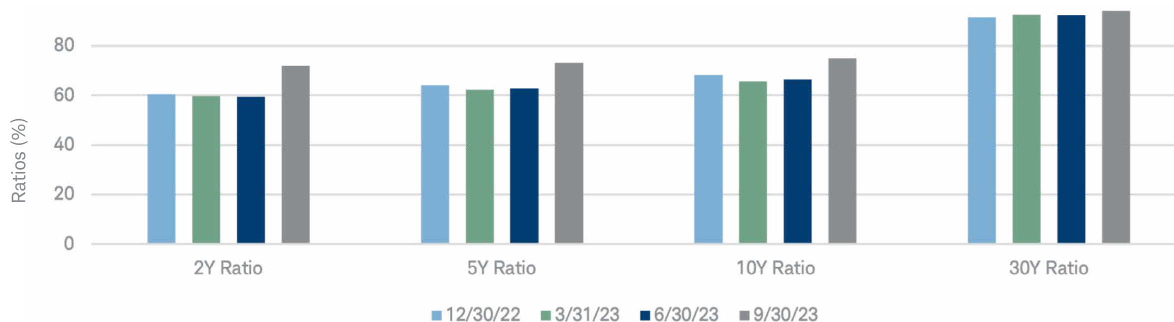
Credit quality was not a material attribution point during the quarter, which was surprising given that lower-rated bonds tend to underperform higher-quality munis during periods of negative performance. However, the Bloomberg General Obligation Index (-4.10% total return during the quarter) and the Bloomberg Revenue Bond Index (-4.04% total return) were remarkably in line with each other. Continued robust demand for A and BBB rated bonds, coupled with light issuance in lower-rated market segments, helped drive favorable technical conditions and supported the performance of lower-rated securities. Fundamentally, aggregate credit conditions continue to appear favorable, with operational challenges in specific sectors, like healthcare, showing signs of improvement, as issuers have focused on margin repair and debt covenant compliance. State and local revenue trends, encompassing income, sales, and property tax revenues, have remained resilient.

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 September at -21 bps. Meanwhile, the slope of the muni curve from 10 years to 30 years ("10s30s") ended the quarter at +98 bps, which remains significantly steeper than the 10s30s slope in the Treasury market at +14 bps. This suggests there are potential relative value opportunities for investors willing to venture into longer-duration muni bonds.

Municipal-to-Treasury yield ratios generally increased across most areas of the market. 2-year (72%), 5-year (73%) and 10-year (75%) ratios all ended September at year-to-date highs. The 30-year area of the curve wrapped up the quarter at 94%, which is slightly above the 2023 average reading (91%). The combination of higher absolute yields and more attractive ratios suggests a fairly priced market, especially during the traditionally low-supply months of December and January.

Muni Curve Ratios



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While opportunities are promising, we must also acknowledge potential risks in the forward outlook. Ongoing weakening of Treasuries could introduce further instability across the tax-exempt market. Municipal bond mutual funds have experienced persistent outflows, emphasizing the need for cautious market navigation. As we approach year-end, the secondary market may witness increased tax-loss harvesting activity, potentially affecting bid wanted and offering levels. Despite these potential headwinds, the overall value proposition in municipal bonds suggests the possibility of a robust end to the year.

Taxable Market

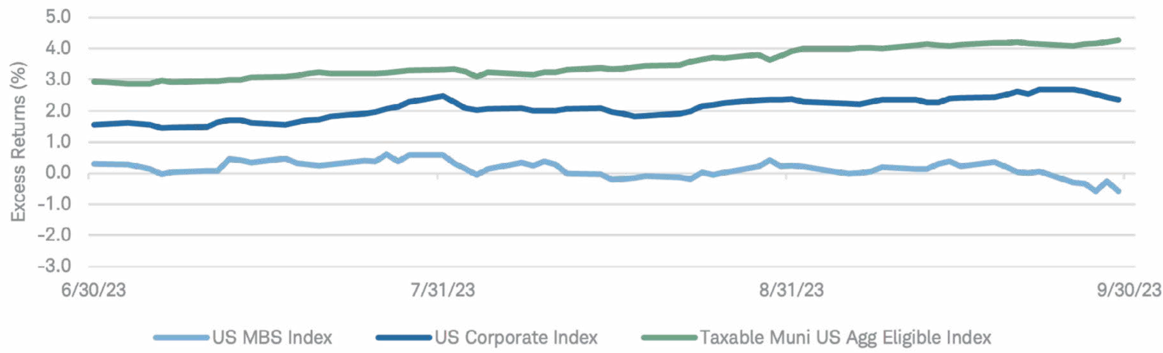
Brian Ferry, Senior Portfolio Manager

The corporate bond market traded sideways for most of the third quarter. In fact, the option-adjusted spread (OAS) of the Bloomberg Corporate Index traded in a tight 13-basis-points range (112 to 125) throughout the quarter. Overall, the index tightened 2 bps in the quarter and finished at an OAS of 120 bps. The reduction in volatility in the corporate market allowed investors to focus on collecting coupon payments rather than worry about spread widening, and corporate bonds outperformed similar-duration Treasury bonds by 86 bps in the quarter. Issuance for the quarter stood at $302 million, a 2% increase from the same period in 2022. The corporate market crossed the $1 trillion mark in year-to-date issuance in the third quarter, bringing it roughly in line with where it was through the third quarter of 2022.

The taxable municipal market put in another strong quarter. The taxable municipal component of the Bloomberg Aggregate Index outperformed similar-duration Treasury bonds by 150 bps in the third quarter. Each month in the quarter saw outperformance relative to its benchmark. New issuance was still wishful thinking for bond buyers with another disappointing quarter of supply. Total supply in taxable municipal bonds for the third quarter was $7.2 billion, a drop of 34% from the same period last year. The reduction in supply was supportive of valuations in the secondary market.

The positive momentum that Agency MBS gained in the second quarter faded into the third quarter due to the increase in interest rate volatility. The U.S. MBS Index underperformed similar-duration Treasury bonds by 86 bps in the third quarter. The move to an even higher interest rate environment, especially in September, hurt the mortgage investor and created more uncertainty. The Fed continued to let its mortgage portfolio pay down without any communications about stopping in the foreseeable future.

YTD Excess Returns Over Treasuries



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In summary, the move to a significantly higher interest rate environment throughout the third quarter didn't result in a credit sell-off as was the case earlier in the year. Investors were seemingly more comfortable with the underlying reasons for higher risk-free rates, such as stronger-than-expected GDP growth, full employment, and a resilient housing market. Credit spread sectors were able to build on their 2023 gains, while negatively convex products, such as Agency MBS, were negatively impacted by higher rates.

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

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

Mr. Richmond earned a Master of Science in Applied Mathematics and a Bachelor of Science in computer science with minors in economics and management from Rensselaer Polytechnic Institute.

Jason D. Diefenthaler
Managing Director, 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).

Mr. Diefenthaler earned a Bachelor of Science in finance from Florida State University. He is a member of the Southern Municipal Finance Society and the National Federation of Municipal Analysts.

Brian E. Ferry
Senior Portfolio Manager

Brian Ferry is a Senior Portfolio Manager supporting the Wasmer Schroeder taxable bond strategies at Schwab Asset Management.

Mr. Ferry earned a Bachelor of Science in finance from Miami University. He is a CFA® charterholder and is a member of the CFA Society of Cleveland and the CFA Institute.

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