Fixed Income Outlook

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The U.S. economy continues to expand at an above average pace, despite a recent surge of COVID-19 cases. Data points show that demand is quite strong and that consumers are more than willing to spend. However, supply chain issues still constrain some areas of the economy, pushing up prices, most notably in autos and semiconductors. Inflation remains at the front of the mind for investors, furthering a trend seen in previous quarters. Equity markets have remained calm in the face of these uncertainties while the bond market has softened slightly.

Looking at economic growth, U.S. GDP grew 6.7% in the second quarter, up from growth of 6.3% in the first quarter. Strength in personal consumption expenditures fueled both of these rosy figures. Indeed, growth in personal expenditures expanded at twice the rate of personal income growth over the last twelve months ending in August. Freedom from COVID-19 restrictions alongside government stimulus checks have super charged consumer spending.

Figure 1 Inflation measures PCE Deflator and Core PCE Deflator

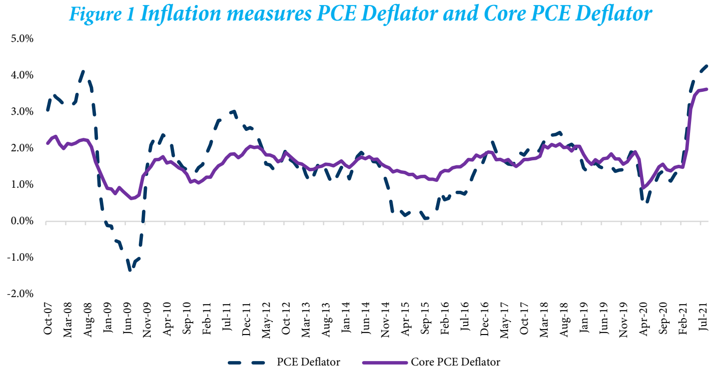

Figure 1 PCE Deflator and Core PCE Deflator, monthly figures Source: FactSet

In conjunction with all of this spending, inflation is on the rise. The Consumer Price Index, excluding the more volatile food and fuel categories, rose 4.0% over the last twelve months ending in August. Another measure, the Personal Consumption Expenditure price deflator (also excluding food and fuel increases) was up 3.6% over the same period. The current supply chain issues certainly contributed to this rise in inflation, but are not the sole cause as increases are quite broad-based.

The Federal Reserve (the Fed) has been closely monitoring the inflation situation. The longer inflation remains above their 2% tolerance limit, the higher the probability that the Fed will begin making larger policy changes. Late in September, the Fed announced that it would likely begin this year to reduce their regular purchases of securities, which currently stands at $120 billion per month. The purchases are expected to be reduced to zero in 2022, paving the way for potential rate increases thereafter.

The U.S. Treasury yield curve has remained steadfastly low on the short end, held down by the current monetary policy. But further out on the curve, we have started to see more activity as the long end has begun to inch up. The 10-year Treasury yield was just over 0.9% at year-end 2020 and now is slightly over 1.5%, a move that has been more of a slow creep than a single, sweeping change. This is in part due to the Fed's deft handling of communicating their expected actions. The Fed has been very careful in telegraphing such a move to the markets, which resulted in minimal impact at the time of the announcement.

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

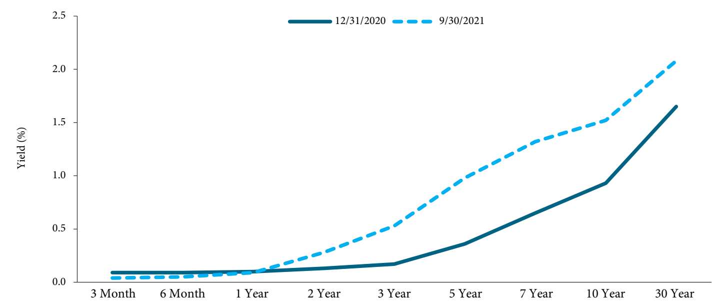

Figure 2 U.S. Treasury Yield Curve Today and at Year End 2020 Source: FactSet

Credit spreads, or the additional yield investors require to compensate for default risk, still hover near historic lows. The low yield environment continues to drive investors to seek any additional yield that they can find. This has meant that lower quality issues have outperformed as investors chase those higher yields. For example, intermediate BBB rated corporate bond spreads have narrowed by 12 basis points this year, while intermediate AAA rated corporate bond spreads have only narrowed by 5 basis points.

Figure 3 Intermediate Corporate Bond Spreads by Credit Quality

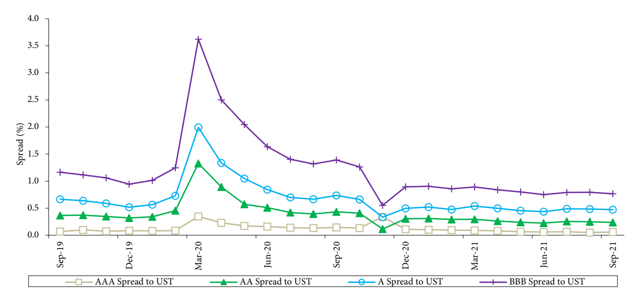

Figure 3 Intermediate Investment Grade Credit Spreads (OAS) 2019 to 2021 (Source: Bloomberg)

Performance for the quarter was muted, impacted only by a slight upward move in interest rates and minimal changes in already tight spreads. U.S. Treasury securities as a group posted a negative return due to the lift in rates on the long end of the curve. Corporate bonds had a positive return due to their higher yields, which was just enough to keep them on the positive side of the ledger. As has been the norm, lower quality issues outperformed higher quality issues over the quarter.

As we look ahead, we expect the Fed to follow through on its pledge to begin tapering its monthly purchases before this year end. Further, we expect the Fed to hold off on raising short term rates until the purchases are fully ceased, which points to a very late 2022 timeframe for the first hike. At the same time, any acceleration of inflation could trigger the Fed to move more quickly, which necessitates watching price indices closely. If inflation slows, we expect any hikes to be delayed into 2023.

We remain committed to our strategy of buying high quality, investment-grade bonds for our client's portfolios. Despite the low yield environment, we favor staying in a high-quality posture and muting the amount of interest rate risk taken by our strategy. Now is not the time to add risk to seek a higher yield, either by going down in quality or by increasing interest rate risk. In the current environment, a reversal of the current trends could cause lasting damage if this approach is taken.

We hope that you all remain safe and healthy.

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