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Weekly Fixed Income Commentary

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Treasury yields rise with the drumbeat of a hawkish Fed

U.S. Treasury yields rose, led by shorter maturities, as U.S. Federal Reserve rhetoric continued to lean hawkish. Chair Powell emphasized his commitment to fighting inflation, pushing back against market expectations for rate cuts in early 2023.

HIGHLIGHTS

- **Most sectors had negative returns, including Treasuries, MBS, CMBS, preferreds, convertibles, and investment grade and high yield corporates.**
- **Taxable municipals and emerging markets rallied, while agencies and ABS had positive excess returns.**
- **Municipal bond yields rose slightly. New issue supply was $6.8B, with outflows of -$1.2B. This week's new issue supply should be $6.4B.**

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Watchlist

- *10-year Treasury yields moved higher last week.*
- *Spread assets weakened amid worsening economic data.*
- *Net-negative supply should provide some support to municipal bonds.*

INVESTMENT VIEWS

Accommodative interest rate policy remains a key market support. While investors continue to focus on more hawkish Fed policy, overall rates are likely to remain relatively low even after several rate hikes.

The underlying growth outlook remains healthy, as consumers have strong balance sheets, businesses are reinvesting and Covid recedes. This should keep defaults low.

Treasury yields are likely to rise this year, but we don't expect the 10-year Treasury yield to rise much above 3.00%.

We favor a risk-on stance, focused on credits with durable free cash flow and solid balance sheets across a wide range of sectors. Mid-quality rating segments appear particularly attractive. Essential service municipal bonds also look compelling.

KEY RISKS

- Inflation fails to moderate as expected, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- The Russia/Ukraine conflict continues to escalate.
- COVID-19 cases increase, or new variants emerge.

HIGH YIELD CORPORATE OUTFLOWS ARE LARGER THAN EXPECTED

U.S. Treasury yields rose last week as the drumbeat of hawkish rhetoric from Federal Reserve officials continued. Chair Powell, in his speech at the Fed's Jackson Hole conference, delivered the grand finale, emphasizing his commitment to fighting inflation, setting the stage for another outsized rate hike at the September meeting and pushing back against market expectations for rate cuts in early 2023. Two-year yields accordingly rose 17 basis points (bps) for the week, while ten-year yields rose a more modest 7 bps.

Investment grade corporates weakened amid low activity, returning -0.23% and underperforming similar-duration Treasuries by -10 bps. The primary market dried up almost completely, with only $1.6 billion of new issuance for the week. That was down -93% versus the prior week as the pre-Labor Day doldrums set in. This week is expected to be similarly quiet.

High yield corporates lagged again, returning -1.05% for the week and underperforming similar-duration Treasuries by -79 bps. The weakness came amid larger-than-expected outflows of -$4.7 billion. That was the second largest outflow of the year. Though loan funds also saw notable outflows of -$987 million, they returned only -0.16%, as the asset class benefits from higher rates due to its floating-rate nature.

Emerging markets outperformed strongly, gaining 0.13% and beating similar-duration Treasuries by 45 bps. Even though the dollar index gained 0.6%, an index of emerging market currencies rallied 0.4%. The asset class was boosted by the announcement of fresh stimulus in China, with the State Council announcing a number of new fiscal stimulus, including new funds for policy banks, local governments and infrastructure.

MUNICIPAL BONDS SHOULD REMAIN WELL BID

The municipal bond market was listless last week and ended with higher yields, as is normally the case in such an environment. The municipal yield curve ended 5 basis points higher on the short end and 12 basis points higher on the long end.

Fed Chair Powell stated that the Fed will continue to raise rates for as long as it takes to wring inflation out of the economy. Fixed income markets experienced modest increases in rates following the statements, but investors appear to be in a wait-and-see mode. We are in the final week of the summer doldrums, and investors appear to be putting off major decisions until after Labor Day in the U.S.

Municipal bonds should remain well bid after Labor Day. We could see periodic tactical sell offs due to large new issues coming to market, as often happens in the fourth quarter. However, heavy demand from institutions should persist through year end as portfolio rebalancing continues. We would see any potential market declines as possible investment opportunities.

The city of Charlotte, NC, issued $477 million water and sewer revenue bonds (rated Aaa/AAA). The deal was well received. It included 30-year bonds with a 4% coupon priced at a yield of 4.11%. Those bonds traded in the secondary market at 4.07%.

High yield municipal bonds are proving rather resilient in the face of market volatility, but not entirely immune. Higher yields are attracting strong interest, but that was less of an issue last week with valuations no longer consistently increasing. Rate anxiety and its impact on the market is steadily waning, and high yield municipal credit strength and higher yield returns are incentives to stay invested. The upcoming new issue calendar is rather light, and should remain so for the remainder of the summer.

Fixed income markets took the Fed news largely in stride, as many investors believe the economy has begun to cool.

In focus

Powell: The Fed means business

At the Fed's annual symposium in Jackson Hole, Wyoming, Fed Chair Jerome Powell struck a hawkish tone amid a period of hot inflation worldwide and slowing global growth.

Powell made clear that the Fed hasn't seen nearly enough evidence of a decrease in the rate of inflation to pause its tightening efforts, let alone begin lowering rates. He not only stuck to his post-meeting script from June and July – emphasizing that the central bank must remain resolute in its mission to lower inflation – but also stated that bringing prices down might entail "some pain" for households and businesses.

The current state of monetary policy is far tighter than most economists could have anticipated back in January, March or even in early June, before 75 bps rate hikes seemingly became the norm. We expect another outsized increase at the Fed's next meeting in September, followed by a handful of smaller hikes.

The outlook for the U.S. economy brightened over the summer, thanks to declining energy prices, steady consumer spending and solid payroll growth. This will likely only provide more justification for the Fed to stand firm on raising rates and keep them elevated. Anticipating looser policy in 2023 is actually pessimistic, because doing so suggests that a weak U.S. economy will force the Fed to prioritize supporting growth over fighting inflation.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	3.40	0.17	0.51	2.67
5-year	3.21	0.11	0.53	1.94
10-year	3.04	0.07	0.39	1.53
30-year	3.19	-0.02	0.18	1.29

Source: Bloomberg L.P., 26 Aug 2022. **Past performance does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	2.21	0.05	0.61	1.97
5-year	2.26	0.06	0.46	1.67
10-year	2.54	0.06	0.33	1.51
30-year	3.23	0.12	0.34	1.74

Source: Bloomberg L.P., 26 Aug 2022. **Past performance does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	84
30-year AAA Municipal vs Treasury	101
High Yield Municipal vs High Yield Corporate	66

Source: Bloomberg L.P., Thompson Reuters, 26 Aug 2022. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg High Yield Municipal Index divided by the yield-to-worst for the Bloomberg High Yield Corporate Index. **Past performance does not predict or guarantee future results.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	3.23	–	6.77	-0.47	-1.87	-8.32
High yield municipal	5.25	216[1]	10.17	-0.55	-1.54	-9.88
Short duration high yield municipal[2]	4.80	245	4.22	-0.23	-0.80	-4.30
Taxable municipal	4.41	115[3]	9.33	0.10	-1.91	-13.99
U.S. aggregate bond	3.83	50[3]	6.40	-0.36	-2.03	-10.02
U.S. Treasury	3.31	–	6.42	-0.21	-1.88	-9.43
U.S. government related	3.89	59[3]	5.43	-0.16	-1.42	-8.98
U.S. corporate investment grade	4.66	137[3]	7.56	-0.23	-1.75	-13.16
U.S. mortgage-backed securities	3.82	39[3]	5.71	-0.72	-2.62	-8.32
U.S. commercial mortgage-backed securities	4.29	104[3]	4.79	-0.55	-1.99	-8.47
U.S. asset-backed securities	4.06	68[3]	2.21	-0.04	-0.57	-3.85
Preferred securities	6.18	237[3]	4.92	-1.19	-1.17	-10.40
High yield 2% issuer capped	8.02	454[3]	4.05	-1.05	-0.67	-9.73
Senior loans[4]	9.11	558	0.25	-0.16	1.66	-1.05
Global emerging markets	6.89	362[3]	6.36	0.13	0.44	-15.02
Global aggregate (unhedged)	2.99	54[3]	6.95	-0.74	-3.09	-14.80

1 Yield difference between the Bloomberg High Yield Municipal Index and the 20-year AAA MMD scale. **2** Data is a subset of the S&P Short Duration Municipal Yield Index that is below investment grade/nonrated. Spread is the yield difference between this subset and the subset rated AAA. **3** Option-adjusted spread to Treasuries. **4** Spread refers to the 3-year discount margin. Duration is estimated based on the frequency of the reset date.

Source: Bloomberg L.P. and Credit Suisse, 26 Aug 2022. **Past performance does not predict or guarantee future results.** Unless otherwise noted, the index is Bloomberg. All index returns are shown in U.S. dollars. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting. **Effective duration** (expressed in years) measures the price sensitivity of a fixed-income investment to a change in interest rates, considering that expected cash flows will fluctuate as interest rates change. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account.

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Performance: Bloomberg, L.P. **Issuance:** The Bond Buyer, 26 Aug 2022. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 23 Aug 2022.

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Representative indexes: municipal: Bloomberg Municipal Index; **high yield municipal:** Bloomberg High Yield Municipal Index; **short duration high yield municipal:** S&P Short Duration Municipal Yield Index; **taxable municipal:** Bloomberg Taxable Municipal Bond Index; **U.S. aggregate bond:** Bloomberg U.S. Aggregate Bond Index; **U.S. Treasury:** Bloomberg U.S. Treasury Index; **U.S. government related:** Bloomberg U.S. Government-Related Index; **U.S. corporate investment grade:** Bloomberg U.S. Corporate Index; **U.S. mortgage-backed securities;** Bloomberg U.S. Mortgage-Backed Securities Index; **U.S. commercial mortgage-backed securities:** Bloomberg CMBS ERISA-Eligible Index; **U.S. asset-backed securities:** Bloomberg Asset-Backed Securities Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield 2% issuer capped:** Bloomberg High Yield 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index; **global emerging markets:** Bloomberg Emerging Market USD Aggregate Index; **global aggregate:** Bloomberg Global Aggregate Unhedged Index.

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Investors should contact a tax professional regarding the appropriateness of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the state of residence. Income from municipal bonds held by a portfolio could be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

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