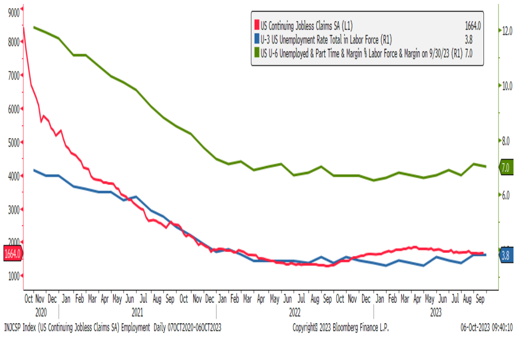
BOND MARKET UPDATE

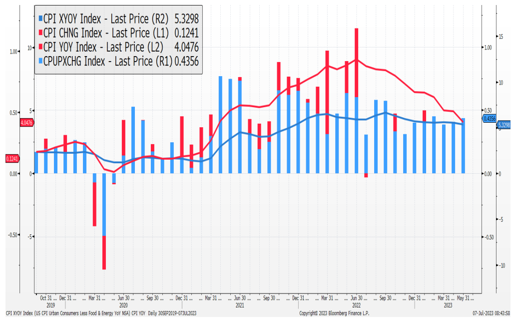
As of 09/30/23 | Volume 12, Issue 3 | FFTAM.com

In the 3rd Quarter of 2023, total returns for both taxable and tax-free investments were negative for the quarter. For taxable portfolios in the 3rd Quarter, the Barclays Aggregate generated a total return of -3.23%. For tax-free portfolios in the 3rd Quarter, the Barclays 1-10yr Muni generated a total return of -2.23%. YTD returns are -1.21% for the Barclays Aggregate and -0.81% for the Barclays 1-10yr Muni. The economy accelerated, inflation continues to dis-inflating, the Fed raised the cash rate in July and paused in September, and confidence in the US government's functionality, deficits, supply and total debt load diminished.

Economy

GDP in the 2nd Quarter of 2023 came in with a final Q/Q reading of +2.1%. GDP Projections for the 3rd Quarter sit at a surprisingly good estimated growth rate of +3.0 to 5.0% Q/Q. Current estimates for 2023 GDP Y/Y have moved up again, Y/Y growth rate projections are now 2.1%. US Unemployment and US Continuing Jobless Claims have leveled off at very low levels, and the economy continues to displaying signs of overall weaker positive momentum in every category except personal consumption. Market expectations remain that employment numbers should start to weaken led by increases in continuing claims, however, labor has and continues to be very sticky. Per the September jobs report, labor demand appears robust as September was strong and July and August saw nice upward revisions to numbers that initially showed weakness. Inflation has drifted lower on a Year over Year (YoY) basis, and we continue to see signs of disinflation in most segments of the CPI on a monthly and quarterly basis. Comps versus the prior year now get more difficult as their are no longer large monthly increases that roll off. Oil surged in the 3rd Quarter and this did cause upside momentum in the headline CPI, however, this has not shown up in the core as of now.





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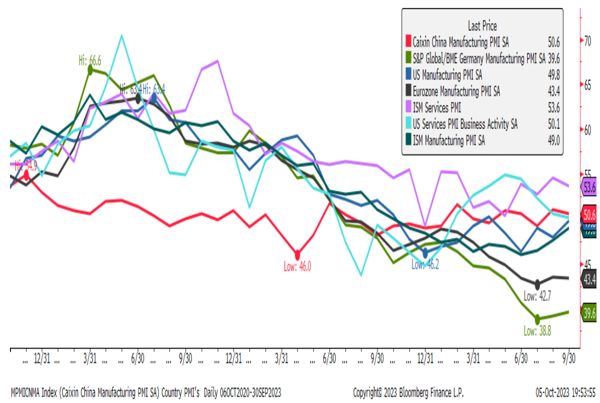
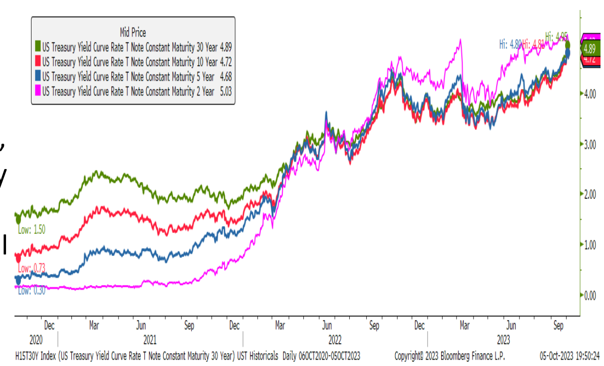
Since the 3rd Quarter of 2021, we have seen a steady downward trajectory of manufacturing and services PMI's from very elevated levels. Manufacturing (30% of the US economy) has been in contraction now for roughly three quarters, at some point, if not now, manufacturing will stabilize at lower levels and stop contracting. Housing is a good example, however, 8% mortgage rates have the ability to impede any comeback. Services (70% of the US economy) is still expanding but at much slower levels. The consumer with a job continues to buoy the economy, however, depletion of savings in conjunction with higher prices will continue to cause overall demand to weaken at some point, as it hasn't happened yet.



Rates

Year to date 2yr, 5yr, and 10yr U.S. risk free rates (nominal) are ǳLJ approximately 59bps, 68bps and 84bps, respectively. This has created a less inverted UST yield curve. The 10yr to 2yr UST spread hit a high of Ƅ160bps early last year, a low of -108bps in the summer of this year, to currently an inverted -30bps. Real rates have also risen substantially starting in 2022. Currently, 10yr TIPS are pricing at 2.41%. This validates that market rates are restrictive, and that the Fed's policy will eventually succeed in its fight against inflation. Mortgage rates have also moved substantially higher, 30yr mortgage rates ǑdzNJNJŜƴǘfè ǎʎǘǘʎƴ∃ l·ǘ ᴛɸ76̰̂ .



The Fed

The Fed had two meetings in the 3rd quarter, July and September. At the July meeting, the Fed raised the cash rate by 25bps to a range of 5.25% to 5.50%. At the September meeting, the Fed elected to pause and keep rates at the same level as before. At the press conference, Powell acknowledged that they are close to their destination and future interest rate hikes would be based on the economic data. This is the FOMC's second hike then pause. Powell also communicated that members of the committee will view inflation in the context of the real rate. What does this mean? If inflation continues to move the direction they anticipate (lower), their may be an opportunity in the back half of 2024 to ease policy due to real rates becoming more restrictive even with a Fed on hold, hence, the Goldilocks outcome of the illusive soft landing. Quantitative Tightening (QT) continues to work in the background at $95B/month, it will stay at this level until further notice. We have never experienced QT of this magnitude, and the effects are still unknown.

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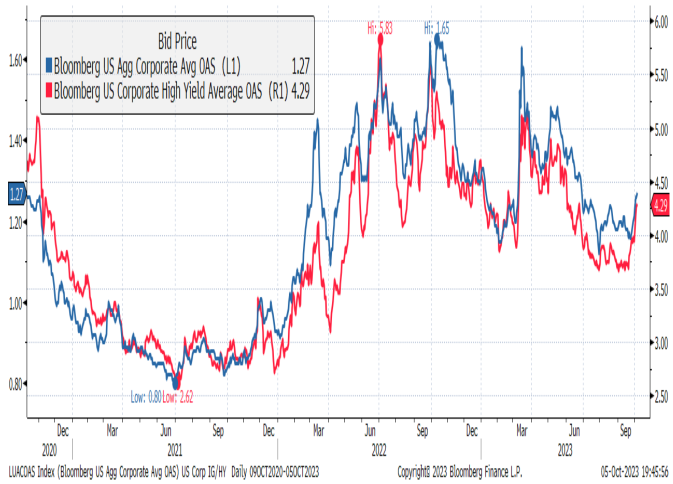
Credit

Credit risk was positive versus risk free in the 3rd Quarter of 2023. Spreads where roughly flat for both Investment Grade (IG) and High Yield (HY). For the quarter, IG spreads tightened by roughly 2bps and HY spreads widened by roughly 4bps. YTD, spreads have tightened by 9bps and 75bps, respectively. Risk premiums, starting in September, started to increase with the big move in long dated risk free rates . Overall, financial conditions have tightened significantly since the beginning of 2022 and have the potential to tighten further if labor continues to remain sticky, the consumer continues to spend, and the price of oil elevates. This has the potential of forcing the Fed's hand to keep raising the cash rate.



Looking Forward

Over the past 19 months, the market has absorbed a substantial amount of Fed tightening in a short amount of time. With a cash rate at 5.50%, a 2yr UST at 5.02%, and now a 10yr UST at 4.73%, the market looks very enticing. September's job report does bring the Fed into play for November. The huge selloff in long rates in the 3rd Quarter, coupled with an increase is volatility has created an excellent opportunity in Agency MBS. QT is still a wild card and the effects of QT (less liquidity) are working in the background. We have found some pockets of IG credit risk that we like, however, this quick rise in long-term UST's does raise a yellow flag in the credit markets. We continue to be void of High Yield, and continue to build up our US Treasury and Agency MBS exposure. Forward returns continue to look very enticing, and this is something we haven't been able to say in over a decade. Taxable portfolios can be constructed discounting at 6%, tax-free portfolios for high net worth individuals can be constructed discounting at 7+% TEY's. As always, we run a high-quality portfolio that looks to take advantage of opportunities as they present themselves. We have been active in seeking those opportunities and feel good about the changes that have been made.

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