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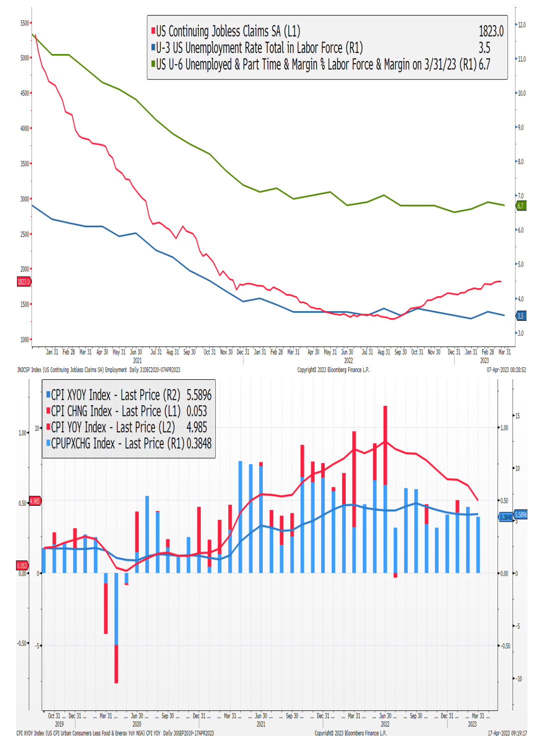
BOND MARKET UPDATE

As of 03/31/23 | Volume 12, Issue 1 | FFTAM.com

In the 1st Quarter of 2023, total returns for both taxable and tax-free investments were positive for the quarter. For taxable portfolios in the 1st Quarter, the Barclays Aggregate generated a total return of 2.96%. For tax-free portfolios in the 1st Quarter, the Barclays 1-10yr Muni generated a total return of 2.00%. The economy's growth trajectory continued to slow, inflation is starting to disinflate, the Fed continues to raise the cash target rate, and a lack of confidence in regional banking has arisen.

Economy

GDP in the 4th Quarter of 2022 came in with a final Q/Q reading of 2.6%. GDP Projections for the 1st Quarter sit at an estimated growth rate of +1.6% Q/Q. Current estimates for 2023 GDP Y/Y have moved up slightly, Y/Y growth rate projections are now 1.0%. US Unemployment and US Continuing Jobless Claims have leveled off at very low levels, and the economy is displaying signs of weaker positive momentum. Expectations are that employment numbers should start to weaken lead by increases in continuing claims. Job openings, while still elevated, are clearly in a downtrend. Current job openings sit at 9.9M versus a peak of 11.8M in March of 2022. Inflation continues to remain elevated on an Year over Year (YoY) basis; however, we are starting to see signs of disinflation in some segments of the CPI on a monthly and quarterly basis. Comps versus the prior year should continue to put a downward bias on the forward YoY print. Shelter (the largest core component) has a massive lag and, unfortunately, this will continue to keep the core component of the CPI elevated. Housing prices and rents have declined for multiple months in a row, this will influence the shelter component of the CPI in the future. Our best estimate for the shelter lag to start showing up in the CPI currently sits in the summer of this year. At some point (if not now), the depletion of savings in conjunction with higher prices will cause overall demand to weaken.



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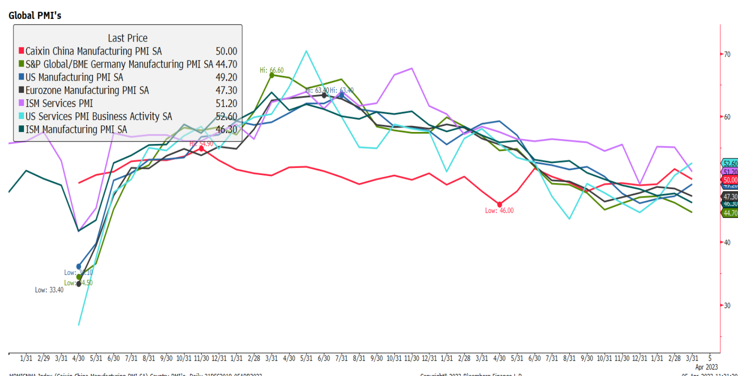
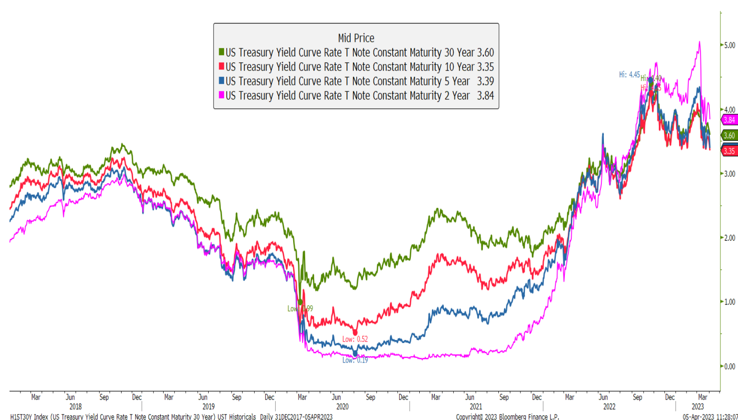
Since the 3rd Quarter of 2021, we have seen a steady downward trajectory of manufacturing and services PMI's from very elevated levels. All manufacturing PMI's are now at levels signaling that growth is contracting. Services PMI in the US has also tailed off and is clearly in a downtrend, however, it remains at levels still indicative of modest growth. Starting in early 2022, the consumer shifted from goods to services and this trend is still intact for now.



Rates

Year to date 2yr, 5yr, and 10yr U.S. risk free rates (nominal) are down approximately 40bps, 43bps and 41bps, respectively. This has created an inverted UST yield curve, compressing the 10yr to 2yr UST spread from a high of 160bps early last year to currently an inverted -55bps. Real rates have also risen substantially starting in 2022. Currently, 10yr TIPS are pricing at 1.20%. 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 continue to remain at elevated levels and currently sit at 6.57%, briefly piercing 7% in the back half of 2022.



The Fed

The Fed, at the February and March FOMC meetings, raised the cash rate by 25bps at each meeting. The current target rate for Fed Funds is 4.75% to 5.00%. The May meeting is currently a toss up. Per the press conference after the March meeting, Powell communicated that the Fed will be watching to see how financial conditions transpire after the failure of two mid size regionals, however, they feel they are close to getting the cash rate to a point where it should be sufficiently restrictive to lower inflation. More recently, we have heard from several members of the FOMC communicate their desire /need for the possibility of further rate hikes to solve the inflation problem. 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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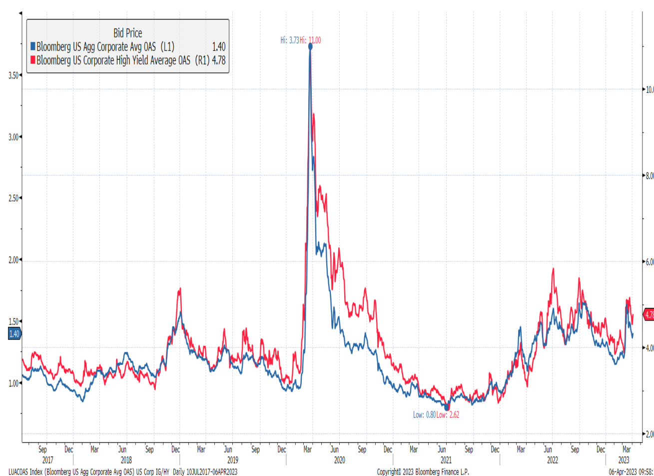
Credit

Credit risk was positive versus risk free in the 1st Quarter of 2023. Spreads where mixed for Investment Grade (IG) and High Yield (HY). IG spreads widened by roughly 8bps and HY spreads tightened by roughly 14bps. Risk premiums in IG and HY expanded quite a bit on the back of two regional bank failures but recovered nicely into the end of the quarter. Spread risk diverged quite meaningfully in March, Financials, REITs and Insurance sectors widened meaningfully while all other sectors experienced minor erosion. Overall, financial conditions have tightened significantly since the beginning of 2022 and have the potential to tighten further if the Fed continues to raise interest rates and banking confidence erodes.



Looking Forward

Over the past year, the market has absorbed a substantial amount of Fed tightening in a short amount of time. With a 2yr UST at 3.80% and a cash rate at 5.00%, the market and the Fed have once again diverged with two very different rate path outlooks. The Fed may or may not raise rates at the next meeting. On the back of two regional failures, financial conditions have the potential to tighten more throughout the year. Banking confidence is key to sustained growth in the economy. The focus on large and midsized regionals continues to be intense. The Fed is walking a tightrope if they decide to press the cash rate to the upside in the future. The liquidity facility put in place by the the Fed has the ability to address short term funding issues for banks impacted, however, the cost of the facility is punitive. Banks tapping the facility will face margin pressure, in turn, tightening lending standards across the board. QT is still a wild card; the economy is slowing/stalling, and the effects of QT (less liquidity) are working in the background. We have found some pockets of IG credit risk that we like, continue to be void of High Yield, and continue to build up our US Treasury and Agency MBS exposure. 2023 looks to have the potential to be a much better year than 2022. Forward returns continue to look very enticing, and this is something we haven't been able to say in over a decade. 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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