BOND MARKET UPDATE

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In the 2nd Quarter of 2022, total returns for both taxable and tax-free investments were negative for the quarter. For taxable portfolios in the 2nd Quarter, the Barclays Aggregate generated a total return of -4.69%. For tax-free portfolios in the 2nd Quarter, the Barclays 1-10yr Muni generated a total return of -0.84%. YTD returns are -10.35% and -5.55%, respectively. The economy's growth trajectory has slowed, inflation is elevated, and the Fed has started raising the cash target rate in a meaningful way.

<u>Economy</u>

GDP in the 1st Quarter of 2022 came in with a final Q/Q reading of -1.6%. GDP Projections for the 2nd Quarter of 2022 are quite wide, with an average estimate of +1.6% Q/Q. Current estimates for 2022 are for a Y/Y growth rate of 2.4%, down from 3.4% at the beginning of the 2nd Quarter. US Unemployment and US Continuing Jobless Claims have leveled off at very low levels, and the economy is starting to display signs of weaker positive momentum (Chart 1). Expectations are that employment numbers should start to weaken slightly lead by slight increases in continuing claims. Inflation continues to elevate (Chart 2); however, we are starting to see signs of easing in some segments of the CPI underneath the surface. At some point, the depletion of savings in conjunction with higher prices causes demand to weaken (Chart 3).

Since the 3rd Quarter of 2021, we have seen a steady downward trajectory of manufacturing and services PMI's from very elevated levels. All manufacturing PMI's are now at levels signaling that growth has slowed substantially (Chart 4). Services PMI in the US have also tailed off, however, remain at levels still indicative of good growth. The one outlier is China, it is starting to improve as self-imposed Covid lockdowns are being eased.

Chart 1

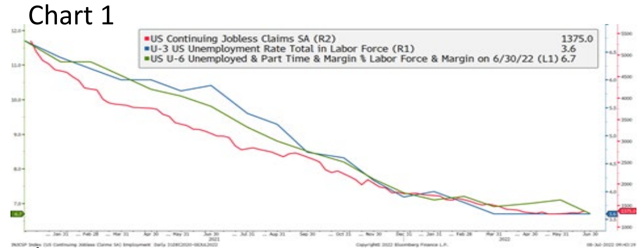


Chart 2

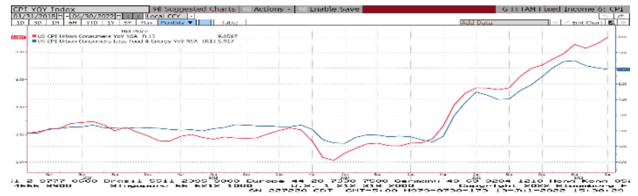


Chart 3

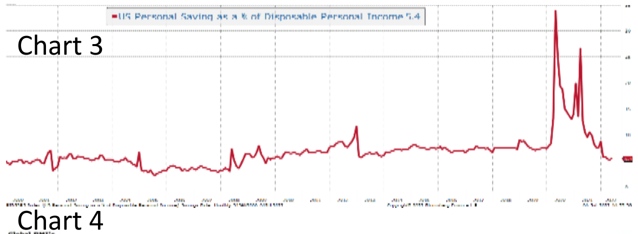
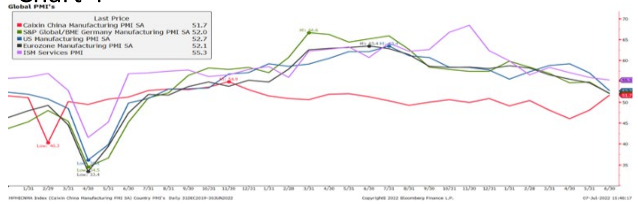


Chart 4



ABILENE
400 Pine Street
Suite 300
Abilene, TX 79601
325-627-7100

BEAUMONT
3515 Dowlen Road
Beaumont, TX 77706
409-600-6460

BRYAN/COLLEGE STATION
1716 Briarcrest Dr
Suite 400
Bryan, TX 77802
979-260-2134

FORT WORTH
1000 Forest Park Blvd
Suite 200
Fort Worth, TX 76110
682-703-6404

HOUSTON
24080 Hwy 59 N
Kingwood, TX 77339
281-318-4625

FIRST FINANCIAL TRUST
LOCATIONS

ODESSA
3555 Billy Hext Rd
Odessa, TX 79765
432-367-8912

SAN ANGELO
222 S. Koenigheim St San Angelo, TX 76903 325-659-5987

SAN ANTONIO
9601 McAllister Fwy
Suite 1204
San Antonio, TX 78216
210-864-4774

STEPHENVILLE
2201 W. South Loop
Stephenville, TX 76401
254-918-6262

SWEETWATER
201 Elm Street
Sweetwater, TX 79556
325-235-6644

Rates

Year to date 2yr, 5yr, and 10yr U.S. risk free rates are up approximately 225bps, 175bps and 150bps, respectively (Chart 5). This has created a flat UST yield curve, compressing the 10yr to 2yr UST spread from a high of 160bps early last year to currently an inverted -2bps. Mortgage rates have also moved substantially higher, 30yr mortgage rates started the year at 3.47% and currently sit at 5.92% (Chart 6).

The Fed, at the May and June FOMC meeting, raised the cash rate 50bps and 75bps respectively. The current target rate for Fed Funds is 1.50% to 1.75%. It is widely expected that the Fed will raise the target rate again at its July meeting, most likely by 75bps. The Fed has clearly raised expectations for future rates hikes as current market expectations at the end of the year for the target rate currently sit at 3.375%. In addition to the increase in the target rate, QT started in June at $47.5B, it will stay at this level for July and August. In September, QT will be increased to $95B/month. We have never experienced QT of this magnitude and the effects are still unknown.

Credit

Credit risk underperformed versus risk free in the 2nd Quarter of 2022. Spreads widened for both Investment Grade (IG) and High Yield (HY). IG spreads widened by roughly 34bps and HY spreads widened by roughly 244bps. YTD, IG has widened 57bps and HY has widened a staggering 288bps. Risk premiums in High Yield have exploded to the upside. Considering the move in risk free and credit risk premiums, HY funding has gone from roughly 4% at the beginning of the year to almost 9% today. Financial conditions have tightened significantly (chart 8).

Chart 5

Chart 6

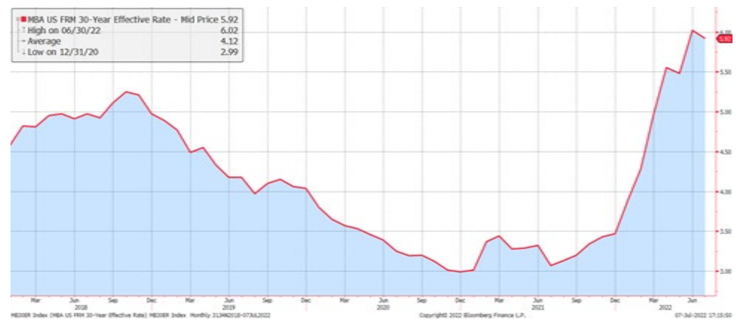


Chart 7

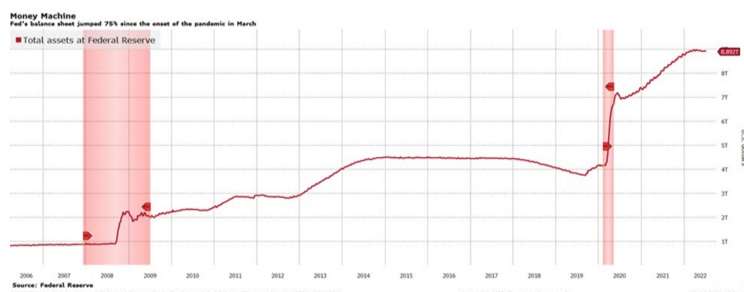


Chart 8

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Looking Forward

The market has priced in a substantial amount of Fed tightening. With a 2yr UST at 3.00% and a cash rate at 1.50%, the market has front run the Fed for all of 2022. It is expected that the Fed will continue to raise rates at every meeting this year until the CPI starts to show signs of meaningful deceleration. Financial conditions have tightened rapidly and materially and appear to have finally started to effect inflation. QT is still a wild card; the economy has already started to slow and the effects of QT are only starting. Risk-free rates should peak in the 3rd Quarter if they already haven't. Historically, risk-free rates peak a little more than halfway through a tightening cycle. Are we halfway? After the July meeting, I think so. Credit has come under massive pressure and QT could possibly intensify that pressure. We have reduced credit risk, completely exited High Yield early in the year, and have built up our short US Treasury exposure. At some point, we will start to build up credit again, but we need the Fed to stop tightening financial conditions to do this. 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.