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Fixed Income Outlook

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As the COVID-19 virus related restrictions have been widely curtailed, the U.S. economy has leapt back to life. Sagging economic data has been reinvigorated by a boisterous population that is exhilarated to be out and about unfettered once again. With the resurgence came some negative side effects, such as supply chain constraints and inflation fears. While investors and economists debate whether these are long-term or short-term affairs, the fixed income markets have already voiced their opinion.

Economists do not have to look hard to find data points that reveal the strength of the recovery. Gross Domestic Product, perhaps the best indicator of overall economic health, was a robust 6.4% in the first quarter of 2021. Another positive key indicator was the May report for Durable Goods Orders which were up over 25% on a year-over-year basis, excluding the noisy Transportation sector. After grinding to a screeching halt in early 2020 due to the pandemic, the domestic economy has gained traction and is speeding ahead.

Figure 1 Inflation measures PCE Deflator and Core PCE Deflator

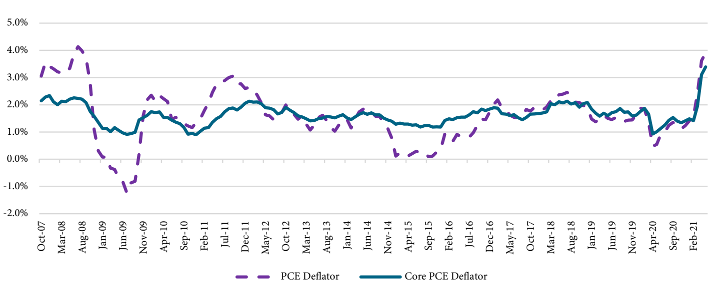

Figure 1 PCE Deflator and Core PCE Deflator, monthly figures Source: FactSet

In concert with the return to growth, inflation indicators have perked up as well. Both the Core CPI and Core PCE Deflator, both of which exclude the impact of volatile fuel and food prices, rose in repeated measurements during the quarter. Regular readers will recall that we have been monitoring these data points over time and they are finally beginning to show some life. These figures will be under heavy scrutiny going forward as investors try to determine whether the increase in inflation is temporary or permanent.

The Federal Reserve (the Fed) was quick to comment on the inflation data, immediately suggesting that it is indeed transitory. First, they focused on the low starting base for measuring the change, pointing out that with such a low denominator the calculation result is exaggerated. Second, they pointed to multiple bottlenecks that have arisen as the economy emerges from its dormancy. Their mantra has been that these problems have been spurred by a sudden increase in demand that will dissipate over time.

Perhaps the most important statement made by the Fed was to maintain short term rates at a near zero target level. In revealing the "steady as she goes" policy, the Fed reiterated that it would need to see inflation remain above its 2% tolerance limit for quite some time. The markets generally appeared to agree that inflation is not yet a problem, albeit with some mild volatility at the longer end of the yield curve.

Figure 2 US Treasury Yield Curve at Year End 2020 & Q2 2021

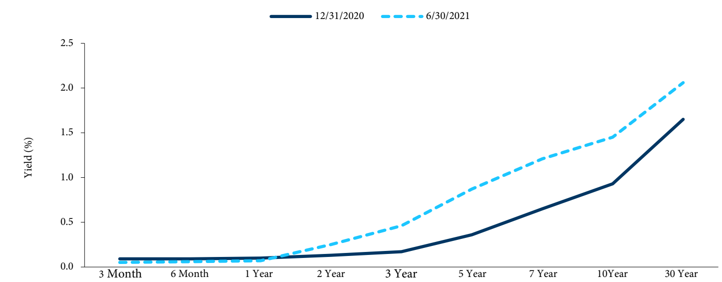

Figure 2 U.S. Treasury Yield Curve Today and at Year End 2020 Source: FactSet

Indeed, market measures of expected inflation imply that investors believe that inflation will be transitory. One such measure is the breakeven rate, or the difference between the nominal yield on a U.S. Treasury note and the real yield on a similar maturity U.S. Treasury Inflation-Protected note. This value implies what investors expect annualized inflation to be over the life of the bond, on average. The one-year breakeven rate was approximately 3.2% in June while the 10-year breakeven rate was about 2.3%, suggesting that inflation is expected to be higher in the near term but then settle down to a more modest level over time.

Figure 3 Intermediate Corporate Bond Spreads by Credit Quality

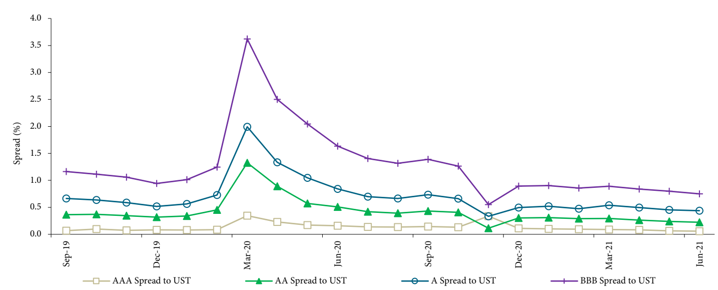

Figure 3 Intermediate Credit Spreads Broken Out by Quality Cohort Source: Bloomberg Barclays

Credit spreads, or the additional yield investors require to compensate for default risk, remain quite narrow. Investors are still seeking any additional yield they can find above historically low U.S. Treasury rates. This hunger has compressed spreads, especially for lower quality issues within the investment grade space. Intermediate BBB rated corporate bond spreads have narrowed by 14 basis points this year, while intermediate AAA rated corporate bond spreads have only narrowed by 5 basis points.

The narrowing of credit spreads came in the face of an announcement by the Fed regarding their liquidity support program for corporate bond issuers. As of April 30th, the program had purchased over $5 billion of corporate bonds outright as well as over

$8 billion of exchange traded funds (ETFs) that hold corporate debt. In early June, the Fed announced that they would liquidate these holdings with an eye to completing these sales by the end of the calendar year. Despite the removal of this support, credit spreads narrowed instead of widened, underlining the markets unrelenting thirst for these issues.

Performance for the quarter was predictable given a lack of material movement in the yield curve and a narrowing of spreads. Returns for the quarter were positive but not quite of the magnitude to lift the year-to-date return to a positive number. Corporate bonds were the leader, easily outperforming U.S. Treasury and Agency issues. Lower quality issues within the Credit sector outperformed higher quality issues.

Looking forward, we expect the Fed to maintain its current loose monetary policy, despite the recent uptick in inflation. We acknowledge that the last few readings were high, but we concur with the thought that these impacts appear transitory. Assuredly, we will continue to monitor the economic data for any worsening trends. As for the Fed's next move it will likely begin to have discussions about when they will raise rates well before they actually change their policy stance. It would be unlikely to see any rate hikes before 2023 given the current economic variables.

We remain committed to our strategy of buying high quality, investment-grade bonds for our clients' portfolios. While the current market yields can seem underwhelming at times, we savor the safety of remaining high in quality and taking on only modest interest rate risk. If the markets should falter, our long-term strategy will be a benefit to our clients.

We hope that you all remain safe and healthy.

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