FIXED INCOME STRATEGY HIGHLIGHTS

JULY, 2021

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

For the past 3 months, Personal Consumption Expenditures have continued to grow above the Fed's target rate of 2%. This is attributable to year-over-year comparisons having been exacerbated by the economic shutdown. The resurgence of demand that coincided with vaccinations ignited upward pressure on prices as the economy ramped up activity. The Fed expects inflation to gradually move back down, citing "the fading of base effects along with smaller expected monthly price increases". Next year, they believe transitory pressures from supply disruptions should subside as demand eases after its initial surge. As a result, the Fed expects inflation to revert back within target levels in 2022, before rising modestly again in 2023. The members agreed to maintain current interest rate and bond purchasing programs, until labor market conditions return to maximum employment levels and inflation is at risk of exceeding 2% for a longer period of time. In contrast, global central banks have turned hawkish, raising rates for the first time since 2019. China however, was an outlier cutting its reserve requirement offsetting the global direction of policy tightening for now.

Brief Thoughts on Inflation

The sharp upswing in U.S. consumer price inflation in Q2 had exceeded most economists' expectations, with core CPI inflation reaching an unprecedented pace of 4.5% year-over-year in June. Although transitory forces have been a large driving force behind inflation to-date, we believe there is likely more upside to come ahead; core CPI is now looking likely to close the year with inflation approaching the upper end of 2.0%, a prospect which is underappreciated by the consensus. The key question remains whether inflation will settle around 2%, once the current supply constraints/reopening-driven distortions fade - or whether inflation prove sticky and make a sustained push above the 3% level in 2022 on a cyclical basis, and continue higher on a multiyear horizon.

The unprecedented strength of inflation's pickup through May drove the Fed to acknowledge the risk that U.S. consumer inflation might be more persistently higher than they had been expecting over the coming years. The possibility of inflation surprising on the upside on a 12–18-month basis had gained traction with investors as the second quarter unfolded, and dampened market enthusiasm for bonds as yields peak during the quarter. Still, the Fed believes that inflation will settle at around 2% on a two-year horizon, a view that is shared by economists' consensus. We remain in the camp that disagrees with the Fed and the consensus, and expect a sustainable cyclical rise in inflation to develop over the coming quarters, driven by GDP growth that will be above its pre-pandemic trend level and its potential level through the end of next year. It's worth noting that the base effects of this year's temporary inflation upside will subsequently work in the opposite direction next year, and could briefly drive the illusion of inflation descending back from above 3% in the first half of 2022. However, by the end of next year, we expect that it will become evident that inflation's durable, medium term rate will be nearer 3% rather than 2%.

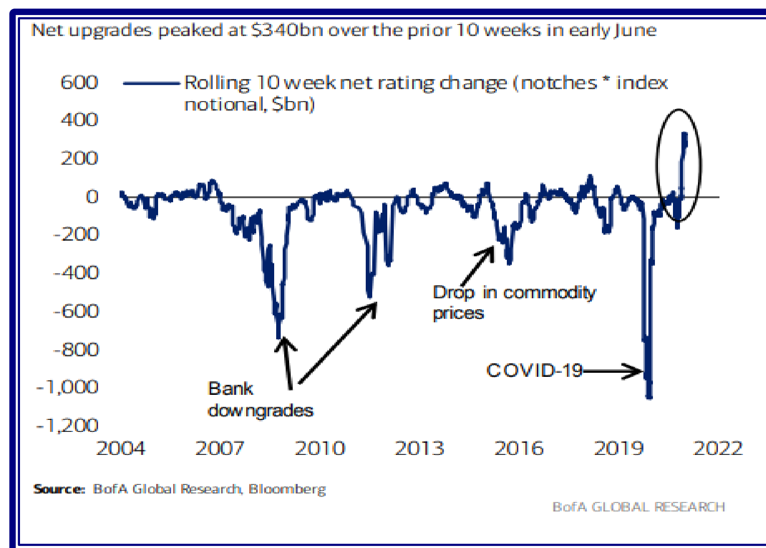
Our out-of-consensus view on inflation reflects two factors: First, the consensus expects economic growth to slow more next year than we expect. Second, and more importantly, is that the consensus believes that above-potential growth will have no impact on inflation. Given the temporary price distortions that will play out through much of the next 6-12 months, incoming CPI/PCE inflation reports will be far too noisy to conclusively settle the ongoing debate over whether significant real inflation will have any credence this cycle. It is therefore essential for investors to sift through the noise and track the underlying trends of prices, wages and rents in the "underlying" trends in order to avoid being blindsided by future strength.

With GDP growth likely to be well above its pre-pandemic trend for the next 2-3 years, we expect that this pickup will amplify the effects that move the trend of inflation to rise to or above 3% by the end of next year. Core inflation is likely to converge upward to the underlying trend, once the major distortions affecting it gradually fade.

Corporate Credit

Bank balance sheets have swelled as the overall rate of loan growth reaches its lowest level in nearly 8 years. This available low-cost liquidity - coupled with an improving capex cycle led by an earnings recovery and a resurgence in consumer demand - should help revive lending growth. The massive corporate upgrade cycle already underway reflects this improved outlook for economic productivity.

Record Corporate Bond Upgrades Over Last 3 Months



Fixed Income Sector Performance – Q2 2021

	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing 12m TR
Treasury (Intermediate)	Aaa/AAA	4	3.81	0.64%	N/A	$102.83	-1.12%
Agency	Aaa/AA+	3.88	3.37	0.65%	0.01%	$104.95	-0.14%
MBS	Aaa/AAA	5.16	4.71	1.54%	0.90%	$104.78	-0.39%
Municipal	Aa3/A+	4.6	3.33	0.47%	-0.17%	$114.27	1.71%
Corporate (Intermediate)	A2/A-	5.9	5.22	1.74%	1.10%	$109.23	0.82%
High Yield	B1/B	6.46	3.51	3.77%	3.13%	$105.29	15.62%

Source: Altman Investment Management Research and Bloomberg

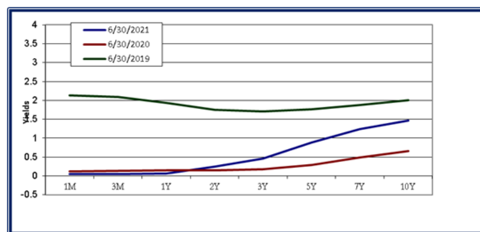
Sector Close-Up:

➢ Government Bonds

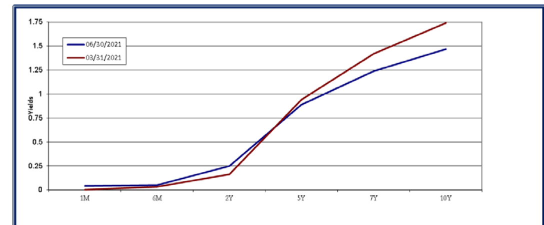
As Q1 came to an end, there was a brief sell-off in Treasuries and yields climbed to over 1.7%. Bonds then rallied as the Fed turned slightly less dovish, alongside a modest and likely temporary rise in inflation. The 2-year/10-year spread narrowed slightly in Q2 flattening overall Treasury curve. While the spread has tightened a bit, which can be an indicator of concern about the outlook for longer term economic growth, we anticipate yields at the long end to edge slightly higher from here.

New issuance of Treasuries has grown substantially, nearly tripling since pre-pandemic levels. Investors will likely demand higher yields as supplies increase, even more so when the Fed begins to taper, as higher yields are required to absorb excess supplies.

Long Term U.S. Treasury Yield Curve



The Short Term U.S. Treasury Yield Curve Has Flattened Since Q1



The 10-Year Treasury Yield

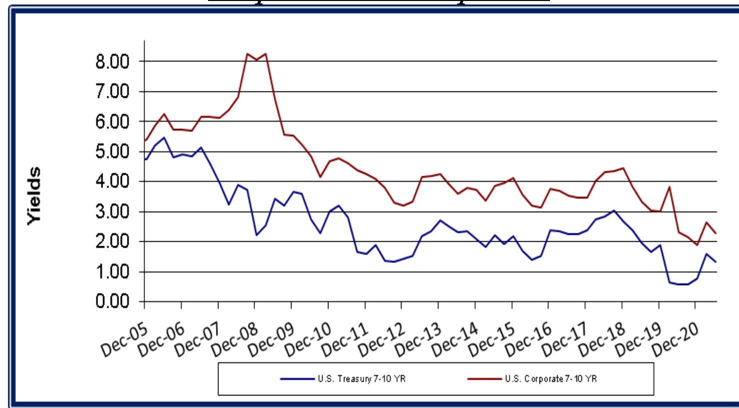
Source: Bloomberg and Altman Investment Management Research

➢ Investment-Grade Corporate Bonds

As we wrote in our last report, 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. Yield pick-up is evident in the BBB arena of the investment grade universe. This comes as investors unwind temporary positions created to chase yields offered within lower quality.

Investment grade corporates offer liquidity, quality and competitive yields. With slim yields available elsewhere, they remain a focus in diversified portfolios. Headwinds down the road could come from tax reform though are likely a way off and should be offset by improving economic growth. Even with current low cost of borrowing, which encourages leverage build up, we have not seen trends implying a worrisome level which would impact credit quality.

Corporate Credit Spreads

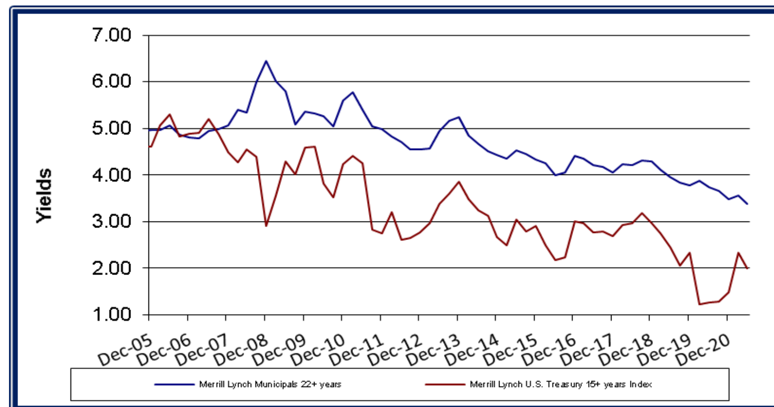


Source: Bloomberg and Altman Investment Management Research

➢ Municipal Bonds

Municipal bond fund flows have increased $120 billion over the last year as compared to an average annual inflow of $28 billion over the past 7 years. Municipal bonds rallied, returning 1.71% during this time, as above average inflows met a limited supply of bonds. Yields which move in the opposite direction of price fell contracting spreads.

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



Source: Bloomberg and Altman Investment Management Research

Municipal quality spreads have narrowed, allowing an opportunity for investors to transition out of the lower quality issues in which they pursued in search of yield pickup to navigate the low interest rate environment. As the economy recovers, rating agencies have begun to raise their outlook in sectors significantly burdened by the shutdown.

IN SUMMARY:

Based on the most recent core PCE deflator, or even the 2.6% 10-year CPI swap rate, the U.S. real 10-year Treasury yield in our opinion is deeply negative. The low level of yields stems in part from the Fed's aggressive bond buying, which has limited the supply available for the public. The 3.1% increase in the core PCE deflator over the past year is so far fully consistent with the Fed's objective of achieving inflation sustainably above 2% over the economic expansion. In light of our forecast that U.S. real GDP will expand approximately 6.0% this year and 4.5% next year, it will be increasingly difficult for the Fed to justify, and for investors to accept, a deeply negative real long-term interest rate even if real growth reverts back toward to the 1.75% potential rate thereafter.

Keep in mind that the Fed forecasts are based on a long-run real equilibrium policy rate of 0.5%. With the 10-year yield averaging a stable 1.2% above the Fed funds rate over the past 50 years, the implication is that the associated equilibrium level for the real 10-year Treasury yield would also be approximately 1.75%. Given longer-term inflation uncertainty, such a real yield may be a modest underestimation. Assuming the core inflation averages 2%, then Treasuries are overvalued, and we expect yields to move higher as the economic expansion proceeds.

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