# Fixed Income Quarterly

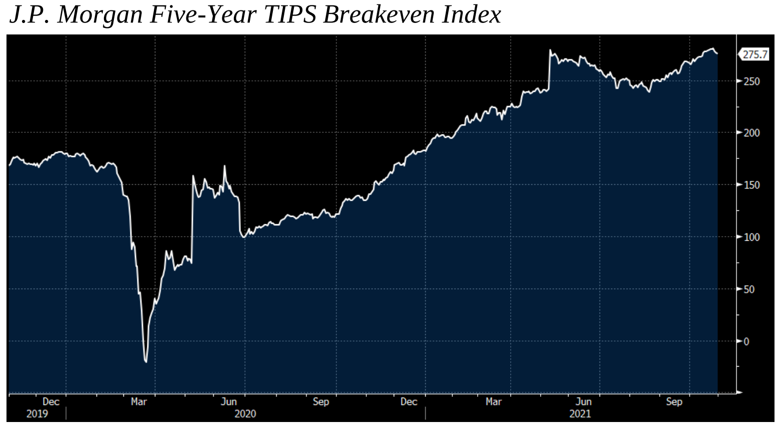
November 2021


- Inflation continues to rise, although we believe many price escalations should normalize over the next year or so. Still, some labor and rent escalations are likely to persist, creating higher inflation than existed prior to the pandemic.
- Tighter Fed policy and the tapering of bond purchases should not create high levels of interest rate risk. We anticipate only mild upside pressure on intermediate and longer-term yields.
- Portfolio duration is around 6.2 years for the Fixed Income Taxable strategy, slightly shorter than the benchmark, which has been around 6.7 years. We remain even-weight Treasuries, overweight corporates and underweight MBS.
- Portfolio duration of 6.3 years in the Fixed Income Tax-Exempt strategy is in line with the benchmark and municipal sector weights favor revenue bonds over general obligation (GO) bonds, especially in the transportation and essential services segments.

Bond investors recently witnessed a rise in inflation not seen since 1990 as the CPI rose in October by 6.2%. At the same time, the Fed has begun to telegraph plans to withdraw its easy monetary policy, first by tapering the monthly volume of Treasury and MBS purchases followed by raising short-term interest rates in 2022. Inflation and changing Fed balance sheet policy together form a rather interesting intersection of bond market theory. From one direction, inflation is the framework for the *Expectations Hypothesis*, which posits that interest rates across maturities reflect anticipated inflation over different time frames. In contrast, the *Market Segmentation Hypothesis* states that interest rates are determined by unique supply and demand at each maturity, something the Fed explicitly manipulates through bond market transactions.

With both theories indicating the potential for higher rates, we provide consideration for each one. With regard to inflation expectations, we illustrate the trend with the breakeven rate for the five-year TIPS over the past couple years. The decline from the economic shutdown in 2020 was very brief and we see inflation expectations have been on the rise since that time.

*J.P. Morgan Five-Year TIPS Breakeven Index*




*(Source: Bloomberg)*

Although both actual and expected inflation continue to grind higher, our view is that much of the current inflation will decline cyclically over the next year or so. Demand in our economy can change very quickly, while supply adjusts much more gradually. Suppliers have faced a lot of fits and starts with demand patterns and have been understandably cautious in embracing recent surges. In addition, logistics at ports and in transportation remain somewhat disjointed. Nevertheless, in time, we expect supply to rise in response to higher prices, creating a pathway back to the equilibrium that existed prior to the pandemic for many goods and services. For example, most consumers are aware of how surging demand for toilet paper created widespread shortages. But, supply ultimately responded, and, in most cases, availability has returned to pre-pandemic conditions. Lumber, another product supplied by the timber industry, also experienced surges in demand and shortages. In this chart, we can see lumber price volatility, with its escalations and declines, through the two-year period ending October 2021.

*Lumber Futures, Generic Front Month Contract*


*(Source: Bloomberg)*

Of course, not all goods and services will follow the same pattern, but we expect a fair amount of progress in the coming quarters. That being said, one area that appears to have had a longer-lasting change caused by the pandemic is the labor market. Even with the ongoing recovery, the labor force hasn’t really grown since the middle of 2020 and there are about two million fewer workers in the civilian labor force relative to the pre-pandemic level. Across a wide range of industries, employers face numerous challenges in hiring workers. Throughout 2021, job openings in both the private and government sectors have outpaced actual hiring by a wide margin. The pandemic and various policies have created frictional employment barriers that should decline, but the broad hiring solution most likely includes higher wages. Separately, higher home values indicate rising owners’ equivalent rent, which is a large component of the CPI. Taken altogether, we expect most of the current inflation to decline, tempering upside pressure on intermediate- and long-term interest rates from the *Expectations* hypothesis; however, we also believe wages and rents may elevate inflation to levels a bit higher than where they had been prior to the pandemic.

The Fed’s entire Quantitative Easing policy has been an effort to manipulate interest rates by reducing supply and increasing demand in the bond market. So, as the Fed tapers its bond buying, does this indicate higher interest rates? Surprisingly, the data indicate a weak and rather inconclusive relationship between intermediate bond prices and the application of QE. In reviewing the monthly change in the Fed’s balance sheet and the 10-year Treasury yield, the months with the highest growth of the Fed’s balance sheet created only mild downward pressure on yields; at the same time, months with the biggest declines in the Fed’s balance sheet created no discernable upward pressure on yields, except for in January 2009, when the Fed’s balance sheet shrunk by over 15%. Accordingly, our expectation is that as the Fed embarks on tapering, upward pressure on intermediate- and long-term rates derived from the *Market Segmentation* hypothesis is unlikely, unless the Fed tapers unexpectedly and suddenly.

In summary, we don’t expect inflation or tighter Fed policy to create significant upside pressure on intermediate- and long-term interest rates. (Our 10-year Treasury yield model indicates a fair value in the neighborhood of 1.5%.) Some cost pressure in the economy is likely to stick, but globalization and technological innovation are likely to keep inflation generally low. With mild amounts of interest rate upside pressure, we believe bond investors can maintain an even-weighted exposure to Treasuries but should keep portfolio duration slightly shorter than the benchmark.

## Corporate Sector

The corporate bond sector maintains spreads that are generally tighter than average. Corporate spreads over the past two years are illustrated in the following chart and remained steady during the third quarter. Capital flows into both public and private bond markets remain elevated but new issuance has also been high, fostering an equilibrium. Operating fundamentals are solid, and defaults are likely to remain low given that corporate earnings are on a positive trend. On the horizon, it seems likely that Congress may raise the corporate income tax rate, which could create some mild pressure on corporate cash flow. Fortunately, the risk will likely be offset by the benefits of the ongoing economic expansion and from the lower interest rate burden many companies now have. For these reasons, we believe an overweight exposure to the corporate sector is appropriate.

*Two-Year Trend in Investment-Grade Corporate Bond Spreads*


*(Source: Bloomberg)*

## Mortgage-Backed Securities (MBS) Sector

Similar to trends in corporates, the mortgage-backed securities (MBS) sector also maintained spread levels below historical averages. This chart illustrates option-adjusted spreads (OAS) for fixed rate MBS over the past two years and shows that although spreads were more volatile during the first half of the year, they steadied in the third quarter. The big unknown for the MBS sector is how the Fed's tapering of purchases may affect spreads. The Fed announced it would taper $15 billion from its November purchases, comprising $10 billion in Treasuries and $5 billion in MBS, a proportion that is similar to its current balance sheet allocation. The MBS market response thus far has been rather muted, and the sector continues to benefit from slower MBS prepayment speeds as mortgage refinancing volumes have declined. Oftentimes, slower speeds indicate rising levels of duration extension risk for MBS. But in this cycle, the risk may be contained by rising home values, which tend to facilitate housing turnover and prepayments. Overall, the environment for MBS is relatively stable, but we believe an underweight exposure is appropriate given the relatively tight level of spreads.

*Bloomberg U.S. MBS Agency Fixed Rate Average OAS*


*(Source: Bloomberg)*

## Municipal Bond Sector

The strong demand and limited supply that are conspiring to lift inflation for goods are also prevailing upon municipal bonds. The combination of near retail investor flows that are on course to set a record this year, institutional demand for municipals as High-Quality Liquid Assets [HQLA], and a lack of new issuance by municipalities have resulted in historically tight spreads. As an example, the five-year Muni/Treasury ratio stood at 0.51% as of early November.

From a legislative standpoint, as of this writing, the expansion of the State and Local Tax [SALT] cap beyond the current limit of $10,000 is still being debated in Washington. An expansion of this cap would be somewhat detrimental to municipal bonds as it would lessen retail demand. However, its inclusion in any legislation is mere conjecture at this point. Another piece of legislation that would have revived the provision for tax-exempt refunding of municipal securities was not included in the infrastructure package. The absence of this legislation will continue to weigh upon the supply of new municipal bonds. Against the legislative provisions and continuing investor appetites, we expect municipals to continue to remain tight relative to taxable bonds.

Within municipal bond segments in the Tax-Exempt strategy, we have a decided tilt toward revenue bonds in the ETFs we employ, especially those in the essential services and transportation sectors. In the latter segment, we believe that airports, bridges, roads, and ports will benefit from the proposed infrastructure spending. In addition, the physical plants of schools, affordable housing, and hospitals should be well supported in the bill as it unfolds over the next several years. Therefore, we believe that municipal bonds carry limited solvency risk at this point in the cycle.

The duration posture of the Tax-Exempt strategy remains neutral to the benchmark at 6.3 years, with over half of the strategy being distributed among the rungs of a ladder of target-maturity municipal bond ETFs stretching from 2024 to 2030.

David Miyazaki, CFA
*Portfolio Manager*

Greg Ellston
*Chief Investment Officer—Asset Allocation*

*Portfolio characteristics, including duration, represent the model portfolio as of 10/21/2021. Client accounts may vary based on individual client considerations and market fluctuations.*



## Confluence Investment Management LLC

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, company-specific approach. The firm's portfolio management philosophy begins by assessing risk and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.

20 ALLEN AVENUE, SUITE 300 | SAINT LOUIS, MO 63119 | 314.743.5090
WWW.CONFLUENCEINVESTMENT.COM