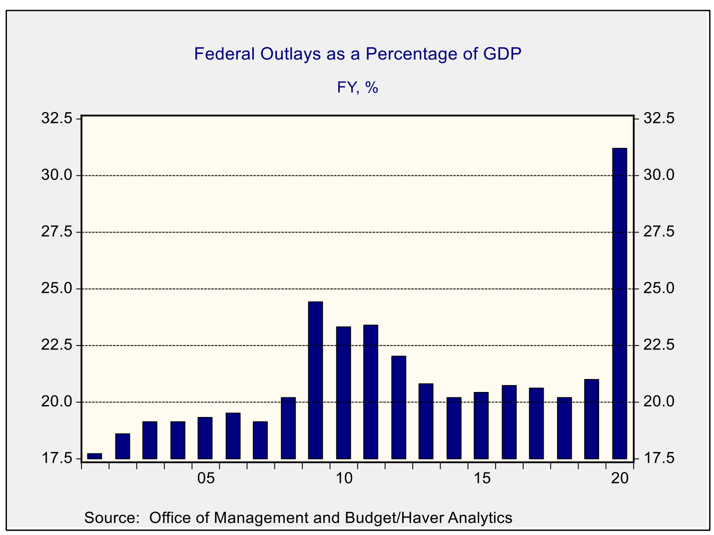
Fixed Income Quarterly

February 2022

- With the economy in expansion mode, extraordinary fiscal and monetary policy support is being withdrawn and the likelihood of policy errors is elevated.
- A portfolio centered on intermediate maturities allows bond investors to capture much of the income available from current yield curves, while allocations to short and long maturities provide a measure of protection from interest rate, geopolitical, and policy mistake risks.
- We continue to favor higher allocations to the Treasury and corporate sectors, while maintaining a cautious view toward mortgages.
- We also favor municipal revenue bonds, especially essential services such as water and sewer. Though general obligation [GO] bonds have improved support from federal infrastructure programs and should benefit from increased housing prices and associated rising property taxes, and progress has been made on pension funding, GOs still carry premium prices relative to similar maturity and rated tax-exempt revenue bonds.

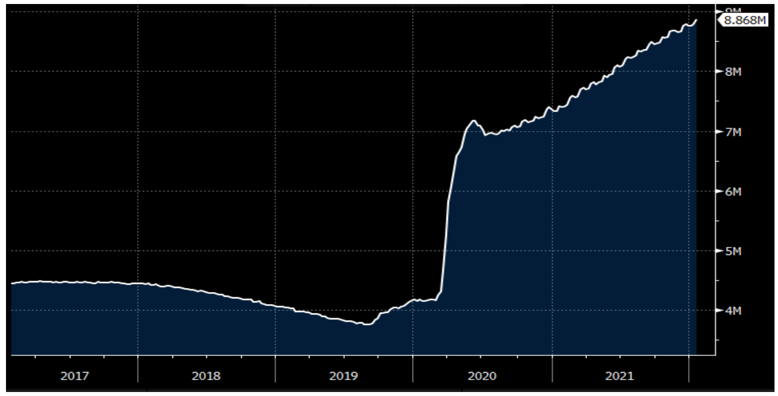
Although COVID continues to spread through its Greek alphabet soup of mutations, society is learning to adapt and move forward. In turn, the economy is also adjusting and has found its way back toward a productive growth trajectory. Nevertheless, the path has been disjointed as the pandemic altered, distorted, and exacerbated the nature of how and when goods and services are consumed. These changes resulted in demand surges, shortages, and, in many cases, inflation. Policymakers struggled to respond appropriately and usually erred on the side of providing or doing too much in an effort to avoid the pitfalls of not having done enough.

From an economic perspective, the policies of greatest consequence are fiscal and monetary, and we illustrate their magnitudes in the accompanying charts. On the fiscal side, this first graph shows federal outlays as a percentage of the economy over the past 20 years. As Washington scrambled to provide supplemental income throughout various stages of lockdown, federal spending became an enormous part of the economy, rising to levels not experienced since WWII.



On the monetary policy side, lowering short-term rates to zero and quantitative easing, where the Fed injects money into the financial system by purchasing Treasury and mortgage bonds, were wellknown policy tools. However, the *magnitude* of quantitative easing in 2020 was breathtaking. Our second graph illustrates the size of the Fed's balance sheet and its tremendous growth to around $8.9 trillion at the beginning of 2022, a level well more than twice the pre-pandemic level.

Federal Reserve Total Assets



(Source: Bloomberg)

With the economy now in expansion mode, employment widely available, and widespread pockets of inflation, both fiscal and monetary policymakers face the challenge of beginning to withdraw pandemic-related policy support. Withdrawing either policy by itself would be a challenging endeavor but drawing them down simultaneously increases the likelihood of mistakes that could harm the economy.

We agree that the time is right to begin withdrawing emergency policies. At the same time, we believe many of the current pockets of inflation should naturally recede as demand patterns normalize and supply chains adjust. This trend should help make the Fed's job a bit less complicated. Still, bond investors often fret as the Fed begins tightening, worrying that interest rates across the bond market may rise in response. *But we stress that in this cycle, it is actually the Fed that has followed the bond market, rather than the other way around.* For example, in early 2021, the Fed's own members almost unanimously forecast that its overnight rate would be unchanged and near zero at the end of 2022, while the bond market forecast a rate near 1.0%, indicating four rate hikes. Fast-forward to the beginning of 2022 and the Fed's median one-year forecast was essentially 1.0%, having risen up to the bond market's expectation, which remained at 1.0%. It is odd that the bond market has been better at anticipating Fed policy than the Fed itself, but this has actually been the case in this cycle.

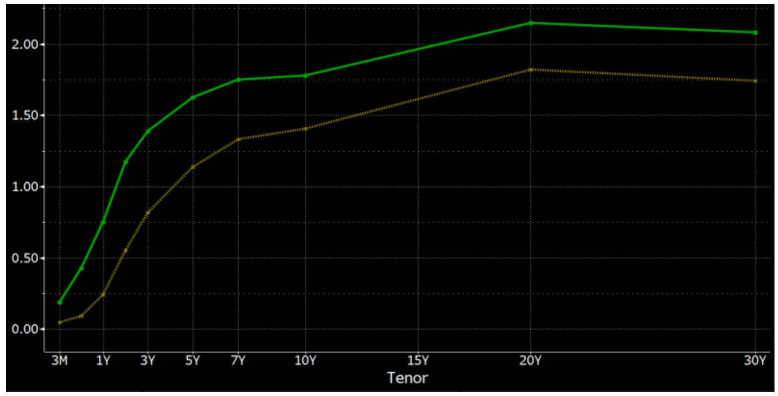
Looking forward, we believe policy mistakes may create some of the highest risks to the financial markets, a possibility reflected in the choppy start equities have had in the early part of 2022. Accordingly, bonds continue to offer important utility to investors, providing diversification and substantially less volatility relative to equities. We don't anticipate large spikes in interest rates as bonds have seemingly already moved prior to Fed tightening. Our anticipation of a cyclical decline in inflation would also help to stabilize rates.

Treasury Sector

Treasury yields began 2022 by moving higher. Interestingly, rates have moved proportionally higher for short and intermediate Treasuries relative to longer maturities. We illustrate this change through "yield curves," which show Treasury yields at various maturities from three-month bills to 30-year bonds. In the following chart on the next page, the lower yield curve (in yellow) is from early December 2021, while the upper yield curve (in green) is from late January 2022. Rates moved higher across all maturities, with short and intermediate yields up by around 40-60 bps, while the long 30-year was up by around 30 bps. These changes show how the slope of the yield curve flattened a bit as we began 2022.

The shape of yield curves and how they change are topics of great debate among bond theorists. In order to avoid sudden episodes of slumber, we'll limit our comments to some big-picture concepts. Yield curves tend to be steeper when future economic growth is expected to be higher, inflation is likely to rise, and Fed policy may become tighter. We believe the steepness in short and intermediate maturities currently reflects this expectation. On the other hand, yield curves tend to flatten, or even invert (meaning long-maturity yields are below those of shorter maturities), when growth and inflation are expected to decline and Fed policy may become easier. The flat part of the curve beyond 10 years implies lower long-term growth and declining inflation. The inversion between the 20- and 30-year maturities may be a signal of caution from the bond market that the Fed could tighten monetary policy too much or too fast, potentially causing a recession. We don't foresee this outcome right now, but the aforementioned possibility of a policy error is apparently manifesting in longer Treasury yields.

Treasury yield curves from January 2022 and December 2021



(Source: Bloomberg)

Another observation about the current yield curve is that most of the available Treasury yield can be captured with maturities less than 10 years. Accordingly, we believe exposure to intermediate maturities is constructive in pursuing income, given that incremental interest rate risk in this part of the yield curve is generally being rewarded with incremental yield. At the same time, some allocation to shorter maturities would be helpful should interest rates increase more than expected, while longer maturities provide a measure of protection against policy errors and geopolitical risks. In summary, we believe a bond exposure centered on intermediate maturities is appropriate, with some inclusion of both short and long maturities. We also believe tilting sector weights in favor of Treasuries makes sense, given the possibility of mistakes in fiscal and monetary policy.

Corporate Sector

Generally speaking, the recent decline in interest rates has been good for corporate borrowers. During the pandemic, the Fed lowered its overnight target rate to near zero, while simultaneously pumping trillions of dollars into the bond market. These policies made an enormous flow of capital available to corporate borrowers at very low rates and many corporations wisely took the opportunity to refinance existing debt and extend bond maturities many years into the future. And although shutdowns, tight labor markets, and supply interruptions presented many challenges for companies, default levels are low and most borrowers are in good shape.

That being said, with the Fed now changing its policy direction, concern is beginning to grow in the corporate sector. Corporate spreads, which show the incremental yields relative to Treasuries, declined in 2020 and remained low for most of 2021 until rising near the end of the year. Corporate spreads continued to widen in the early part of 2022, often in tandem with equity market volatility, reflecting a broader "risk off" paradigm.

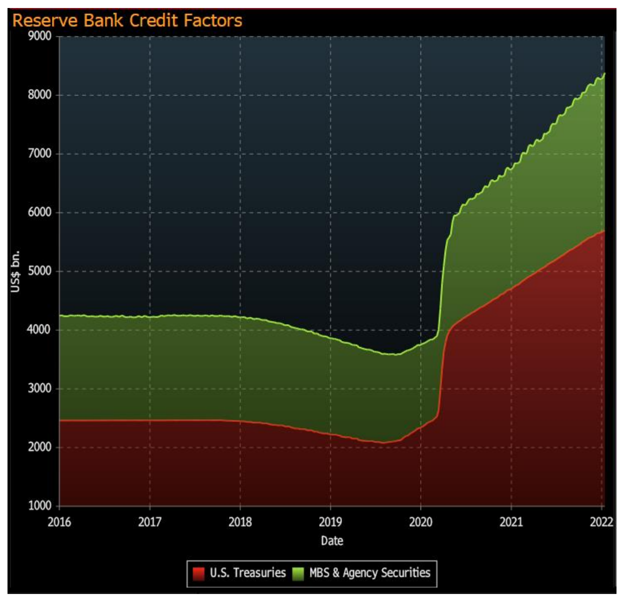
Investment-grade corporate bond spreads 2017-2022

(Source: Bloomberg)

With the Fed beginning a shift into tighter monetary policy, in some ways it makes sense that corporate spreads have widened. Yet we believe low default rates are likely to continue, given the broad strength of balance sheets in the sector and the ongoing economic expansion. For these reasons, we believe investors should continue to take advantage of the incremental yield provided by corporates and that a higher allocation to this sector remains appropriate.

Mortgage-Backed Securities (MBS) Sector

There has long been a multiplicity of macro factors affecting the mortgage-backed securities (MBS) market, including mortgage rates, refinancing rates, housing market trends, mortgage origination volume, MBS spreads, and Treasury rates. But when the Fed began its quantitative easing policy after the Great Financial Crisis in 2008, its participation became one of the most important market factors. Notably, during the pandemic, the Fed was the dominant purchaser of MBS.



(Source: Bloomberg)

This chart illustrates the proportion of Treasuries and MBS that the Fed holds on its balance sheet. Recently, this proportion was around two-thirds in Treasuries and one-third in MBS.

With the Fed scheduled to end its balance sheet expansion in the first half of 2022 and to potentially begin lowering its holdings later in the year, an important market dynamic becomes how MBS prices are affected as the Fed steps back. To be clear, the Fed will continue to reinvest much of the principal amortization from its existing MBS position, meaning that the Fed will remain a huge buying force in the market. However, Fed officials have mentioned their preference for balance sheet holdings to be mostly, if not entirely, in Treasuries. Such a change would likely take place over many years, but the sheer size of the Fed's MBS holdings indicates that even small reductions could create spread volatility.

After reaching multi-year lows in the first half of 2021, MBS spreads widened in the latter part of the year, a trend that has continued into 2022. We regard this sector as one that tends to have more appeal when interest rates are stable, given that MBS investors collect yield spreads relative to Treasuries through the embedded structure that is similar to writing interest rate option straddles. Given our expectation for relatively steady rates, along with wider MBS spreads, we expect MBS may present attractive opportunities in coming quarters. However, we believe a below-market allocation is appropriate right now, given the uncertainty caused by tighter Fed policy.

Municipal Bond Sector

The Infrastructure Investment and Jobs Act signed into law in mid-November promises to provide support to state and local governments through adding $550 billion of new funding, on top of existing funding, for roads, bridges, airports, railroads, and essential services such as water, sewer, and a new essential service of broadband. This legislation holds the potential to change the supply/demand balance of municipal bonds. Since the funding is expected to be in the form of grants from the federal government, most municipalities will likely issue bonds in anticipation of this funding, hence the term "grant anticipation notes." While the municipal bond market has been marked by nearly insatiable demand from investors, especially since the most recent presidential election, this new source of supply combined with a mid-term election outcome that is likely to be more pleasing to tax-sensitive investors holds the potential to put pressure on municipal bond prices.

Beyond the legislation and its support of state and local fiscal positions, progress has been made on pension funding, principally due to the rise in equity markets. Moreover, the advances in the prices of housing have elevated the property tax collections of municipalities. Overall, the fiscal health of most states and municipalities is the most solid it has been since prior to the Great Recession. A note of caution is in order, however. Although fiscal conditions are much improved and the infrastructure legislation promises to assist with funding of projects, the supply and demand for municipal bonds hold the potential to shift through this year. Layering the potential for a policy mistake by the Fed results in a degree of caution when structuring our Fixed Income Tax-Exempt strategy. Accordingly, our preference involves a focus on intermediate maturities, including the use of a laddered maturity posture, which will produce flexibility in its inexorable reduction in duration. We also favor lesser exposure to GOs, as we find them to be fully priced even without supply/demand changes. Conversely, we find municipal revenue bonds attractive, especially essential services such as water and sewer, as well as transportation-related issues, which have not been as fully valued and hold the prospect for federal fiscal support throughout the period that the infrastructure bill provides funding.

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Confluence Investment Management LLC

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