Confluence INVESTMENT MANAGEMENT

Fixed Income Quarterly

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- Anticipating Fed policy has become more difficult in an uncertain environment where the Fed itself is unsure of its own decisions.
- The yield curve indicates ongoing increases in short-term rates in coming quarters, as well as the possibility for lower rates within the next few years. The inverted portion of the curve reflects a rising possibility of recession.
- The silver lining of higher rates is that conservative investors can now earn meaningful income from bond allocations.
- We recommend a laddered exposure across short and intermediate maturities with an overall maturity profile roughly in line with common benchmarks. Our sector preferences remain even-weight Treasuries, overweight corporates, and underweight mortgage-backed securities (MBS).
- On the municipal side we also suggest a laddered exposure with a maturity profile slightly shorter than common benchmarks. We also continue to favor revenue bonds over general obligation bonds.

"Don't fight the Fed" is one of the older and more well-known adages circulating in the financial markets, and for good reason. The central bank's interaction with the credit market is profound—it controls money supply, addresses liquidity, and alters the path and nature of economic growth. Over the past few decades, it has become easier for investors to avoid fighting the Fed because its policy was telegraphed far in advance, except when suddenly lowering rates in response to emergencies as it did during the Great Financial Crisis and the pandemic. But in 2022, as the Fed rather suddenly prioritized its efforts to lower inflation, investors across many asset classes found themselves inadvertently fighting the Fed as monetary policy tightened. Riskier asset classes, including equities and real estate, turned sharply lower with rising volatility. At the same time, safer asset classes like bonds delivered negative returns across all sectors, with loss severity increasing as maturity lengthened.

Not fighting the Fed involves predicting its future policy. Of course, investors are perpetually attempting this feat, but it has become more challenging in 2022. In recent quarters, Fed statements have changed focus, policy implementation has been erratic, and there's a palpable sense the Fed is "behind the curve" in addressing inflation. We recognize that directing monetary policy for a complex economy is never easy. Furthermore, the pandemic shutdown, sudden economic growth, supply interruptions, and fluid conditions in foreign economies have added substantial opacity for policymakers. It's become apparent that the Fed itself is unsure what it may do, creating a real challenge for investors trying to stay out of its way.

Recent statements made at the Fed's annual meeting in Jackson Hole, Wyoming, indicate that the Fed is deeply committed to fighting inflation, at least for now. Accordingly, bond investors can expect tighter monetary policy, again, at least for now. But despite all the uncertainty,

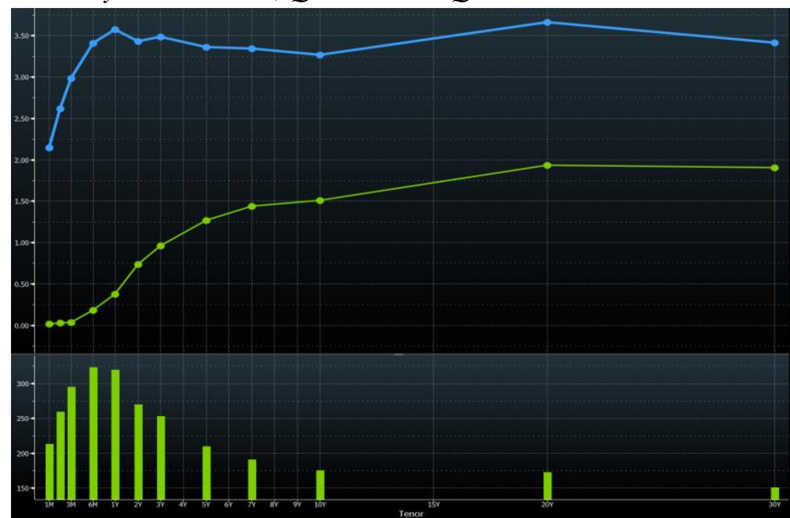
unpredictability, and attendant volatility, bond investors should not overlook a rather important silver lining: *higher interest rates allow conservative investors to finally earn a measure of income from the conservative side of their portfolios, which was difficult to achieve when the Fed held its overnight rate close to zero.* Also, bond investors don't have to get carried away with excessive interest rate or credit risk to capture yields. It's nice not to have to "reach for yield" for a change.

A good approach in the bond market may be to focus on how the world *is* as opposed to betting on what the Fed *may* do. Yields are attractive among short and intermediate maturities, while longer maturities can provide a measure of risk protection from geopolitical events. The challenge is to position portfolios to earn not just elevated nominal yields, but attractive yields against the backdrop of higher inflation. We believe the right balance involves primary allocations laddered across short and intermediate maturities. This posture creates a yield profile meaningfully higher than what has been available in recent years, while also creating a structure that facilitates investing in higher future yields should inflation and interest rates remain elevated. Accordingly, our maturity and duration preferences remain in line with broad bond market measures, while our sector preferences remain neutral toward Treasuries, overweight corporates, and underweight MBS. On the municipal side, we similarly suggest a laddered maturity structure in the majority of the short- and intermediate-maturity segments. Across the entire strategy, we prefer an overweight to revenue bonds as contrasted with general obligation (GO) bonds relative to the benchmark yet favor a duration profile in line with the broad index, albeit slightly shorter.

Treasury Sector

Our Treasury commentary is focused again this quarter on the shape of the yield curve, which graphs the relationship of Treasury yields across maturities, ranging from three months to 30 years.

Treasury Yield Curves, Q3 2022 and Q4 2021



(*Source: Bloomberg, Confluence*)

In this chart, the blue line shows the curve from the third quarter, while the green line illustrates the yield curve at the end of last year. The green bars on the bottom measure how much yields have risen in 2022 for the various maturities.

Very short maturities tend to reflect the Fed's overnight rate, while intermediate and longer maturities tend to show technical factors and market expectations for future rates. A "normal" curve shape has lower short-term rates, with rates escalating higher as maturities lengthen. A "flat" curve shape is one where rates are similar across maturities, while an "inverted" curve shape has higher rates for shorter maturities, with rates declining as maturities lengthen.

The normally shaped curve indicates positive economic growth, which may lead to higher inflation and higher rates in the future. Conversely, an inverted curve expresses low or negative growth

expectations, which may lead to lower inflation and lower rates in the future. The flat curve is between the normal and inverted shapes and often indicates a transition in expectations.

So, is the shape of today's Treasury curve normal, inverted, or flat? The answer appears to be "yes." In the near term, the very steep, upward slope is a nod to the Fed's hawkish language, recognizing that the overnight rate will likely continue to rise. At the same time, the inverted portion reflects expectations that the Fed may ease rates sometime in the next three years, perhaps in response to a recession. Still, the inversion is relatively mild and the general flatness across intermediate and long maturities indicates a measure of ambiguity with regard to longer-term growth, Fed policy, and inflation.

Inverted curves are noteworthy as recessions in the modern era have been preceded by such inversions. Because the present inversion is still relatively mild and not uniform across longer maturities, it appears that a recession is expected, but there isn't yet much conviction regarding its likelihood, magnitude, and tenor. Against the backdrop of this uncertainty, we believe allocations to short and intermediate maturities can capture much of the yield available in the bond market. At the same time, bond investors can bring a measure of ballast to their portfolios by including longer-term Treasuries. Although this exposure may lag the broader market if inflation and growth remain elevated, it can perform in differentiated form, perhaps even with positive returns, should our country enter a recession or if adverse geopolitical events unfold. Liquidity and quality can play important roles during times of uncertainty and turmoil. For this reason, our Treasury sector guidance is even-weight relative to common benchmarks, which involves an allocation of just over half the portfolio.

Corporate Sector

Rising interest rates, inflation, and monetary policy uncertainty continue to spill into the corporate sector, affecting not just how bonds trade, but also the corporate borrowers themselves. As rates rose in the first half of 2022, capital exited the sector, causing investment-grade corporate spreads to widen, as illustrated in this chart. However, part of this trend was offset by declining volumes of new corporate bond issuance. Many borrowers paused and took time to adjust to higher rates and wider spreads. Accordingly, spreads widened through the end of the second quarter but recovered and tightened in the early part of the third quarter.

Corporate Investment-Grade Spreads, YTD Q3 2022

(Source: Bloomberg)

Tightening corporate spreads helped the sector generally outperform Treasuries across a wide range of maturities in July, although the trend reversed as the third quarter progressed. In part, the sector's strength was derived from strategic decisions made by corporate borrowers who took advantage of the pandemic's low-interest rate environment by issuing longer-term bonds. These borrowers locked in attractive borrowing costs and created a measure of protection against rising interest rates. In this

regard, much of the sector was reasonably well-prepared for the recent escalation in rates. Still, there remains a large proportion of corporate borrowers with floating-rate liabilities, and higher rates will create a headwind for many of them. Furthermore, the abundance of capital available to corporate borrowers in recent years caused lending standards to decline in certain cases. So, while defaults remain relatively low and we are generally satisfied with corporate credit quality, we temper our enthusiasm given the growing possibility of a recession. Accordingly, we suggest only a modest overweight to the corporate sector.

Mortgage-Backed Securities (MBS) Sector

In television shows ranging from *M*A*S*H* to *All in the Family*, characters held mortgage burning parties, wherein homeowners reached their final payment and ceremoniously burned the paper lien at a party. But over time, as homeowners became more mobile and the mortgage market allowed for refinancing, fewer and fewer homeowners ever reached this milestone, and the parties went the way of the television antennae.

Yet fires still take place today among mortgages, even as the form is substantially more metaphorical. Our mortgage chart illustrates 10 years of the refinancing index from the Mortgage Bankers Association (white solid line) along with the Bank Rate 30-Year fixed-rate mortgage (blue dotted line). Mortgage refinancing trends are one of the most powerful forces in the MBS market because of how they affect the maturity and duration of mortgage pools. From the graph we can see enormous gyrations in the level of mortgage refinancing, which generally moves inversely relative to mortgage rates. When mortgage rates decline, refinancing volume rises, and vice versa.

Mortgage Refinancing and 30-Year Mortgage Rates, 10 years ending Q3 2022

(Source: Bloomberg)

The pandemic, mortgage payment holidays, large swings in Fed policy, Quantitative Easing and Tightening, inflation, and the kitchen sink collectively created all kinds of metaphorical fires in the MBS sector. However, with the 30-year mortgage rate rising in 2022 to around 6%, refinancing volume has rapidly declined. Lower prepayment rates among MBS have improved maturity and duration predictability, even as MBS spreads have widened. Accordingly, we believe the return/risk profile of the MBS sector has improved. Still, the consequences of the Fed's Quantitative Tightening are difficult to predict, and for this reason we continue forward with an underweight bias toward MBS, even as the environment has become more constructive.

Municipal Bond Sector

In general, state and local governments remain in a healthy fiscal position to aid municipals in the event of an economic downturn. As evidence, at the end of the second quarter, revenue collections, aided by increased sales and property tax revenues, and reserves were at the highest levels since the

early 1980s. In the aggregate, total reserves and state rainy day funds are expected to exceed $260 billion and $130 billion, respectively, this year. Given total expenditures of close to $1 trillion, these represent significant proportions. Moreover, federal stimulus in the form of the Bipartisan Infrastructure Law and the American Rescue Plan Act will help to mitigate expenditures over the next several years. However, market movements this year have helped to dampen investment returns for state and local pension funds which will also be impacted by other post-employment benefits (OPEB) expenditures. Nevertheless, the overall fiscal positioning of municipals offers a fair degree of resiliency should economic conditions contract.

Regarding the market for municipal bonds, the elevation of rates this year has resulted in a dampening of supply of bonds. Relative to last year at this time, refunding of municipal debt is nearly 50% lower. Consequently, overall supply has declined by over 10%. On the demand side, municipal bond mutual funds and ETFs have experienced outflows of nearly $75 billion year-to-date through the end of August. Although supply has been constrained, the outflows from retail investors have led to higher municipal-to-Treasury yield ratios. Contrasted with the five-year muni/Treasury ratio of 51% at the beginning of this year, near historic lows, the ratio now stands at 70%, modestly higher than the historic average.

Our preference retains an overweight to municipal revenue bonds, particularly essential services and transportation, as these entities continue to recover from the effects of the pandemic. Our duration guidance is slightly lower than the benchmark and we continue to recommend a laddered maturity structure as its core.

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