ALTMAN
INVESTMENT MANAGEMENT

# FIXED INCOME STRATEGY HIGHLIGHTS

**APRIL, 2021**

## IN BRIEF: The U.S. Fixed Income Markets, Performance, and Strategy

**U.S. Treasury yields rose during the first quarter on the backs of improving GDP growth, fiscal stimulus and rising inflation.** The Fed has expressed its intentions to stay accommodative, until inflation exceeds its average target rate of 2%. This poses some risk at the longer end of the curve leading us to prefer shorter duration securities favoring higher quality corporate issues. Allowing for diversification into modestly lower quality issues and/or callable features are considerations we prefer to extending durations.

**So far, the first several rounds of fiscal stimulus have not been particularly inflationary.** A recurring study by the New York Federal Reserve illustrates that nearly 3/4 of each stimulus check was used to pay down household debt or put into savings. While this behavior is not currently inflationary, as we look ahead (and the economy re-opens with activity resumption closer to normal levels) the savings level could be tapped as a source for consumption lifting inflation.

**How Households Use Their Stimulus Checks**

| Stimulus Round | 1 | 2 | 3 |
|---|---|---|---|
| Reporting month | June | January | March |
| Average percentage spent | 29.2 | 25.5 | 24.7 |
| Average percentage saved | 36.4 | 37.1 | 41.6 |
| Average percentage toward debt | 34.5 | 37.4 | 33.7 |

Source: New York Fed Survey of Consumer Expectations (SCE).

Notes: Round 1 results are based on 1,423 respondents to the June 2020 special SCE survey who reported receiving a stimulus check. Rounds 2 and 3 results are based on 1,062 and 1,007 respondents to the January and March 2021 Core SCE surveys, respectively, who received or expected to receive second- and third-round stimulus checks.

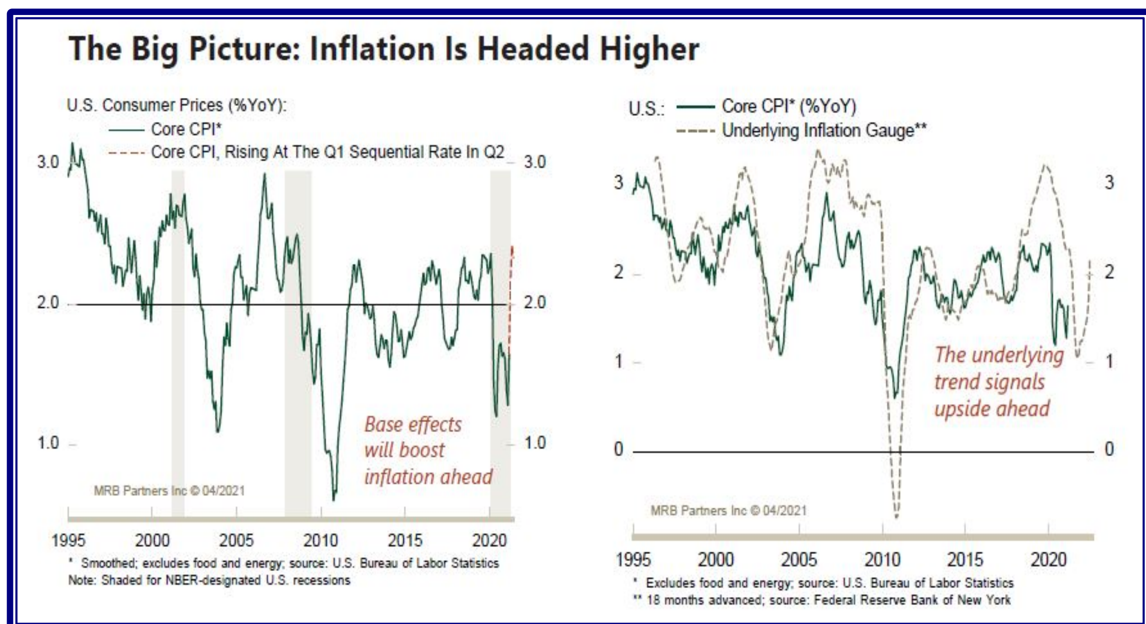
**The 12-month return for the Merrill Lynch Domestic Master Bond Index was 1.6%, below the average annualized return of 2.91% over the last 10 years.** This is due in part to a pullback of -1.6% in Q1 of 2021. The yield on the 10-year Treasury opened the year at .92% before climbing to 1.74% at quarter end. Since that time the yield has subsided about 10 basis points. While pullbacks in the bond market are disappointing, they continue to provide a vehicle for long term preservation of capital and income generation. A quick look at the past two decades tells us the downturns are relatively short lived - only occurring 20% of the time. The average quarterly drawdown in the stock market as measured by the S&P 500 index during this time period was -8.2%. The corresponding bond market performance during those drawdowns was 1.6%.

**Considering that bond market performance for the 20-year duration was an annualized 4.1%, it speaks to the ability of bonds to provide a level of balance and stability to portfolios over time.** Even as low yields are encouraging investors to seek bond alternatives, one must remain disciplined. It's tempting to let risk tolerance take a back seat in search of higher yields, but the whip saw effect can be fast and unforgivable. A strategy that incorporates long term risk tolerance will better serve portfolios as a whole. The low relative volatility of historical bond returns coupled with income generation and capital appreciation are what continues to make bonds an appropriate tool for adding diversification and balance to portfolios.

## *Fixed Income Sector Performance – Q1 2021*

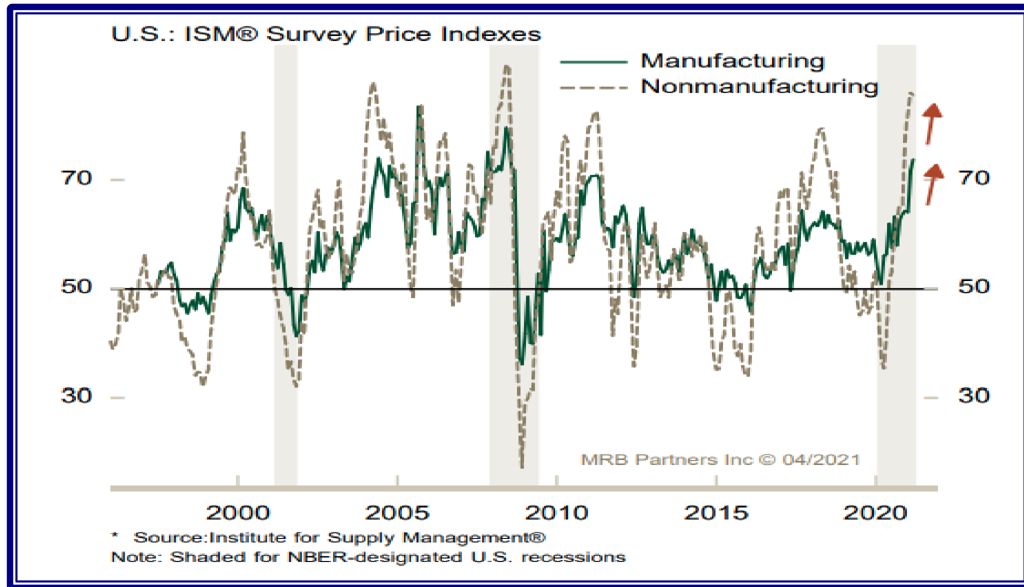
| | Rating | Maturity | Duration Mod Adj | Yield | Spread | Price | Trailing 12m TR |
|---|---|---|---|---|---|---|---|
| **Treasury (Intermediate)** | Aaa/AAA | 3.96 | 3.77 | 0.65% | N/A | $102.84 | -1.36% |
| **Agency** | Aaa/AA+ | 3.94 | 3.48 | 0.69% | 0.04% | $104.43 | -0.15% |
| **MBS** | Aaa/AAA | 4.86 | 4.45 | 1.47% | 0.82% | $105.17 | 0.10% |
| **Municipal** | Aa3/A+ | 4.69 | 3.38 | 0.56% | -0.09% | $114.14 | 3.73% |
| **Corporate (Intermediate)** | A2/A- | 5.78 | 5.19 | 1.52% | 0.87% | $106.19 | 4.51% |
| **High Yield** | B1/B | 6.33 | 3.51 | 4.16% | 3.51% | $104.08 | 23.31% |

*Source: Altman Investment Management Research and Bloomberg*



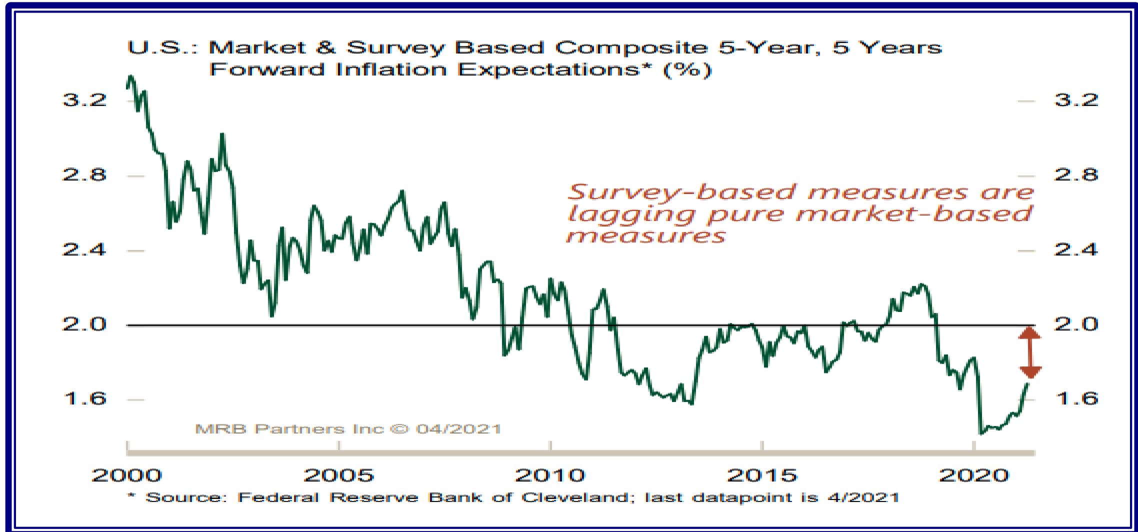

**In March, CPI inflation was still mainly driven by items whose prices have strengthened over the pandemic.** this includes transportation-related services and commodities like car rentals, resale cars, auto insurance, and repairs. The pickup in YoY core CPI was also slightly boosted by the favorable base effects for items that saw price declines beginning last March

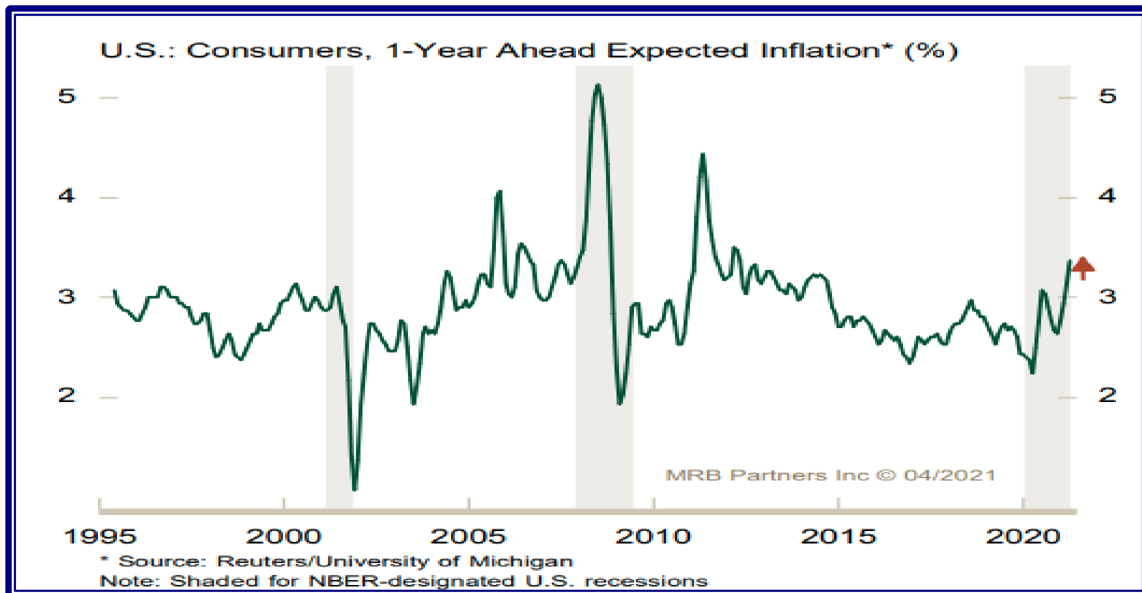
**As vaccinations mount, pent-up demand will lift prices in COVID-19-sensitive sectors (like public transport, non-hospital medical services, personal care services, hotels), especially if the supply side faces extended periods of disruptions.** We continue to monitor prices outside of COVID-19 sensitive sectors closely however, as upward price pressure later this year should signal a broad, sustainable rise in inflation, driven by above-potential economic growth, instead of temporary and idiosyncratic pent-up demand. In general, a pickup in the inflation rate of specific items that tend to have fairly stable prices (i.e., the prices are not frequently adjusted by producers) would also signal mounting broad-based inflationary pressure.




**Generally, sustained shifts in U.S. core CPI inflation (See chart below) need to be accompanied by a rent upcycle.** Rent accounts for 30% of the CPI basket, and 40% of the core CPI basket. According to Yardeni Research, it would take an 80 bps increase in the contribution of rent to core CPI inflation from the middle of this year, through the end of 2022 (i.e., a repeat of the 2005-2007 'late cycle' rent pickup) as well as a 50-60 bps increase in the contribution of all other items, to get to 3% core CPI inflation by the end of 2022. Note that rent's contribution to the CPI would rise by 60 bps by the end of 2022, if the monthly rate of inflation converges as it did in the 2017-2019 average over the period. Rents would need to rise faster than the pre-pandemic monthly pace for several months, in order to propel core CPI above 3% by 2022. There is a risk that the recent shift toward remote-working, de-urbanization and movement of jobs outside of expensive cities could outlast the pandemic and place a cap on rent growth, even if economic activity broadly normalizes.

**Market-based inflation expectations have risen meaningfully this year.** Despite the fact that the PCE inflation tends to run about 20 bps below CPI, we would conclude that markets are not yet pricing in a rise in PCE inflation above 2%. As incoming inflation data begins to pick up, we believe inflation expectations are at risk of rising significantly.



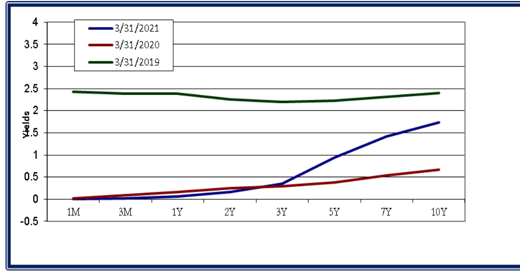




## *Sector Close-Up:*

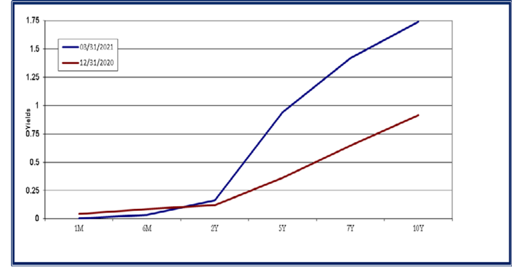
### ➢ Government Bonds

**Rising yields on the long end of the curve produced negative returns of -7% and -16% on the 10 and 30-year Treasury during Q1.** The 2-year Treasury and the 3-month T-bill during this same time period were flat. This comes after a strong 2020 as rates dropped below 1% during the second half of the year. Supply is abundant amongst Treasuries with the Federal Reserve slated to buy up a little less than half. Underperformance in this sector could therefore continue until yields are high enough to stimulate additional demand.

***Long Term U.S. Treasury Yield Curve***




***The Short Term U.S. Treasury Yield Curve Has Steepened Since the End of Q4***




***The 10-Year Treasury Yield***

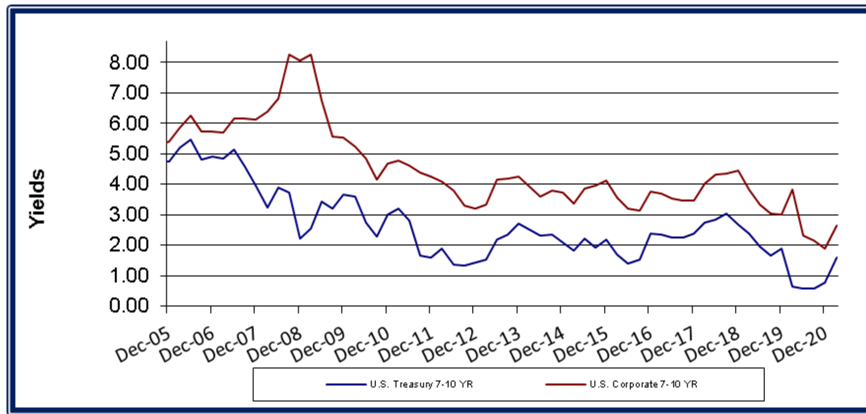
*Source: Bloomberg and Altman Investment Management Research*

## ➢ Investment-Grade Corporate Bonds

**Corporate spreads have held up despite the low interest rate environment.** This is due in part to the relatively slow speed of rising yields off the bottom, but a more rapid rise could ignite a more negative tone amongst corporate investors. Yield-seeking investors are incentivized by corporate spreads helping to offset money outflows from investors focusing on capital appreciation. The reopening of the economy should strengthen corporate fundamentals that were vulnerable during the pandemic. Improvement in earnings and the shoring up of balance sheets is most likely priced into corporates, leaving little room for spread tightening from here.

**Longer term, credit quality could be at risk with corporate taxes set to rise in accordance with President Biden's infrastructure spending plan.** Additionally, the cost of debt relative to equity is more favorable as the tax code offers more deduction allowances. This environment encourages corporations to take on additional leverage which in turn could impact credit quality.

***Corporate Credit Spreads***

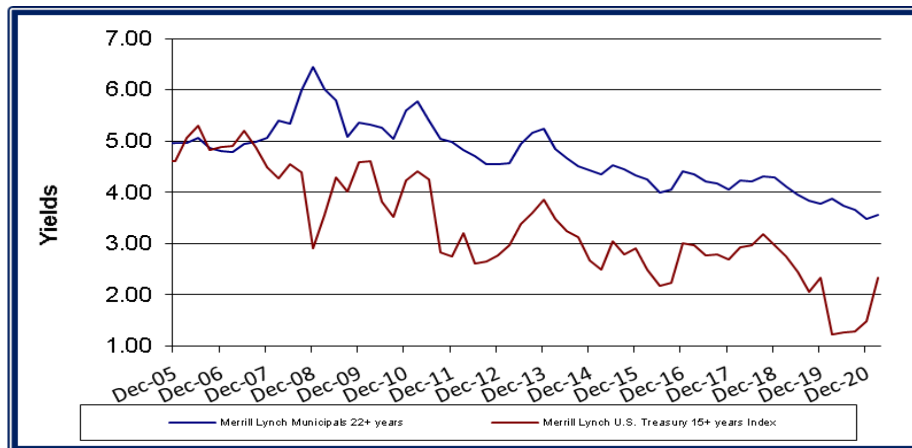



*Source: Bloomberg and Altman Investment Management Research*

## ➢ Municipal Bonds

**The move by the Federal Reserve to purchase $500 billion in municipal market securities helped support municipal bonds during the year tightening the spread.** The Merrill Lynch 1–10-year muni index returned 3.73% over the past 12 months including a modest pullback in Q1 of -0.4%. Municipal outperformance is expected for the duration of fiscal support from the Fed.

***10-Year AAA Municipal Bond Spread Over 10-Year Treasury***




*Source: Bloomberg and Altman Investment Management Research*

## IN SUMMARY:

**Pent-up demand or temporary supply-side constraints were not evident in the March CPI data, but we expect they will eventually boost inflation in select areas over the coming months.** Although widely anticipated, inflation's upside over the next few months should pose a meaningful risk to long-term inflation expectations. We expect inflation expectations will be vulnerable to signs of broad-based upward price pressures, i.e., outside of sectors like hotels, airfare or personal care services that will face pent-up demand. There appears to be early signs of upward price pressure building in the goods pipeline, although it is important to note that U.S. inflation is mainly determined by services prices, including rent. Rent inflation ticked up in Q1, but the likelihood of an imminent, sustained rent upcycle is still low. The Fed and the consensus believe that this year's inflation upside will fade next year. However, we expect that core CPI inflation will trend at or above 2.5% year over year on a sustainable basis by the end of 2022, consistent with a large, positive output gap. While economic overheating (core CPI inflation between 3.5%-5%) is not yet our base-case expectation, expansionary fiscal policy may drive a sharper upward bias in inflation expectations as a self-reinforcing factor.

**While the short-term environment for bonds remains challenging, they do provide a level of stability and balance to temper overall portfolio risk.** We continue to position portfolios with relatively short durations as the low interest rate environment poses risks to the long end. Credit spreads offer greater opportunities for income and appreciation - with an emphasis towards low duration, liquidity, and quality.

---

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.

ALTMAN INVESTMENT MANAGEMENT, LLC
33 Witherspoon Street, 2nd Floor – Princeton, NJ 08540 – (609) 252-0048 – www.AltmanInvest.com