BOND MARKET UPDATE

As of 03/31/22 | Volume 11, Issue 1 | FFTAM.com

In the 1st Quarter of 2022, total returns for both taxable investments and tax-free investments were negative for the quarter. For taxable portfolios in the 1st Quarter, the Barclays Aggregate generated a total return of -5.93%. For tax-free portfolios in the 1st Quarter, the Barclays 1-10yr Muni generated a total return of -4.76%. The economy continues to grow, inflation is elevated, and the Fed has effectively signaled a much faster rate hike and quantitative tightening path.

Economy

GDP in the 4th Quarter of 2021 came in with a final Q/Q reading of +6.9%. GDP Projections for the 1st Quarter of 2022 are estimated at +1.5% Q/Q. Current estimates for 2022 are for a Y/Y growth rate of 3.4%. US Unemployment and US Continuing Jobless Claims continue to decline (chart 1), and the economy continues to build on reopening momentum. Expectations are that employment numbers should at a minimum hold steady and most likely continue to improve. Unfortunately, inflation has been on the rise and the addition of a war that erupted between Russian/Ukraine has only exacerbated this problem (chart 2). Supply chain issues have been a problem for a while and now they only stand to get worse. More importantly due to the war, commodities inflation is in full force and not expected to resolve itself anytime soon.

Over the last several quarters, we have seen a slight downtick of manufacturing and services PMI's from very elevated levels, signaling that the 2nd Quarter of 2022 was indeed peak growth for manufacturing (chart 2). Services PMI in the US has tailed of some and expectations are that the consumer will continue to shift from goods to services. Most developed market PMI's are still elevated in the upper 50's (strong growth), however, China continues to show its weakness to Covid variants due to weak vaccine efficacy.

Chart 1

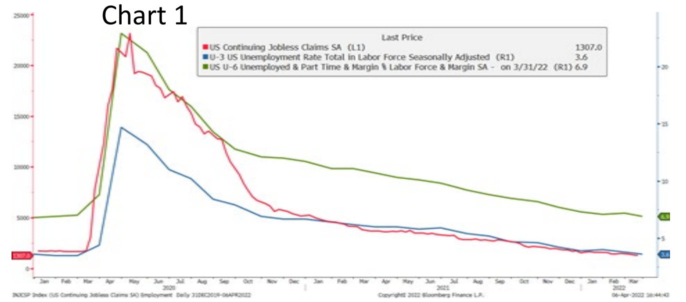


Chart 2

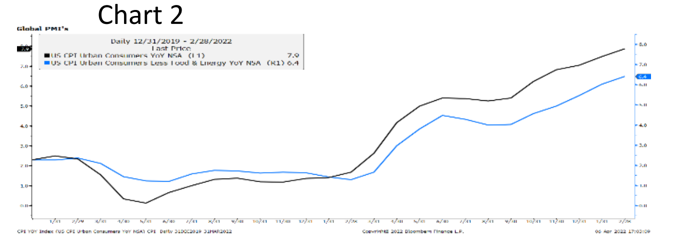
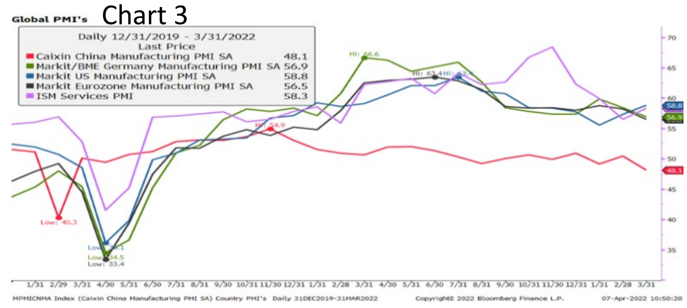


Chart 3



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Rates

Year to date 2yr, 5yr, and 10yr U.S. risk free rates are up approximately 170bps, 140bps and 110bps, respectively (chart 4). 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 at 17bps. Mortgage rates have also moved substantially higher, 30yr mortgage rates stared the year at 3.47% and currently sit at 5.06% (chart 5).

The Fed, at the March FOMC meeting, raised the cash rate 25bps to a target range of .25% to .50%. It is widely expected that the Fed will raise the target rate again at its May meeting, most like by 50bps. Just recently, minutes were released from the March meeting. In the minutes, the Fed laid out a blueprint for what Quantitative Tightening (QT) will look like. Per the minutes, QT will start in May with a ramp of 2-3 months until a total of $95B/month of debt supply is being reintroduced into the system. The Fed's balance sheet currently stands at $8.94T (chart 6). Per the Feds QT projections, the balance should be reduced to roughly $6.5T by the end of 2024.

Credit

Credit risk underperformed versus risk free in the 1st Quarter of 2022. Spreads widened for both investment grade and high yield. Investment grade spreads widened by roughly 23bps and high yield spreads widened by roughly 42bps. Risk premiums where actually quite higher heading into the March Fed meeting, and since then, have tightened nicely as the Fed has communicated a more hawkish tone towards inflation (chart 7).

Chart 4

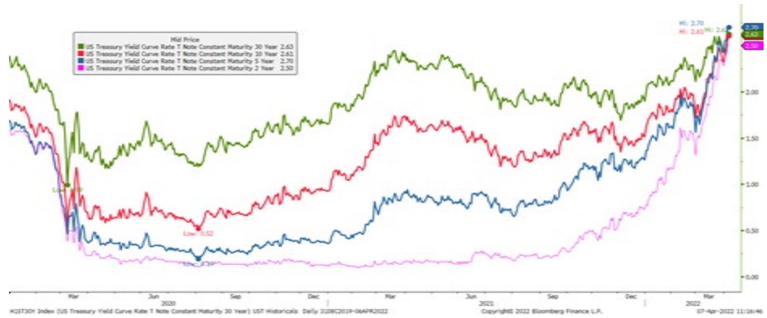


Chart 5

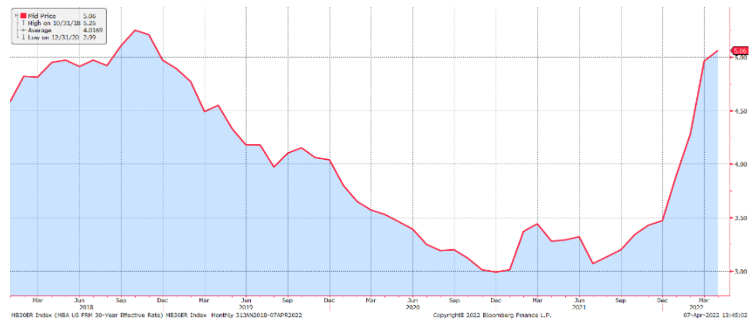


Chart 6

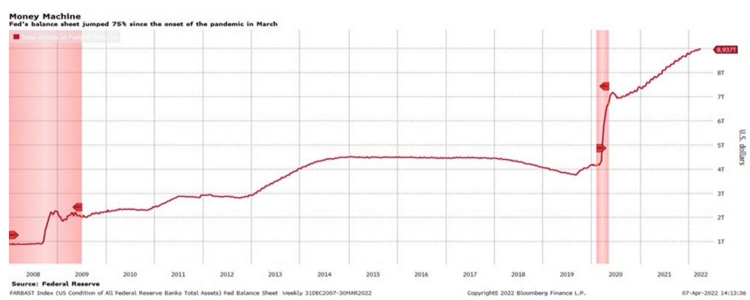
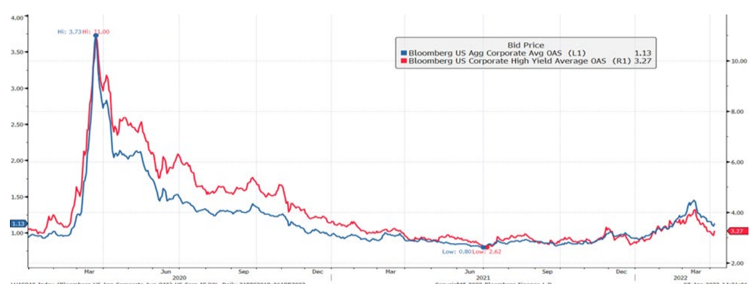


Chart 7



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Looking Forward

The market has priced in a substantial amount of Fed tightening. With a 2yr UST at 2.50% and a cash rate at 25bps, the market has front run the Fed for all of 2022. It is expected that the Fed will raise rates at every meeting this year and get the cash rate to a target range of 2.25% to 2.50% by the end of 2022. The Fed has done an excellent job in communicating their wishes and the fact that the market has reacted this way may be very beneficial for the Fed. Market conditions have tightened rapidly and will hopefully start to act as a govern to inflation. The QT announcement that it will start in May and reach $95B/month a few months later should really start to slow growth in the 3rd Quarter of 2022. Rates will most likely continue to be under pressure to the upside until the 3rd Quarter when QT will be at its full monthly amount. Credit has already underperformed YTD and we expect that trend to continue. QT should start to intensify that pressure. We have already started reducing credit risk this year and that trend will continue as we progress throughout the year. 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.