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Weekly Fixed Income Commentary

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Favorable economic data push Treasury yields lower

U.S. Treasury yields fell across the curve, as U.S. consumer price data showed a further moderation in inflationary pressures. Futures markets now price in less than 60 basis points of total additional rate hikes from the U.S. Federal Reserve over the next several meetings.

HIGHLIGHTS

- **Total returns were positive across all major fixed income asset classes.**
- **Municipal bond yields generally declined further. New issue supply remained undersized at $4.1B with inflows of $1.9B. This week's new issuance should increase to $7.9B.**

Anders Persson
CIO of Global Fixed Income

John Miller
Head of Municipals

Watchlist

- *U.S. Treasury yields fell across the curve.*
- *Spread assets gained.*
- *Net-negative supply should provide some support to municipal bonds.*

INVESTMENT VIEWS

The end to central bank tightening appears near, as we expect Fed rate hikes to cease early this year. The overall level of rates is likely to remain historically low.

The underlying growth outlook remains healthy, as consumers have strong balance sheets, businesses are reinvesting and Covid recedes. This should keep defaults low.

Treasury yields are likely to fall this year, and we expect the 10-year Treasury yield to end the year around 3.25%.

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 bonds also look compelling.

KEY RISKS

- Inflation fails to moderate as expected, negatively affecting asset values.
- Policymakers remove accommodation too rapidly, undermining the global economic expansion.
- Geopolitical flare-ups: China, Russia, Turkey, Iran.
- Covid cases increase, or new variants emerge.

INVESTMENT GRADE CORPORATE SPREADS ARE THE TIGHTEST SINCE APRIL

U.S. Treasury yields fell again, with 10-year yields down -5 basis points (bps) to 3.50%, as the latest consumer price data showed a further moderation in inflationary pressures. Headline consumer prices rose 6.5% year-over-year in December, as expected, down from 7.1% in November. Core inflation also moderated, to 5.7% year-over-year. While the details of the report largely matched consensus expectations, markets responded positively to the reduction in perceived risks around more persistent, above-target inflation over the medium term. Futures markets now price in less than 60 bps of total additional rate hikes from the Fed over the next several meetings.

Investment grade corporates rallied, returning 1.40% for the week and beating similar-duration Treasuries by 75 bps. Overall yield levels for the asset class dipped below 5% for the first time since September, while spreads declined -8 bps to 124 bps, their tightest level since April 2022. The asset class also saw a large inflow, with $8.4 billion entering the market, for the strongest such week since June 2021. This dynamic helped investors comfortably digest another heavy week of new issuance, with $31.1 billion of new supply for the week, which was 4.2x oversubscribed on average.

High yield corporates outperformed again, gaining 1.57% and outpacing similar-duration Treasuries by 117 bps for the week. As in the investment grade market, inflows picked up, with $2.5 billion entering the asset class. The new issue market also started to reopen, with two deals pricing, totaling $1.5 billion. The loans market was quieter, with no new deals, but still returned 0.95% for the week.

Emerging markets lagged again somewhat, but still returned 1.21% and beat similar-duration Treasuries by 64 bps. High yield names continued to outperform, with high yield sovereign spreads tightening -11 bps versus 3 bps widening for investment grade. As in other markets, inflows picked up, with $994 million entering the hard currency market and $538 million entering the local currency market. Those were the biggest weekly inflows since April and February 2022, respectively.

MUNICIPAL BONDS REMAIN WELL BID DUE TO POSITIVE TECHNICALS

Municipal bond yields rallied again last week across the board, following U.S. Treasury yields. The new issue calendar remained undersized and was well received. Weekly fund flows turned largely positive. This week's new issue supply is expected to increase and should be well received.

Fixed income in general has a good tone. Many investors believe U.S. inflation fears are continuing to abate. Although last week's Consumer Price Index (CPI) remained robust, individual components showed easing.

Tax-exempt bonds remain well bid, mainly because oversized January 1 coupon money is not yet fully invested and new issue supply remains low. This imbalance should remain for the next couple of weeks and potentially benefit municipal investors.

Plano Independent School District, Texas, issued $631 million general obligation school bonds (rated Aaa/AA+). The deal was well received. For example, 5% coupon bonds due in 2041 came at a yield of 3.40% and traded later in the secondary market at 3.22%.

High yield municipal bond yields decreased by 14 bps on average last week, outperforming high-grades and U.S. Treasury bonds. High yield muni fund flows turned firmly positive at $917 million, while new issuance remains very light. Investors will need to compete in the secondary market for supply, likely putting ongoing downward pressure on yields and credit spreads. Brightline reported its largest monthly ridership in December, and 2022 ridership was 117% of 2019 ridership (the last full year before pandemic shutdowns). Additionally, ticket prices are up 27%. Continued increases are expected in 2023, especially with new stations in Boca Raton and Aventura opening in late December.

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In focus

Muni market shows reasons for optimism

U.S. macroeconomic factors became more balanced late in 2022. For example, while 12-month trailing inflation remains very high, the last five months' trajectory is in line with the Fed's target. The Fed remains determined to fight inflation, but we've seen a subtle shift in its hawkish tone and a decelerating pace of rate hikes.

This more balanced interest rate picture fueled the late-year municipal market rally. The positive returns are even more impressive considering elevated fund outflows until last week.

This resilience in the face of a volatile macro environment and Fed tightening offers several reasons for optimism in 2023. Municipal returns have historically bounced back strongly the year after a negative year. This trend has tended to correlate with fund flows which, when they reverse, may strengthen a market recovery. While economic and Fed policy uncertainty will likely lead to more Treasury rate volatility in 2023, municipals now have much higher yields as a cushion.

Traditional municipal bond factors took a back seat to Fed policy in 2022, but these elements currently look favorable overall. Stable tax policy highlights the value of the tax exemption. And low tax-exempt bond supply and strong credit fundamentals position the asset class well for a possible recession. We believe a less active Fed should pave the way for these municipal factors to create a market recovery this year.

U.S. Treasury market

		Change (%)		
Maturity	Yield	Week	Month-to-date	Year-to-date
2-year	4.24	-0.02	-0.19	-0.19
5-year	3.61	-0.09	-0.39	-0.39
10-year	3.51	-0.06	-0.37	-0.37
30-year	3.61	-0.08	-0.36	-0.36

Source: Bloomberg L.P., 13 Jan 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Municipal market

		Change (%)		
Maturity	Yield to Worst	Week	Month-to-date	Year-to-date
2-year	2.27	-0.14	-0.33	-0.33
5-year	2.18	-0.18	-0.34	-0.34
10-year	2.31	-0.17	-0.32	-0.32
30-year	3.24	-0.16	-0.34	-0.34

Source: Bloomberg L.P., 13 Jan 2023. **Performance data shown represents past performance and does not predict or guarantee future results.**

Yield ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	66
30-year AAA Municipal vs Treasury	90
High Yield Municipal vs High Yield Corporate	68

Source: Bloomberg L.P., Thompson Reuters, 13 Jan 2023. 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. **Performance data shown represents past performance and does not predict or guarantee future results.**

Characteristics and returns

				Returns (%)		
Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Week	Month-to-date	Year-to-date
Municipal	3.18	–	6.09	1.15	2.31	2.31
High yield municipal	5.49	246[1]	7.60	2.07	3.99	3.99
Short duration high yield municipal[2]	5.20	298	4.12	1.03	1.98	1.98
Taxable municipal	4.80	110[3]	8.37	1.11	4.19	4.19
U.S. aggregate bond	4.32	46[3]	6.28	0.88	2.74	2.74
U.S. Treasury	3.86	–	6.31	0.59	2.27	2.27
U.S. government related	4.46	58[3]	5.40	0.79	1.96	1.96
U.S. corporate investment grade	5.03	124[3]	7.33	1.40	3.43	3.43
U.S. mortgage-backed securities	4.29	39[3]	5.64	0.88	3.04	3.04
U.S. commercial mortgage-backed securities	4.89	112[3]	4.62	0.68	2.26	2.26
U.S. asset-backed securities	4.85	69[3]	2.88	0.41	1.02	1.02
Preferred securities	6.80	234[3]	4.94	2.22	5.53	5.53
High yield 2% issuer capped	8.12	409[3]	3.75	1.57	3.84	3.84
Senior loans[4]	9.95	601	0.25	0.95	1.65	1.65
Global emerging markets	7.16	337[3]	6.22	1.21	2.21	2.21
Global aggregate (unhedged)	3.46	48[3]	6.81	1.91	3.33	3.33

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, 13 Jan 2023. **Performance data shown represents past performance and does not predict or guarantee 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, 13 Jan 2023. **Fund flows:** Lipper. **New deals:** Market Insight, MMA Research, 11 Jan 2023.

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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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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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