WASMER SCHROEDER STRATEGIES

Quarterly Bond Market Overview

March 31, 2024

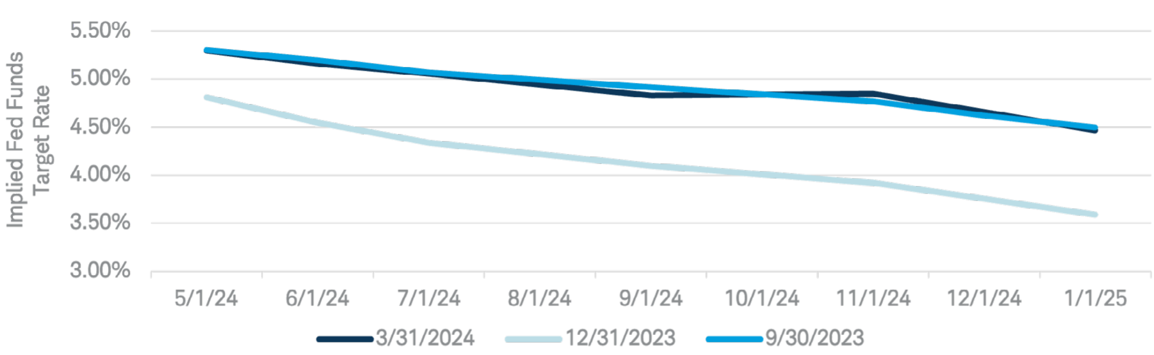
The Pause That Refreshes

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

The first quarter of 2024 was relatively quiet and relatively good from a domestic, macroeconomic standpoint. Economic activity as measured by real GDP growth was estimated to be a shade over +2%; while not as strong as the pace seen in the second half of 2023, this still represents a solid economy. The unemployment rate crept slightly higher, to 3.9%, mostly owing to a modest increase in the labor force participation rate, but job creation continued at an historically strong pace. Consumer spending was robust, although slightly down from prior quarters, and consumer confidence measures showed continued optimism. Business fixed investment was likewise steady. If there was any fly in the macro-ointment it may have been that gauges of inflation, which had been falling steadily for many months, were reported as 'stickier' in January and February - with the core rate of Personal Consumption Expenditure (PCE) inflation falling marginally from 2.9% to 2.8% over the period.

Seeing this, the Federal Reserve (Fed) continued to preach data dependence and patience regarding the eventual and widely assumed loosening of monetary policy. Despite the continuing rhetoric that seems to lean hawkish, the most recent Summary of Economic Projections (the "Dot Plot") still showed that the median projection of Committee Members was for three rate cuts in the Federal Funds target before the end of the year. While an overly exuberant market had priced in several more cuts than that at the end of last year, the first several weeks of the year saw investors fall in line with the Fed's thinking, leading to higher rates across the yield curve. The calm backdrop, however, as you will read further, led to good performance by, and demand for, risk assets across virtually all sectors of the market.

Fed Funds Futures



Source: Bloomberg 3/31/2024

Unless the incoming data surprises the Fed and the markets, or an unforeseen geopolitical headline surfaces, we suspect that this situation may linger a bit longer and that the Fed will probably remain on the sidelines, perhaps even longer than the market currently implies. The current environment seems to indicate that the US economy can tolerate today's elevated short-term borrowing rates with few issues. And if the employment picture and growth prospects remain solid it seems that the Fed will be in no hurry to cut rates, lest the 'last mile' of the 'bumpy' path of inflation toward the Fed's target of 2% prove hard to navigate. This leads us to believe that rates across the yield curve may be range bound for now and that risk will continue to be well supported. We think, however, that the second half of the year could be more challenging as the Fed actually talks about cutting rates (and the Presidential election nears); we believe that volatility could well become elevated throughout the second half of the year.

Tax-Exempt Market

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

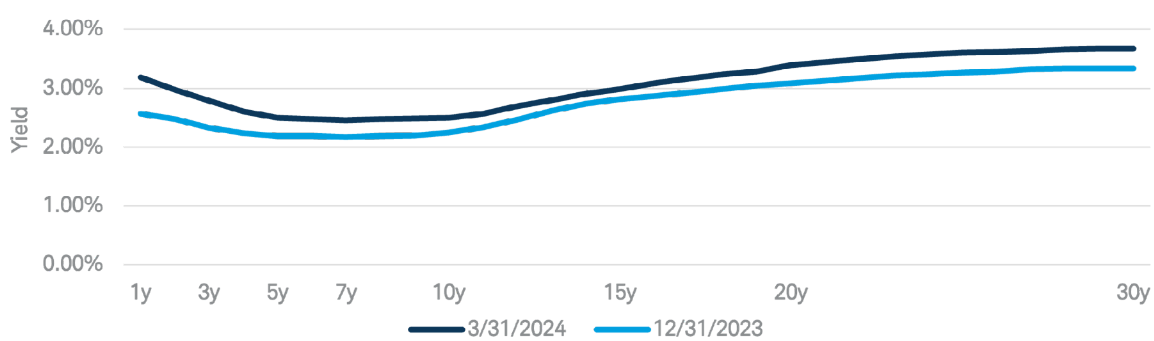
It was an uneventful quarter for the municipal bond market from a performance perspective. The U.S. Treasury market set the tone for tax exempt bonds, with government bond yields higher by 25-40 basis points ("bps") across the curve. Tax exempt yields were also higher by 20-60 bps. Performance across the municipal market was generally negative, with lower rated credits representing an area of general outperformance, and longer duration securities seeing the largest negative returns. 10-year AAA municipal yields ended March at 2.49%, higher by 29 bps since the start of the year but still 108 bps below the high-water mark set in October 2023.

The Bloomberg Municipal Bond Index posted a loss of -0.39% during the first quarter; this was its smallest performance move (positive or negative) since the first quarter of 2021 and a reflection of the orderly trading backdrop in tax exempt bonds. The primary narrative during the quarter was the continued outperformance of lower rated credits. The Bloomberg BAA Municipal Index experienced its largest quarter of relative outperformance (+141 bps) versus the Bloomberg AAA Municipal Index since the second quarter of 2021; the Bloomberg High Yield Municipal Index saw similar relative outperformance (+232 bps) during the period.

Strong fundamentals across the municipal market help explain the outperformance in lower rated credits. State and local governments continue to benefit from stable revenue collections and positive credit rating momentum. While some large issuers with more economically sensitive credit profiles, like the State of California and the City of Chicago, are projecting increased forward deficits, the presence of accumulated rainy day reserve balances suggest a strong ability to manage through the remainder of the current credit cycle. Most revenue sectors also remain well positioned in terms of debt service coverage and leverage ratios, and even more troubled sectors including healthcare and private higher education appear to have generally turned the corner. But given the extent to which lower rated issuers have outperformed in recent quarters, we continue to lean more market neutral in our strategy positioning at this stage relative to our positioning in recent years.

The slope of the tax exempt yield curve remains inverted, as it has been for over a year. The spread between yields on 2-year municipal bonds and 10-year municipal bonds ended the quarter at -48 bps; this is the deepest inversion the market has registered in modern history and even more inverted than the U.S. Treasury curve. This continues to suggest value in a barbelled maturity structure that de-emphasizes the lowest yielding areas of the market (5-10 year maturities), with a corresponding overweight to 1-5 year and 10+ year areas of the curve. For longer duration strategies, the slope of the yield curve outside of 10 years appears quite compelling. The yield difference between 10-year and 30-year municipal maturities ended March at +117 bps, which is the steepest levels the municipal market has seen in over a decade – and more than 100 bps steeper than the same area of the U.S. Treasury curve. For investors that can tolerate higher levels of volatility in exchange for additional yield, looking for opportunities further out the curve could be an attractive option for active portfolios.

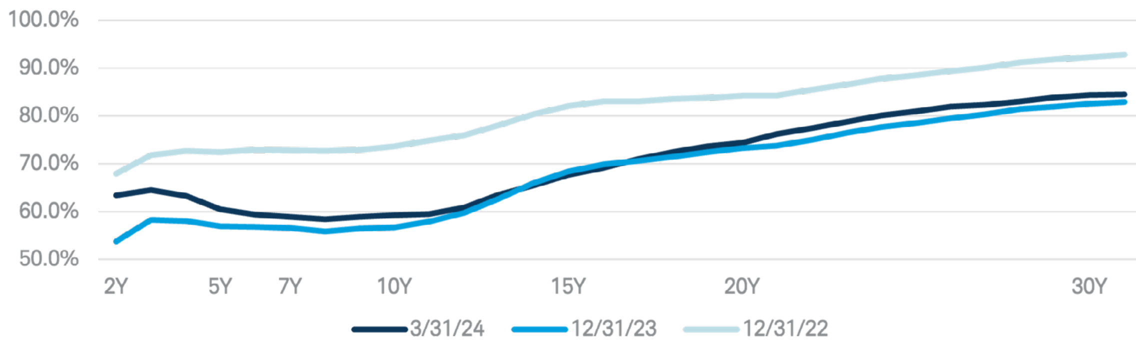
Bloomberg AAA Municipal Curve



Source: Bloomberg 3/31/2024

The combination of supply and demand has also been a significant driver of the municipal market this year. New issuance activity eclipsed $100 billion during the first quarter – a 25% increase over the first quarter of 2023. From a supply perspective it was also the fastest start to a year since 2007. Several large +$1 billion deals came to market during the period, helping to propel the headline number. In many instances this reflects a need for additional new capital as balances from prior years' federal transfer payments begin to dwindle. In heavy supply environments, like we've experienced to date this year, the conventional wisdom is that valuations would see some degree of softness. Yet municipal-to-Treasury yield ratios have remained stubbornly anchored, particularly inside the first 10 years of the yield curve. This can be attributed to the steady investor demand we've seen in 2024 from both new money flowing into mutual funds, separate accounts, and ETFs, as well as the reinvestment of cash from coupon and maturity payments.

Municipal-to-Treasury Yield Ratios



Source: Bloomberg 3/31/2024

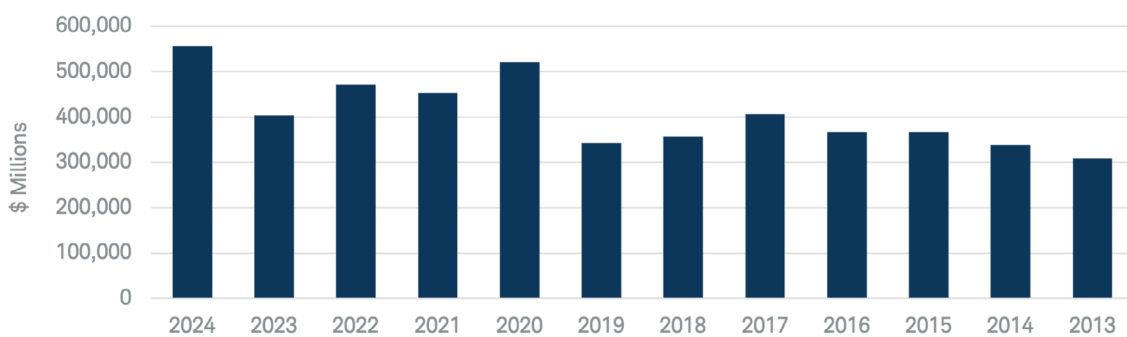
There are a few themes across the market which will demand extra attention in the coming quarters and the year ahead. Fed policy is clearly front and center for fixed income investors, and municipal bonds are no exception. The degree to which the tax exempt yield curve remains inverted, or if it returns to its typical positively sloped posture, is likely to be one of the primary determinants of our portfolio positioning over the coming quarters. Given the uncertainty about the path of monetary policy, we believe the environment for fixed income will likely remain 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 continue to look attractive for investors in high tax brackets– particularly considering the strong credit characteristics of municipal bonds, as we approach a potentially slower economic growth backdrop.

Taxable Market

Brian Ferry, Senior Portfolio Manager

The investment grade corporate bond market had a record amount of issuance to start the year, coming in at $556 billion during the first quarter of 2024, and surpassing the previous record of $521 billion in the first quarter of 2020. A busy primary calendar is typically a sign of a healthy market – and the performance illustrated this dynamic. The Bloomberg US Corporate Bond Index outperformed like duration Treasury bonds by 89 bps in the first quarter. The option-adjusted spread (OAS) of the index touched multi-year lows and finished the quarter at 90 bps, or 9 bps lower than it started. Mergers and acquisitions funding picked up from last year, especially in the healthcare sector, which bolstered overall supply.

1st Quarter Investment Grade Corporate Bond Market Issuance



Source: Bloomberg 3/31/2024

The taxable municipal market likewise had an incredibly positive quarter. The Bloomberg Taxable Municipal Index outperformed like duration Treasury bonds by 153 bps in the first quarter. The OAS of the index also touched multi-year lows, like their corporate counterparts, and finished the quarter at 78 bps. Issuance surprised to the upside relative to last year with $101 billion of deals, 41% ahead of last year's pace. Breadth in the primary market was similarly strong, with 1,364 issuers that came to the market. The taxable municipal market benefited as the economy continued to expand, coupled with a seemingly insatiable demand from investors in the first quarter.

The first two months of the quarter were rocky for mortgage bonds due to elevated interest rate volatility. As the Treasury market settled down in March, the mortgage sector performed better, but there was too much ground to make up. The Bloomberg US MBS Index underperformed like duration Treasury bonds by 14 bps for the quarter. Deeply discounted mortgage pools, such as 30-year 2.00% and 2.50%, led the underperformance for the sector. On the other end of the coupon stack those mortgage bonds closer to par, 30-year 5.0% and 5.50%, had a strong quarter of outperformance.

In summary, the move to higher interest rates in the first quarter did not cause the credit markets any hiccups. Issuers and credit investors seemed to be comfortable with the fundamental reasons behind the Treasury market reprice, so much so that credit spreads in multiple sectors were the tightest they have been in years, in the face of historic issuance. It was a Goldilocks quarter for the credit markets.

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
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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.

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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.

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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