BOND MARKET UPDATE

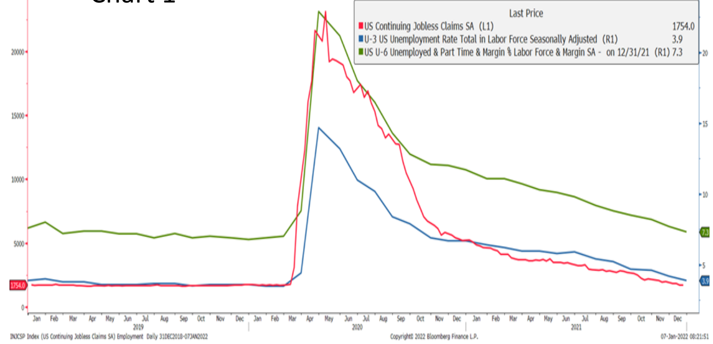
As of 12/31/21 | Volume 10, Issue 4 | FFTAM.com

In the 4th Quarter of 2021, total returns for both taxable investments and tax-free investments were essentially flat for the quarter. For taxable portfolios in the 4th Quarter, the Barclays Aggregate generated a total return of 0.01%. For tax-free portfolios in the 4th Quarter, the Barclays 1-10yr Muni generated a total return of 0.18%. YTD returns are -1.54% and 0.54%, respectively. The economy continues to show signs of resiliency from Covid variants , the Fed communicated a quicker taper, and the markets are now firmly pricing in multiple Fed rate hikes for 2022.

Economy

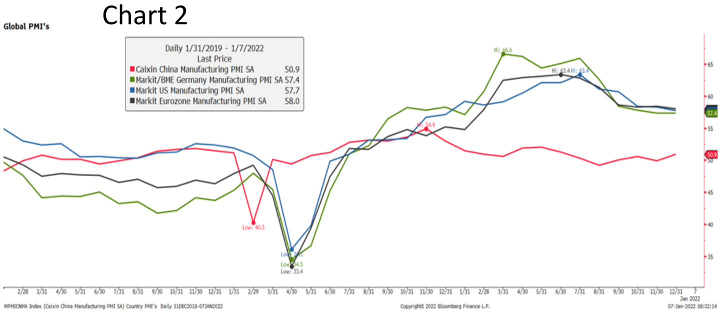
GDP in the 3rd Quarter of 2021 came in with a final Q/Q reading of +2.3%. GDP Projections for the 4th Quarter of 2021 are estimated at +6.0% Q/Q. Current estimates for the year of 2022 are for a Y/Y growth rate of 3.9%. US Unemployment and US Continuing Jobless Claims continue to decline, and the economy continues to build on reopening momentum even in the face of Covid variants. Individuals are changing jobs for higher pay and there are some signs that supply bottlenecks are easing. Expectations are that employment numbers and supply shortage inflation should continue to improve in the coming quarters. (Chart 1)

Chart 1



Over the last several quarters, we have seen a slight downtick of PMI's from elevated levels (Chart 2), signaling that the 2nd Quarter of 2022 may have indeed been peak growth from a trough established in the 2nd Quarter of 2020. There is no doubt that the Delta variant did have some effect on these numbers and Omicron will affect the 1st Quarter of 2022. Omicron is quickly becoming the dominant variant, it's also proving to be a much milder and more transmissible variant which lends to a slight reacceleration and leveling off of PMI's in the near future.

Chart 2



FIRST FINANCIAL TRUST
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Fort Worth, TX 76110
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Rates

For the 4th Quarter of 2021, 2yr U.S. risk free rates moved up almost 50bps while 10yr+ U.S. risk free rates were unchanged. This created a substantial flattening of the UST 10yr versus 2yr curve, compressing it from 121bps at the beginning of the quarter to 78bps at the end of the year. Fortunately, the market and the Fed are doing a better job of looking through the mutated Covid variants. The Fed, at both the November and December FOMC meetings, elected to keep the cash rate at the zero-lower bound. In addition, per script, at its November meeting started the tapering of the $120B/month buy program put in place at the start of the pandemic. At the December meeting, the Fed made a much more hawkish turn and communicated a doubling of the taper pace and telegraphed a steeper path of rate hikes than previously forecasted.

The Fed's balance sheet currently stands at $8.77T (Chart 4). Per the Fed, the balance will continue to grow though the first quarter of 2022. At that point, it is not very clear if the balance will remain constant by the Fed reinvesting cashflows or if the Fed will start to let the balance sheet reduce by not reinvesting cashflows. We will gain more insight into this as we approach the end of the 1st Quarter of 2022.

Credit

Credit risk performed roughly in line versus risk free in the 4th Quarter of 2021. Spreads widened slightly for investment grade and tightened slightly for high yield (Chart 5). Investment grade spreads widened by roughly 8bps. High yield spreads tightened by roughly 5bps. As you can see, we are still at very low risk premium levels and on par and lower than pre-Covid levels.

Chart 3

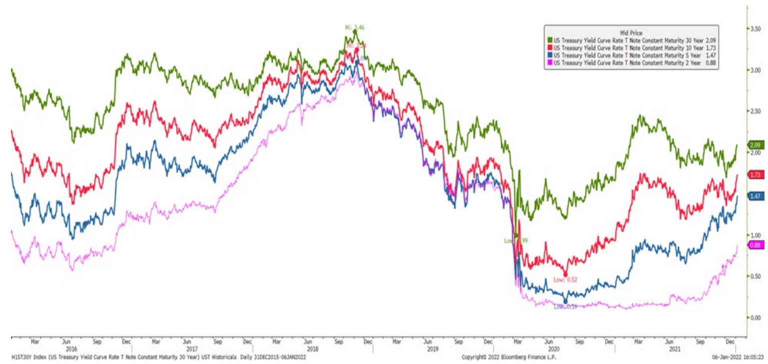

Chart 4

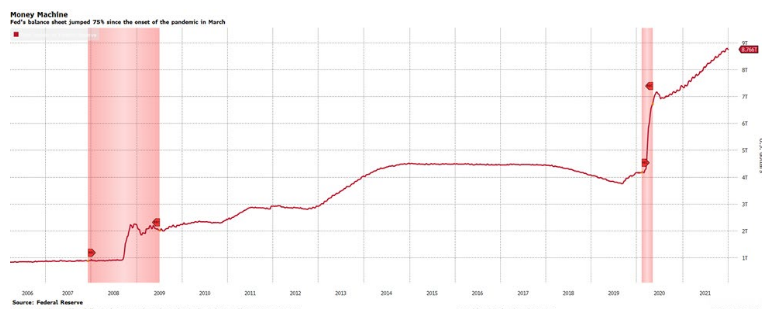

Chart 5

Looking Forward

Looking forward, the risk-free curve on the short part of the curve has priced in three moves by the Fed in 2022. This new pricing makes short duration fixed income assets much more attractive. Longer dated fixed income assets now represent a challenge as they have not repriced near as much as shorter dated assets. The Fed controls the short part of the curve through traditional monetary policy, it is being priced correctly. The Fed historically has not controlled the longer part of the curve; however, the Fed has never owned roughly 25% of the UST market and 1/3rd of the MBS market. The 10yr and longer UST market and MBS market are manipulated. If the Fed chooses to reduce the amount of manipulation (which appears they will be forced to do with inflation running as high as it is) then longer rates can go higher and MBS can widen. Less manipulation will be welcomed by the market and should cause the UST curve to steepen if done correctly toggling between rate hikes to the cash rate and balance sheet reductions. The key word here is done correctly. If the Fed cannot navigate policy correctly, with the current options they have to withdraw accommodation, the yield curve will flatten and credit will come under pressure. The next quarter should be interesting. How the Fed communicates their intentions will dictate if we make changes to our current allocations. Our fund allocations in taxable accounts are now the shortest in duration since I have been here. We will still have duration exposure in the individual bonds that we own, however, it is shorter than the past several years and we will roll to a shorter duration profile as time passes. While most tax-free accounts don't have fund exposures, we will also be doing less extension trades and rolling to a shorter duration as time passes. In addition, all tax-free accounts have exposure to 4% or higher coupons on callable paper. This is a very defensive strategy and will mitigate extension. Of course, for both taxable and tax-free accounts we might do a few select extension trades based on attractive risk/reward profiles. 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.