Congress Asset Management Company, LLP

Fixed Income Outlook

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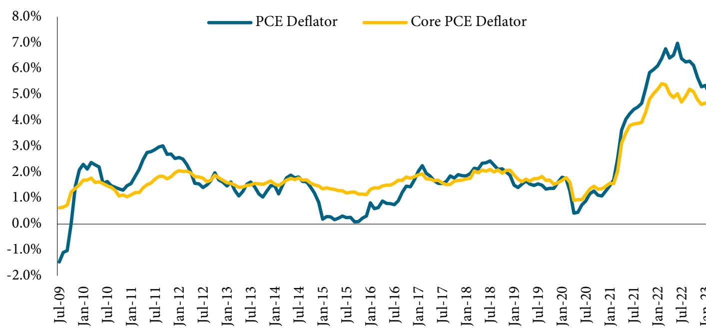
Second Quarter 2023

Fixed income markets saw another notable quarter with yields moving unexpectedly and banking problems injecting additional volatility. Yields generally remain high, despite the U.S. Treasury yield curve becoming more inverted. Total returns for the quarter were positive across broad market segments and were a welcome respite from performance in 2022. The Federal Reserve (the "Fed") remains steadfast in its convictions to fight inflation and we expect them to follow through with a modest set of rate hikes later this year.

Macroeconomic data releases over the past quarter have very much followed the plodding trend of past releases. Inflation is receding, but at a very slow pace. Sequential results show a pattern of shrinking inflation and a slowdown in some growth figures, with the continued strength in housing prices and employment being the largest contrary outliers. From this data we see that the Fed is having an impact, but inflation will probably not be at their 2% target rate in the near term. All of this suggests that this will be a long-drawn-out effort if the Fed sticks to its target without deviation. This will be no quick fix for the Fed.

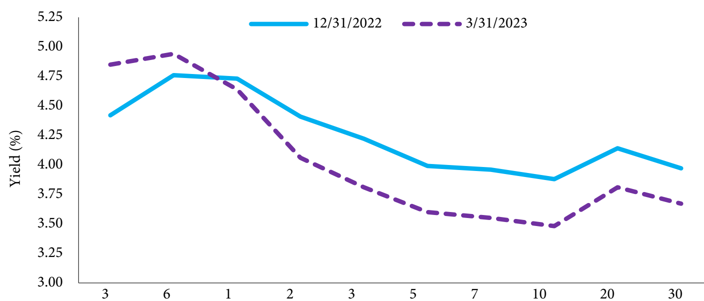
Figure 1 Personal Consumption Expenditures Price Indices (YoY)



Source: FactSet.

Longer term yields fell during the first quarter of 2023, propelled by fear over banking failures and the yet to be felt impacts from multiple interest rate hikes by the Federal Reserve. In an already volatile marketplace, this additional disruption was digested relatively well by investors. There were broad moves in rates, but no sustained panic or snap moves in trading. The net result of these interest rate shifts was a more inverted yield curve, with short term rates edging even higher than long term rates.

Figure 2 US Treasury Yield Curve at December 31, 2022 & March 31, 2023

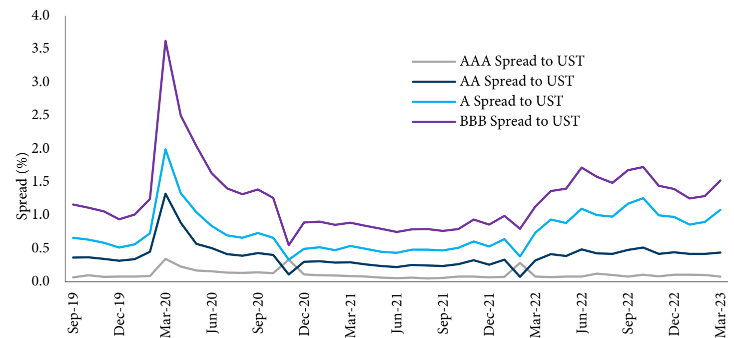


Source: FactSet

The failure of Silicon Valley Bank and the forced closure of Signature Bank sent ripples through the credit markets. Credit spreads, or the additional yield investors require to compensate for default risk, grew over the first quarter on the fear of proliferating banking problems. As the month of March progressed, spreads relaxed and shrank as these fears were assuaged by the Fed's actions and the identification of the banking problems as idiosyncratic rather than systemic. Major money center banks were the first to recover, with most regional banks following suit.

Credit spreads overall grew over the first quarter, led by Financial sector bonds, which were more impacted than Industrial or Utility sector bonds. Spreads for all sectors increased, regardless of sector, as risk factors rose. We did not witness a "blowout" in spreads as we saw back in the Global Financial Crisis of 2008. Instead, we saw a much more modest reaction to the news, perhaps due to the quick action by the Fed. It should be noted that some volatility does remain in spreads, but nowhere near that initially seen in early March.

Figure 3 Intermediate Investment Grade Credit Spreads (OAS) by Rating Cohort September 2019 to March 2023



Source: Bloomberg.

The Fed quickly stepped in to remedy the Silicon Valley Bank implosion. While we appreciate their actions to prevent a cascade of bank runs, their actions propagate an unsettling trend. The Fed is too quick to come to the rescue. Whether it has been domestic banking woes, a pandemic slowdown, or faltering niche market liquidity, the Fed has stepped in to unburden impacted parties. In many cases their actions were pre-emptive and from their view "supportive" in nature. However, these may prove to have been unnecessary in the long run.

The Fed's actions have led to a systemic reduction in risk premia – the final roosting place of moral hazard. Too many parties are profiting from the implied "backstop" from the Fed. Banks and other corporate debt issuers are reaping the benefits, borrowing on the cheap, and profiting on those dollars. We assert that either risk premiums need to increase, or the profits gained need to be curtailed. We are not advocating allowing the financial markets to fall apart, but some fear over failure for our financial institutions, especially those outside of the Fed's direct oversight, is a healthier approach.

As for future monetary policy, the Fed will likely continue to increase interest rates until inflation falls to their target, although this timeline will last longer than markets currently expect. The slow creep downward in inflation figures will require the Fed to continue to hike rates, barring any shocks such as additional bank failures, a COVID flareup, or geopolitical events. Their

messaging has been intensely focused on conquering inflation, making it difficult for central bank officials to quickly change tactics without losing credibility. Unless there is a dramatic change in the pace of change of pricing data, the Fed will plow forward on its path to "higher for longer" interest rates.

U.S. Treasury and Corporate issues performed well over the past quarter, delivering positive returns. They were assisted by the falling long end of the yield curve (yields move inversely with prices) and were offset by expanding credit spreads. Among Corporate market segments, there was little difference in performance between rating cohorts with both low-quality and high-quality issuers posting similar total returns. Financial sector issues lagged both Industrial and Utility sector issues due to the pressure on banks.

We continue to see high quality, investment grade bonds as an attractive opportunity when we look ahead to the remainder of the year. Yields remain much higher today than a year ago, even with the recent dip in long-term interest rates. Inflation continues to trend lower, protecting bond yields from its deleterious effects. For investors who have perhaps been turned off by previously low yields, now is the time to invest in, or make additional investments in, your fixed income portfolio.

Our stable, long-term strategy is to purchase liquid, high-quality bonds for our client's portfolios. We employ thoughtful portfolio construction and measured security selection as the main tenants of our strategy. Over time we seek to have safety, liquidity, and quality as the primary qualities for our fixed income portfolios.

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