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Weekly Fixed Income Commentary

27 September 2021

Fed taper looks likely, boosting Treasury yields

U.S. Treasury yields closed higher last week, led by longer maturities. The Federal Reserve (Fed) indicated it would likely announce a reduction in asset purchases at its November meeting. Most credit sectors showed negative absolute performance but outperformed similar-duration Treasuries.

HIGHLIGHTS

- **Senior loans produced the highest returns, while high yield corporates finished slightly down but outperformed similar-duration Treasuries.**
- **Emerging markets struggled, and was one of the few sectors to underperform similar-duration Treasuries.**
- **Municipal bond yields sold off. New issue supply was outsized at $10.8B, with flows of $1.5B. This week's new issue supply should be large again at $11.2B.**

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OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.
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Watchlist

- *Treasury yields rose last week, and we continue to anticipate higher rates into year end*
- *Spread assets performed well versus Treasuries, as economic growth continues.*
- *Municipal bonds are unlikely to remain so rich*

INVESTMENT VIEWS

Zero/negative global interest rate policy remains a key market support. Investors continue to focus on the eventual tapering of purchases, which we expect to happen later this year.

Unprecedented global fiscal stimulus should continue to boost growth moving forward, as consumers have accumulated more than $2 trillion of savings from prior support.

Record supply of investment grade corporates has been followed by high levels of issuance from high yield, middle market loans and the broadly syndicated loan market. Taxable municipal supply also continues to grow.

We favor a risk-on stance, focused on credits with durable free cash flow and solid balance sheets across a wide range of sectors. Mid-quality rating segments appear particularly attractive. Essential service municipal credits also look compelling.

KEY RISKS

- Policymakers become cautious and remove accommodation too early.
- Inflation rising in a disorderly way, forcing premature policy tightening.
- Further complications with the COVID-19 vaccine rollout and the Delta variant.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.

TREASURY YIELDS RISE AS THE FED INDICATES TAPERING

U.S. Treasury yields closed higher last week, led by longer maturities. After starting the week lower due to Chinese market fears, rates jumped sharply on Thursday to finish the week about eight basis points (bps) higher for maturities 5 years and longer. The move occurred after Chair Powell indicated that the Fed would likely announce a reduction in asset purchases at its November meeting, with tapering concluding by the middle of next year. Economic data throughout the week generally signaled continued expansion, which also put upward pressure on rates.

The investment grade corporate market endured negative total returns last week, as rising Treasury yields eclipsed slightly tighter spreads. Similar to most other non-Treasury sectors, the asset class outperformed similar-duration Treasuries despite negative returns. Investment grade corporates fell -0.35%, but outdistanced similar-duration Treasuries by almost 32 bps. Eighteen issuers brought $15.75 billion in new issues during the week, which was met with strong investor demand spurred by higher investment yields.

The high yield corporate sector bounced back after risk-off sentiment weighed on returns early in the week. High yield finished slightly down with a weekly total return of -0.13%, but outperformed similar-duration Treasuries by more than 14 bps. The market's focus remains on new issues, as total supply has not met demand. More than 20 deals priced last week and the deals were very oversubscribed, leading to aggressive pricing. The senior loan market produced the best returns across taxable fixed income, as it was the only sector with a positive total return for the week at 0.07%.

Emerging market struggled again last week. The risk-off tone was fueled by both the ongoing Evergrande situation in China as well as rising U.S. Treasury yields. Falling -0.89%, EM was one of the few sectors that underperformed the Treasury market, lagging similar-duration Treasuries by 37 bps. However, EM high yield remained well-traded throughout the week due to heavy supply in both sovereign and corporate issues. EM suffered its first outflows in four weeks as sentiment shifted to a more cautious stance and investors pulled nearly $1 billion from the sector.

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HIGH YIELD MUNICIPAL CREDIT SPREADS REMAIN STABLE

Municipal bond yields sold off, but closed the week with a constructive tone.

Interest rates rose on the news that the Fed will begin to taper its easy money policy in the near future, as investors think higher interest rates are on the horizon. Most investors don't think the Fed will raise rates until 2023. Thus, rates will probably drift somewhat higher, but continue to be lower for longer. Municipal bond yields will likely also drift higher due to an outsized new issuance calendar through the end of the year. Deals will be priced to clear the market. However a tremendous amount of cash and short-duration securities remains on the sidelines waiting to get invested when the opportunity arises.

The Commonwealth of Massachusetts issued $226 million general obligation bonds (rated Aa1/AA). The deal included bonds due in 2028 that came at a yield of 0.69%. Underwriters sold same bonds later in the week at a yield of 0.75%. Dealers want to keep inventory moving, as the new issue market will probably remain outsized through the end of the year. Deals will be priced to allow the entire deal to clear the market.

High yield municipal yields were less volatile last week, and credit spreads remain stable at 171 bps on average. High yield municipal fund flows remained robust at $408 million. We expect a much lighter high yield municipal new issue calendar this week. The entire new issue calendar is expected to be served by 60% taxable paper, perhaps a sign of things to come.

Emerging markets suffered its first outflows in four weeks as sentiment shifted to a more cautious stance.

In focus

Fed: "It's almost time to taper"

Last week, the Federal Reserve met to discuss how to steer monetary policy in an environment of slowing growth and inflation.

In its policy statement, the Fed noted that given the steady drop in unemployment (down to 5.2% in August), "a moderation in the pace of asset purchases may soon be warranted." That's Fedspeak for "we plan to announce a taper of our $120 billion/month quantitative easing bond purchases on November 3," the date of the next meeting. Because this signal was widely anticipated, U.S. equity and Treasury markets took little notice. In his press conference, Chair Jerome Powell indicated that the central bank's bond buying is expected to wind down fully by around mid-2022.

The Fed also revised its economic forecasts, which were last updated in June. GDP growth was downgraded from 7% to 5.9% for 2021, but upgraded from 3.3% to 3.8% for 2022. Inflation is projected to rise 3.7% this year (up from the previous forecast of 3.0%) and 2.3% in 2022 (up from 2.1%), as measured by the Fed's preferred inflation barometer, the core PCE Index.

In terms of interest rates, half of the Fed's voting members now believe at least one hike in the fed funds rate will be warranted next year — up from 7 of 18 members in June. Although we don't expect a rate increase until 2023, we acknowledge the risks are tilted toward an earlier "liftoff" if inflation remains well above the Fed's 2% target.

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U.S. Treasury market

Maturity	Yield	Change (%) Week	Month-to-date	Year-to-date
2-year	0.27	0.05	0.06	0.15
5-year	0.95	0.09	0.17	0.59
10-year	1.45	0.09	0.14	0.54
30-year	1.99	0.08	0.05	0.34

Source: Bloomberg L.P., 24 Sep 2021. **Past performance is no guarantee of future results.**

Municipal market

Maturity	Yield to Worst	Change (%) Week	Month-to-date	Year-to-date
2-year	0.14	0.03	0.03	0.00
5-year	0.44	0.03	0.04	0.22
10-year	1.00	0.06	0.08	0.29
30-year	1.59	0.05	0.07	0.20

Source: Bloomberg L.P., 24 Sep 2021. **Past performance is no guarantee of future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	68
30-year AAA Municipal vs Treasury	80
High Yield Municipal vs High Yield Corporate	79

Source: Bloomberg L.P., Thompson Reuters, 24 Sep 2021. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Bloomberg High Yield Municipal Index divided by the yield-to-worst for the Bloomberg High Yield Corporate Index. **Past performance is no guarantee of future results.**

Characteristics and returns

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%) Week	Month-to-date	Year-to-date
Municipal	1.02	–	5.15	-0.20	-0.23	1.30
High Yield Municipal	3.02	160[1]	6.16	-0.18	-0.23	6.98
Short Duration High Yield Municipal[2]	2.60	187	3.62	-0.65	-0.73	5.45
Taxable Municipal	2.19	72[3]	9.72	-0.65	-0.73	1.02
U.S. Aggregate Bond	1.53	33[3]	6.74	-0.40	-0.47	-1.16
U.S. Treasury	0.99	–	7.12	-0.53	-0.69	-2.11
U.S. Government Related	1.37	40[3]	6.12	-0.47	-0.65	-0.93
U.S. Corporate Investment Grade	2.06	82[3]	8.79	-0.35	-0.25	-0.47
U.S. Mortgage-Backed Securities	1.81	30[3]	4.54	-0.26	-0.32	-0.64
U.S. Commercial Mortgage-Backed Securities	1.55	60[3]	5.12	-0.28	-0.65	-0.40
U.S. Asset-Backed Securities	0.62	29[3]	2.26	-0.09	-0.16	0.22
Preferred Securities	2.70	155[3]	4.69	-0.25	0.27	3.74
High Yield 2% Issuer Capped	3.90	278[3]	3.90	-0.13	0.31	4.87
Senior Loans[4]	4.81	440	0.25	0.07	0.52	4.52
Global Emerging Markets	4.09	295[3]	6.98	-0.89	-1.05	-0.52
Global Aggregate (unhedged)	1.13	33[3]	7.57	-0.50	-0.99	-3.29

1 Yield difference between the Bloomberg High Yield Municipal Index and the 20-year AAA MMD scale. **2** Data is a subset of the S&P Short Duration Municipal Yield Index that is below investment grade/nonrated. Spread is the yield difference between this subset and the subset rated AAA. **3** Option-adjusted spread to Treasuries. **4** Spread refers to the 3-year discount margin. Duration is estimated based on the frequency of the reset date.

Source: Bloomberg L.P. and Credit Suisse, 24 Sep 2021. **Past performance is no guarantee of future results.** Unless otherwise noted, the index is Bloomberg . All index returns are shown in U.S. dollars. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting. **Effective duration** (expressed in years) measures the price sensitivity of a fixed-income investment to a change in interest rates, considering that expected cash flows will fluctuate as interest rates change. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account.

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Performance: Bloomberg, L.P. **Issuance:** The Bond Buyer, 24 Sep 2021. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 22 Sep 2021.

Any reference to credit ratings refers to the highest rating given by one of the following national rating agencies: S&P, Moody's or Fitch. Credit ratings are subject to change. AAA, AA, A and BBB are investment grade ratings; BB, B, CCC, CC, C and D are below-investment grade ratings.

Representative indexes: municipal: Bloomberg Municipal Index; **high yield municipal:** Bloomberg High Yield Municipal Index; **short duration high yield municipal:** S&P Short Duration Municipal Yield Index; **taxable municipal:** Bloomberg Taxable Municipal Bond Index; **U.S. aggregate bond:** Bloomberg U.S. Aggregate Bond Index; **U.S. Treasury:** Bloomberg U.S. Treasury Index; **U.S. government related:** Bloomberg U.S. Government-Related Index; **U.S. corporate investment grade:** Bloomberg U.S. Corporate Index; **U.S. mortgage-backed securities;** Bloomberg U.S. Mortgage-Backed Securities Index; **U.S. commercial mortgage-backed securities:** Bloomberg CMBS ERISA-Eligible Index; **U.S. asset-backed securities:** Bloomberg Asset-Backed Securities Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield 2% issuer capped:** Bloomberg High Yield 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index; **global emerging markets:** Bloomberg Emerging Market USD Aggregate Index; **global aggregate:** Bloomberg Global Aggregate Unhedged Index.

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Investing involves risk; principal loss is possible. Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, derivatives risk, dollar roll transaction risk and income risk. As interest rates rise, bond prices fall. Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Preferred securities are subordinated to bonds and other debt instruments in a company's capital structure and therefore are subject to greater credit risk. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. Asset-backed and mortgage-backed securities are subject to additional risks such as prepayment risk, liquidity risk, default risk and adverse economic developments. The value of convertible securities may decline in response to such factors as rising interest rates and fluctuations in the market price of the underlying securities. Senior loans are subject to loan settlement risk due to the lack of established settlement standards or remedies for failure to settle. These investments are subject to credit risk and potentially limited liquidity, as well as interest rate risk, currency risk, prepayment and extension risk, and inflation risk

Investors should contact a tax professional regarding the appropriateness of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the state of residence. Income from municipal bonds held by a portfolio could be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

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