Confluence Investment Management

Fixed Income Quarterly

June 2022

- The Fed's "Crazy Ivan" maneuver[1] with regard to tighter policy created substantial turmoil in the bond market in the early months of 2022.
- Despite simultaneous declines across bonds and stocks in the first quarter, we continue to believe the two asset classes pair well together.
- The flat Treasury yield curve beyond the three-year maturity indicates expectations that interest rates could decline, possibly caused by a recession, a cyclical decline in inflation, or geopolitical events.
- We believe portfolio duration centered on intermediate maturities is appropriate and suggest a posture that is even-weight Treasuries, overweight corporates, and underweight mortgage-backed securities (MBS).
- Although municipals generally outperformed other sectors of the bond market, their valuations have become more attractive, particularly against the backdrop of strengthening fiscal health for state and local governments.

The first quarter of 2022 was pretty rough for fixed income investors. In fact, on the investment-grade side, the quarterly return was the worst since 1980. Inflation concerns certainly played a role in the negative pall cast over bonds, but, in our view, it was really Fed policy that created so much of the turmoil. If we look back over previous quarters, the economy was making good progress emerging from the pandemic and the shutdown. Of course, the stronger economy meant demand for goods and services was on the rise. Unfortunately, the supply side of the equation recovered more slowly, leading to shortages, price escalations, and broad inflation. The Fed consistently characterized this inflation as "transitory," noting that prices would naturally decline as supply adjusted. For this reason, the Fed felt it was unnecessary to remove its easy monetary policy.

Sometime near the end of 2021 and into the early part of 2022, a sort of "Crazy Ivan"[1] took place in the minds of Fed officials. All of a sudden, the Fed turned 180 degrees and decided inflation needed to be checked by tighter monetary policy. Labor shortages, supply interruptions from China, and energy price spikes as Russia invaded Ukraine together fostered a great sense of urgency to tighten. Normally, the Fed makes sudden and dramatic policy changes when easing, but when it comes to tightening the Fed's protocol in recent decades has been to telegraph its intentions well in advance in order to avoid surprising markets and the economy. However, with its newfound urgency, the Fed strayed far from its playbook in the first quarter, seemingly unconcerned with the consequence of surprise. The bond market responded to uncharacteristic Fed policy with uncharacteristic volatility. Bond prices plunged and Treasury yields rose across the entire range of maturities, with shorter maturity yields rising the most.

[1] A submarine tactic from the Cold War era involving an unexpected but strategic turn; the term gained fame in *The Hunt for Red October*: https://www.youtube.com/watch?v=DRUpAipGu5w.

Another aspect of the first quarter bond market decline is that bond prices fell at the same time as equities. Oftentimes, during periods of high equity market volatility, bond prices hold steady or even rise. That obviously wasn't the case in the first quarter and it's natural to question whether or not bonds will continue to provide the diversification and lower volatility that tend to pair so well with equities. We believe so, although tighter Fed policy, higher inflation, and rising geopolitical risks make this relationship quite fluid. Accordingly, we believe an appropriate posture for investment-grade bond allocations includes a laddered exposure across multiple maturities. While a measured exposure to long Treasuries is helpful to address risk, we feel that centering the portfolio on intermediate maturities is an effective way to navigate the possible outcomes. In our Fixed Income Taxable strategy, the maturity and duration positioning remain in-line with broad bond market measures, while our sector preferences remain neutral toward Treasuries, overweight corporates, and underweight MBS.

Municipal bonds moved in sympathy with their taxable cousins. Investor redemptions from municipal bond mutual funds exacerbated the declines that munis suffered from rising rates. However, despite the outflows, municipal bonds did not fare as poorly as corporates or Treasuries over the quarter. State and local finances improved markedly, propelled in part from continuing COVID fiscal support, the beginnings of federal infrastructure grants, and larger tax receipts from appreciated housing properties. These measures helped soothe credit concerns among investors, with the decline in municipal bond prices almost exclusively attributed to increasing rates across the curve. As with the Taxable strategy, we find that a ladder of term maturity municipal bond ETFs is appropriate as the crux of our Fixed Income Tax-Exempt strategy. Although our decision to augment this posture with longer-term municipal bonds was met with headwinds for returns over the past quarter, the elevated rates on long-term municipals decrease the likelihood of being called, increasing the durability of the income stream, especially given the strong credit fundamentals.

Treasury Sector

This first chart illustrates what is known as a yield curve. Here we can see Treasury yields ranging from short-term bills to long-term bonds. The upper blue line reflects the yield curve from May 2022, while the lower green line shows the yield curve from the end of 2021. The bars on the bottom show how much yields rose during the period for each of the maturities. From the chart, it's apparent that an investor could capture almost all of the available Treasury yield with a maturity profile around three years, which we've highlighted in red. Why, then, would an investor even bother with longer maturities, which don't offer much, if any, incremental yield?

Treasury yield curves from May 2022 and December 2021

(Source: Bloomberg, Confluence)

The answer lies in what the shape of the yield curve tells us. Intermediate and longer maturities form a flat curve, reflecting a reasonably high probability that interest rates could actually decline in the future. If rates were to decline, investors in longer maturities could enjoy an investment yield near 3% for a much longer time frame than those who chose to invest in shorter maturities. The flatness indicates a significant expectation that rates, on average, could be lower after three years.

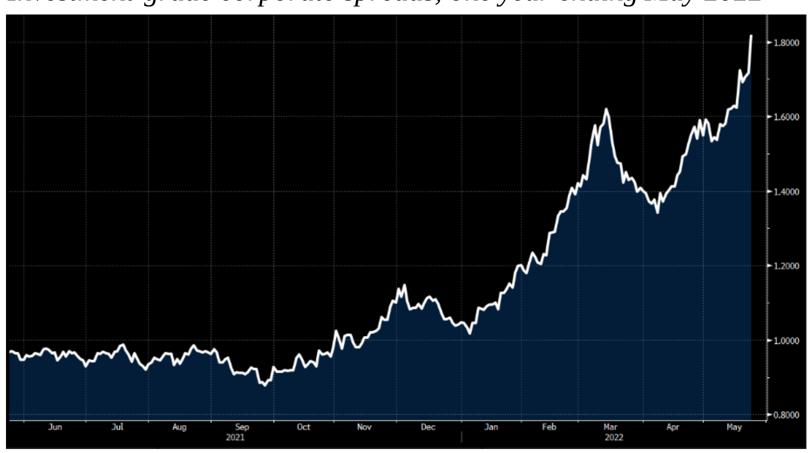
The Fed has made it clear that it plans to not only continue raising short-term rates but also begin lowering the size of its massive balance sheet. Meanwhile, inflation remains at high levels. How in the world could interest rates possibly move lower? We see three likely pathways: 1) the Fed overtightens and causes a recession, one characterized by lower inflation and, ultimately, easier monetary policy; 2) inflation declines cyclically as supply chains adjust, including those related to food and energy production, paving the way for the Fed to possibly dial back some of its tighter policy plans; or 3) geopolitical risks and outcomes worsen, disrupting markets and economies, thus creating a rush of capital toward safer assets, including longer-maturity Treasuries.

Of these three paths, only the second one involves a pleasant journey. Accordingly, our takeaway from the shape of the yield curve is a message of caution. The first and third pathways would likely involve rising levels of risk and volatility across markets and economies around the world. Should either one manifest, investors may be glad they invested in high-quality bonds, including Treasuries with maturities beyond three years.

Corporate Sector

This chart for the corporate sector shows how spreads have changed over the course of a year, ending in the second quarter of 2022. After remaining steady for most of 2021, corporate spreads began to widen a bit near the end of the year. Then, as the Fed began to telegraph tighter policy in early 2022, spreads widened substantially. Although spread widening took a break late in the first quarter, the march upward continued in the second quarter, reaching a level more than twice that of a year ago.

Investment-grade corporate spreads, one year ending May 2022



(Source: Bloomberg)

Corporate spreads tend to widen when liquidity among corporate bonds rapidly wanes and/or when investors become concerned about defaults. Interestingly, high-quality corporate bonds have not recently been plagued by either condition in acute form. There has been rotation out of longer maturities as investors have shifted into shorter ones, but, by and large, liquidity has remained intact. On the default side, many corporate borrowers were able to take advantage of low interest rates in recent quarters by locking in low rates through bond issuances spanning several years. Accordingly, credit quality remains in relatively good shape among investment-grade borrowers.

One trend we've observed in many pockets of the economy are statements from business managers—both large and small—regarding rising costs for goods and services. Thus far, many have been able to pass on the higher costs by raising prices. However, we're increasingly hearing from managers that they can no longer increase prices to customers without harming demand. Thus, if costs continue to rise, these businesses face either lower topline revenue, lower profit margins, or both. This situation is a bit odd in that higher interest rates seem unlikely to cause credit problems (at least initially), but if inflation steadies, companies may actually benefit from tighter policy.

On the other hand, if tighter policy causes a recession, it won't be an ideal environment for the corporate sector. Operating fundamentals will tend to erode, leading to rising defaults and wider spreads. Still, with corporate balance sheets generally in good shape and with spreads having already widened, we view the return/risk profile of the corporate sector favorably and believe an overweight posture is appropriate.

Mortgage-Backed Securities (MBS) Sector

For us, the elephant in the MBS room remains the Fed's balance sheet, which is now almost $9 trillion. In the following chart, we see how the Fed's asset portfolio grew from just under $4 trillion to almost $6.5 trillion in response to the pandemic. Initially, the Fed extended its capital into various positions to ensure liquidity in the domestic and global financial systems. But, since the fourth quarter of 2020, the composition of the portfolio has been around two-thirds in Treasuries (green) and one-third in MBS (red).

As part of its tighter monetary policy, the Fed has telegraphed its intention to lower the size of its balance sheet by allowing its portfolio of bonds to mature and not reinvesting all the principal into new bond purchases. Although the pace of the decline is somewhat fluid, and the ultimate size is not yet clear, recent guidance is to "run off" the portfolio by around $50 billion initially each month, ramping up to $95 billion each month in relatively short order. The proportion of MBS in the runoff is likely to be in the 30-40% range.

Reserve Bank Credit Factors, January 2019 – May 2022

(Source: Bloomberg)

Lowering the balance sheet is referred to as "quantitative tightening," or QT. The Fed's initial QT strategy doesn't involve outright sales of MBS, which would increase the supply; however, not reinvesting maturities removes an aspect of MBS demand that will probably have the same effect. It's worth noting that the Fed is careful to condition its QT plans to market and economic circumstances, which means it is very hard to know what to expect…mostly because the Fed itself isn't exactly sure, either.

What we do know is that the Fed plans to lower its MBS holdings. The MBS market is vast. The Fed amassed its great pile of MBS with the deliberate intent to alter the marketplace. Accordingly, it's hard to see how QT doesn't also alter the marketplace. On the upside, mortgage credit is in good shape, benefitting from the nationwide escalation in home prices, while avoiding the pitfalls of excessive subprime mortgages. In addition, refinancing rates have slowed dramatically. These trends have stabilized and improved the MBS environment. Nevertheless, as we enter the period when QT begins, we expect MBS volatility to rise and, for this reason, we continue to believe an underweight exposure to MBS is appropriate.

Municipal Bond Sector

Mirroring the Treasury sector, in the first quarter of 2022, the yield curve for municipal bonds became extremely flat for maturities beyond two years in what is termed a "bear flattener," where yields beyond two years increased markedly. The resultant decline in bond prices stemmed almost entirely from interest rate movements as opposed to credit concerns. Although flows from municipal bond mutual funds experienced record outflows in the first quarter, nearly -$30 billion, and even eclipsed the COVID reaction outflows during the first quarter of 2020, tax-exempt bonds provided moderately better returns than their taxable counterparts across every maturity. To a great extent, fiscal health for state and local governments helped quell investor angst regarding credit. However, among municipal bond segments, the return of some pre-COVID patterns helped municipal revenue bonds, especially the transportation segment, outperform state and local general obligation (GO) bonds. An increase in travel allayed concerns surrounding airport and toll road revenue issues, and essential services, such as sewer and water, benefitted from the commencement of federal infrastructure investment. Moreover, bond issuance by municipalities was moribund in the quarter, shoring up supply in the face of decreased demand and helped lessen the negative price movement.

While in past publications we have bemoaned the fact that municipal bonds were richly priced and near record levels relative to taxable issues, they are currently trading more reasonably. Although they remain relatively expensive in comparison to very long-term averages, they have stayed popular due to the tax advantages they offer in certain jurisdictions. Beyond the normal interest rate risk that municipal bonds will always face, another factor that appears to be entering the fray is early jawboning among states regarding lowering tax rates. This would undoubtedly be welcome news for taxpayers in those states, yet it would naturally discount the tax advantages of bonds issued in those jurisdictions.

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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.