

BOND MARKET UPDATE

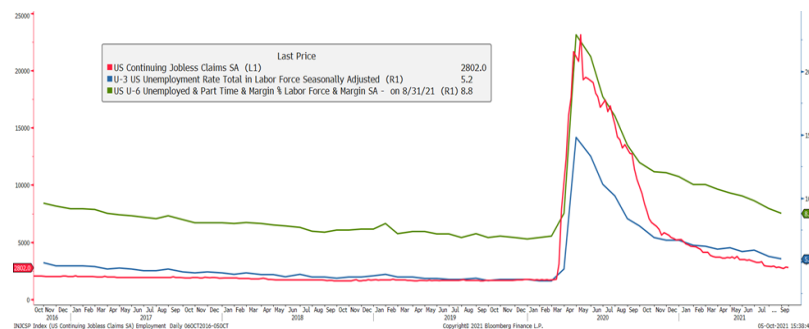
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In the 3rd Quarter of 2021, total returns for both taxable investments and tax-free investments were essentially flat for the quarter. For taxable portfolios in the 3rd Quarter, the Barclays Aggregate generated a total return of 0.05%. For tax-free portfolios in the 3rd Quarter, the Barclays 1-10yr Muni generated a total return of -0.01%. YTD returns are -1.55% and 0.35%, respectively. The economy experienced a Delta shock, the Fed communicated a taper is near, and the markets are now firmly looking to when and how much the Fed will reduce accommodation.

Economy

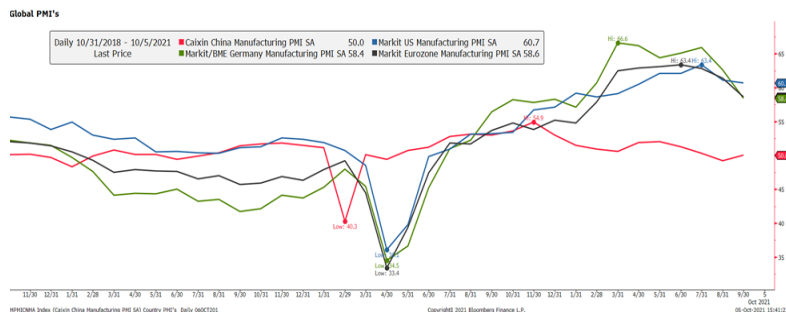
GDP in the 2nd Quarter of 2021 came in with a final Q/Q reading of +6.7%. GDP Projections for the 3rd Quarter of 2021 are estimated at +5.0% Q/Q and current estimates for the year of 2021 are for a growth rate of 5.9%. US Unemployment and US Continuing Jobless Claims continue to decline. As the economy continues to build on reopening momentum, in addition to federal and state unemployment benefits having expired, expectations are that employment numbers should accelerate in the coming quarters. (Chart 1)

Chart 1



Over the last several quarters, we have started to see a leveling off and slight downtick of PMI's at elevated levels (Chart 2), signaling that 2nd Quarter may indeed be 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. Even though PMI's have peaked and retracing slightly, they are leveling off at very attractive and elevated levels. Now that Delta has peaked and infections are declining, growth has the potential to reaccelerate and be solid going forward.

Chart 2



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Rates

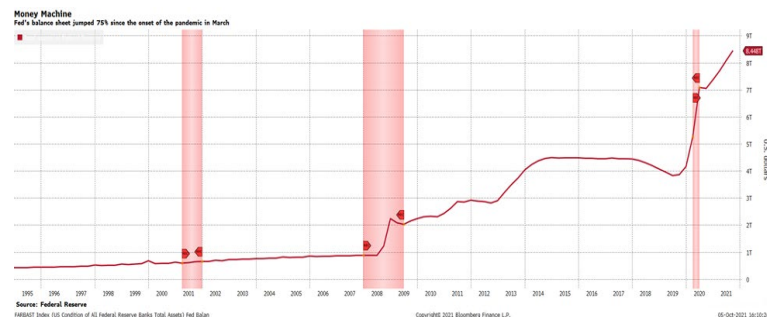
For the 3rd Quarter of 2021, U.S. risk free rates essentially ended up where they started for the quarter (Chart 3). Delta did exert downward pressure for most of the quarter only to see rates reverse with the Delta peak and a Fed commencement of a tapering warning. The Fed, at both the July and September FOMC meetings elected to keep the cash rate at the zero-lower bound and reconfirmed their intention to keep the cash rate at the zero-lower bound for an extended period. However, at the most recent September meeting, the communication by the Fed changed. The Fed put the market on notice that inflation goals have been met and that employment goals will most likely be met in the coming quarters. Based on these two goals being attained, the Fed communicated there would be a need to start the reduction/tapering of the emergency accommodation of \$120B in monthly bond purchases. Essentially, a reduction/taper announcement will happen at the November 3rd meeting. At this meeting, the Fed will layout when the program will start and by how much a month.

Chart 3



The Fed's balance sheet currently stands at \$8.45T (Chart 4). By the end of the year, their balance sheet should grow to roughly \$8.8T. If the Fed does start their tapering plan in the next month or two, the balance sheet would still grow (at a slower monthly rate) until all monthly buying has ended. At that point, expectations are that they will maintain the current level, which is estimated at over \$9.5T in size (Truly Mind-blowing!).

Chart 4



Credit

Credit risk unperformed slightly versus risk free in the 3rd Quarter of 2021. Spreads widened for both investment grade and high yield as risk appetite diminished slightly with the onset of the Delta variant. Investment grade spreads widened by roughly 4bps. High yield spreads widened by roughly 21bps. As you can see, we are still at very low risk premium levels and lower than pre-Covid levels (see chart 5).

Chart 5



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Looking Forward

Looking forward, the risk-free curve should start to rise across all points longer than 1 year with the Fed slowly removing itself from the equation. Whether the curve steepens into a higher rate environment is difficult to gauge. Goods Inflation is sure to persist which lends itself to higher long rates, however, as input cost are rising, volumes are starting to come under pressure (been to a store lately? The shelves are not full!). Supply bottlenecks are not subsiding and estimates for relief continue to get pushed out further into the future. Individuals/Families will most likely shift their consumption elsewhere. Fortunately, we are on the backside of Delta which is a positive and this should help the service sector. Unfortunately, the prices for these services are starting to rise, which also lends itself to higher long rates. In addition to goods and service inflation, energy prices are starting to move up at a healthy clip. This current administration's stance on fossil fuels is starting to show in the form of higher prices due to the lack of capital investment. Who is going to invest in long term capex in a sector where the government wants it to be displaced at some point in the future? Simple answer – no one! Estimates are for the energy supply/demand imbalance to persist for some time. At some point, this will come to a head and it will not be pretty for the economy. Fortunately, we are at least a few quarters (hopefully longer) away from this potential debacle. I just gave you a lot of reasons for a higher and steeper curve, but there is one big rub. The rub comes in how the market perceives tapering. While this is only the second time of having to deal with this (two times too many), markets during the previous tapering flattened into higher rates due to the perception of the tapering being monetary tightening. At this point in time I'm leaning towards steepening but that could change if the Fed's communication on raising short term rates changes. How the market plays out will be interesting to watch and we do have a plan. The easiest and best thing to do when faced with a conundrum is shorten up. This is exactly what we have been doing. Our fund allocations in taxable accounts are now the shortest in duration since I have been here (I'm getting old and I have been here a while!). We will still have duration exposure in the individual bonds that we own, however, you will see less extension trades meaning 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.

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