WASMER SCHROEDER STRATEGIES

Quarterly Bond Market Overview

December 31, 2023

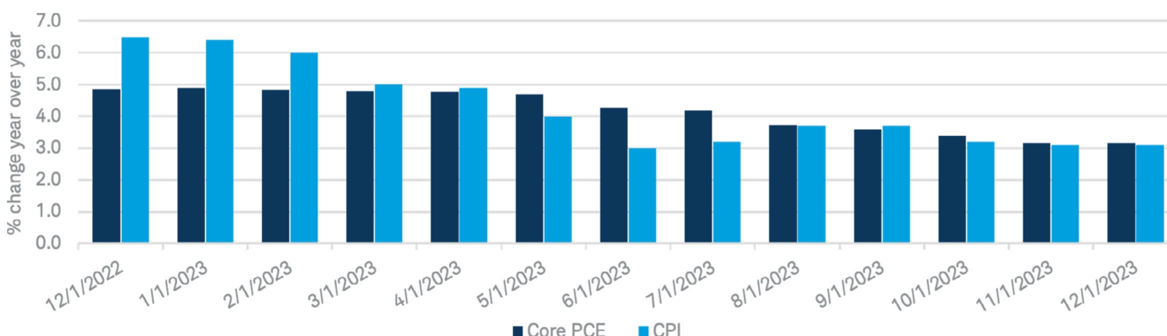
Thank you, Santa!

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

In honor of the recently completed holiday season, I hope you can indulge me for a moment for a story of good tidings, seasonal cheer, and, apparently, redemption. Picture if you can a white-bearded, red-suited, jovial Chairman of the Federal Open Market Committee – as much of a stretch as that might be. For the past couple of years it appeared the Chair and other sleigh-pulling members of the Committee had judged both the U.S. economy and most bond market participants as being on the 'Naughty' list; in response they had delivered lumps of coal, in the form of aggressive short-term interest rate hikes, a reduced balance sheet, and endless hawkish rhetoric to try to slay inflation, slow the economy, and, in turn, they ended up punishing bond investors. Just in time for the 2023 holiday season, that judgement appeared to change, and both (the U.S. economy and most bond market participants) were moved to the 'Nice' list – leading to a plethora of gifts and overflowing stockings. As the Federal Reserve (Fed) pivoted in their rhetoric and seemed to signal the peak in rates for this cycle, the economy continued to chug along, better than most had expected at this time last year, and virtually all sectors of the bond market sang happy carols into year-end.

Kidding aside, the U.S. economy continued to perform remarkably well when viewed through the lens of the Fed's significant actions over the past few years, probably to both the bewilderment and the enjoyment of the Committee members. Inflation has slowed significantly, though not quite to the Fed's target; the core Personal Consumption Expenditure (core PCE) price deflator fell from 3.7% to 3.2% in the fourth quarter, down from 4.9% at the beginning of 2023. Although many had predicted a recession last year, economic growth was quite good - thanks to a stunning 4.9% rise in the third quarter and based on estimates of 1-2% for the fourth quarter, real GDP Growth (net of inflation) should come in at an annualized rate of near 3%, and above most estimates of its long-term trend. The job market remained strong, as the unemployment rate remained below 4%, but not too strong – as wage growth has moderated and the number of open jobs has come down. Bonds for their part, as you will read in the following sections, had a great quarter as interest rates fell significantly and risk spreads tightened in most sectors.

Core PCE and CPI



Source: Bloomberg 12/31/2023

Looking back, it is amazing to see that despite intermittent bouts of volatility and outsized moves in rates—10-year yields got as low as 3.3% following March's bank failures and as high as 5.01% prior to "Santa's" November pivot—the yield on that benchmark finished the year at exactly the same level as it began – a rare occurrence. Shorter rates fell a bit further, especially after the Fed's changed messaging, resulting in a less inverted yield curve; Fed Funds futures ended the year predicting several more rate cuts in 2024 than were originally foreseen by the Fed. The data will ultimately decide if the market has it right, and that either the economy falters or inflation fully cooperates and falls back to target and the Fed will ease policy more aggressively, or whether there was a bit too much celebratory eggnog consumed and policy rates stay higher for longer and other rates end up having to readjust.

Tax-Exempt Market

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

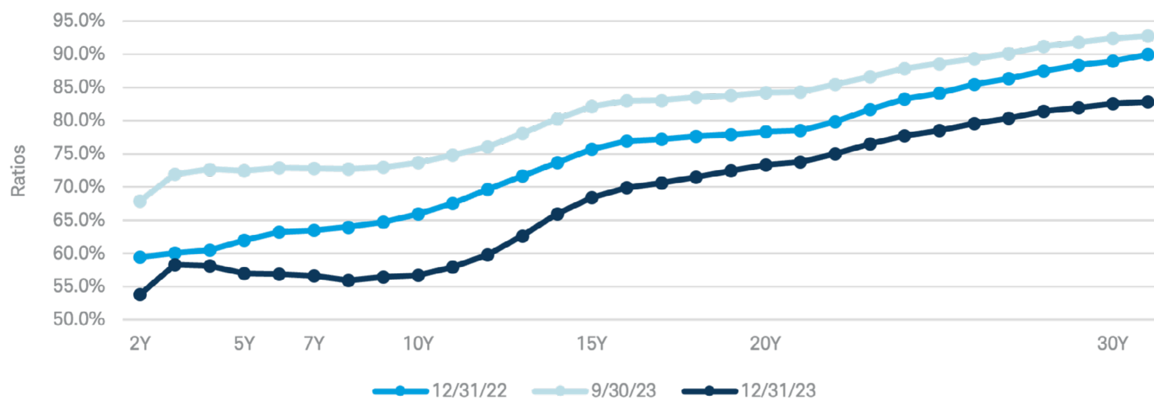
The municipal bond market followed the strong rally in U.S. Treasuries during the fourth quarter of 2023, with the Bloomberg Municipal Bond Index posting its best quarterly return (+7.89%) since the 4th quarter of 1985. Keying in on the Fed's dovish pivot, tax exempt yields were lower by as much as 110 basis points (bps) along the curve. The strong returns came during a period of heightened volatility, with 10-year AAA yields hitting a multi-decade high of 3.63% at the end of October, only to end the year at 2.25% after ferocious moves in November and December. The Bloomberg Municipal Bond Index returned 6.40% for the year, representing its best calendar year return since 2019.

Longer duration bonds exhibited the strongest performance during the quarter with the Bloomberg Long Municipal Index (22+) Index returning +11.61%, compared to the Bloomberg 5-Year Municipal Index's 5.22% return. This was a continuation of the major bond market theme of 2023 which saw duration posture as the primary driver of performance rather than sector, state or credit positioning. In fact, if one were to isolate duration-neutral returns by credit quality, AAA munis slightly outperformed BBB rated bonds during the quarter.

The slope of the tax exempt yield curve from 2-year to 10-year maturities ("2s10s") has been inverted since early February and was relatively unchanged during the 4th quarter, ending at -23 bps. While the muni market has historically avoided yield curve inversions in the past, the current slope in tax exempt yields is fairly consistent with the -37 bps inversion in the Treasury market. Meanwhile, the slope of the muni curve from 10-years to 30-years ("10s30s") ended the quarter at +113 bps, which is significantly steeper than +15 bps 10s30s slope in the Treasury market. This suggests that there are potential relative value opportunities for investors willing to venture into longer-duration muni bonds.

The muni market outperformed the Treasury market during the quarter, which has implications for relative value heading into the new year. The Bloomberg 10-year Municipal Index returned 7.47% during the period compared with a return of 6.87% for the Bloomberg 10-Year Treasury Index; for the full year, the Bloomberg 10-Year Municipal Index outperformed by 257 bps. Municipal-to-Treasury yield ratios ended December at levels historically considered expensive from a relative value perspective: 5-year and 10-year ratios ended the year at 57% and 58% respectively, compared with their 2023 averages of 65% and 67% respectively; 30-year ratios, which had averaged 91% during 2023, ended the year at 84% – the lowest reading since January 2022.

Municipal-to-Treasury Yield Ratios



Bloomberg 12/31/2023

The relative outperformance of municipals can be generally chalked up to positive market technicals during a time of year where supply tends to be light and reinvestment demand tends to be high. New issuance came in at $98 billion during the quarter, which was a slight increase from the 4th quarter of 2022, but well below the $135 billion average from 2019 through 2021. While open-end municipal bond mutual funds continued to see broad based investor outflows, municipal bond exchange traded funds (ETFs) and separate accounts continued to see strong investor demand. Meanwhile, reinvestment momentum from coupon payments and maturities continued to outstrip the supply of new bonds, resulting in periods of negative net supply during the final few months of the year. While muni bonds are still available during these scenarios, the yields available, relative to other areas of the fixed income markets, can become less attractive. This was the case during the last 2 months of the year.

Credit conditions across the muni market remained favorable. State and local governments continued 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 that have shown signs of stress coming out of the pandemic, including healthcare and higher education issuers, are beginning to show some stabilization in their financial profiles. While the jury is still out on whether the Fed can engineer a soft landing, we feel comfortable with our current credit positioning in the market and remain particularly constructive on low investment grade credit (single A and BBB rated) heading into the new year.

There are a few themes across the market which will demand extra attention in the coming quarters and year. Fed policy is clearly front and center for fixed income investors, and munis are no exception. The degree to which the tax exempt yield curve remains inverted, or if it returns to its typical positively sloped posture, will likely be one of the primary determinants of our portfolio positioning in the months ahead. Given the uncertainty about the path of monetary policy, the environment for fixed income is likely to remain volatile. However, even though relative valuations of municipal bonds to other taxable fixed income asset classes appear 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

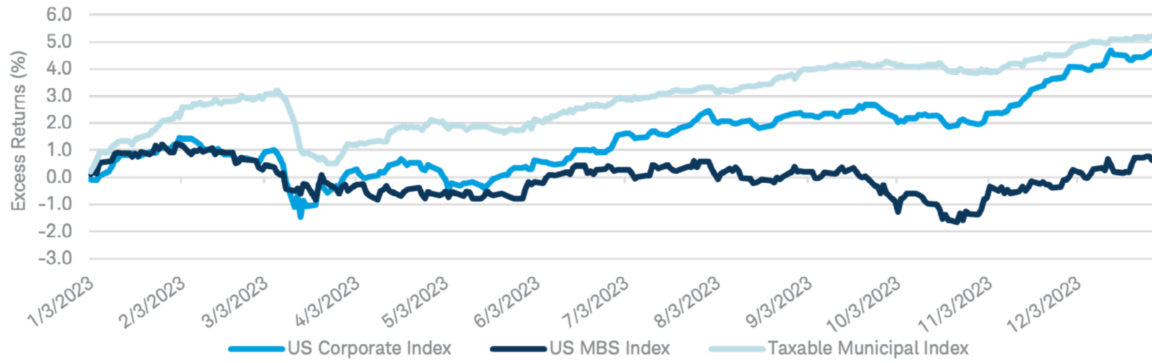
Brian Ferry, Senior Portfolio Manager

The Option Adjusted Spread (OAS) of the Bloomberg U.S. Corporate Bond Index closed out the year one bp above its tightest (most narrow) level of 2023, at 99 bps. The corporate bond market benefited from the “risk-on” environment that fixed income investors favored throughout the fourth quarter, especially in November. The Bloomberg U.S. Corporate Bond Index outperformed like duration Treasury bonds by 201 bps in the fourth quarter and an impressive 455 bps for all of 2023. Issuance was surprising resilient in the face of significantly higher risk-free rates, which can partially be attributed to a healthy, constructive secondary market. Investment grade corporate bond issuance was $1.25 trillion in 2023, a drop-off of only 0.2% from the previous year.

The taxable municipal market also rode the “risk-on” train last quarter, with the Bloomberg Taxable Municipal Index outperforming like duration Treasury bonds by 57 bps. The index also beat out their corporate peers for the year and outperformed benchmark Treasury bonds by 520 bps in 2023. The higher interest rate environment impacted issuance in the taxable municipal market due to lack of refinancing opportunities for issuers. Primary issuance fell 36% from the previous year to $38 billion in 2023, of which $10 billion was priced in the 4th quarter.

Mortgage investors typically like a steady predictable market to collect coupon payments and their worst enemy is volatility and the associated prepayment risk. In 2023, the mortgage market faced significantly higher rates (along with a sharp drop to lower rates), a regional banking crisis and quantitative tightening via mortgage-backed securities (MBS) runoff from the Fed balance sheet, and still somehow managed to outperform for the year. The Bloomberg U.S. MBS Index outperformed similar duration Treasury bonds by 133 bps in the fourth quarter which shifted the index positive 68 bps for year-to-date excess returns.

YTD Excess Returns Over Treasuries



Bloomberg 12/31/2023

In summary, strong gains experienced in November and December for fixed income investors shifted the overall narrative positive for the bond market in 2023. The Fed's pivot in rhetoric at the early December meeting set the table for a continued "risk-on" mentality for markets into year-end. All spread sectors outperformed and added to the gains investors had from a rally in the Treasury market to the benefit of bond holders.

Tom Richmond
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Disclosures

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About the Wasmer Schroeder Strategies: More than 35 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. 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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SAM (0124-431U)