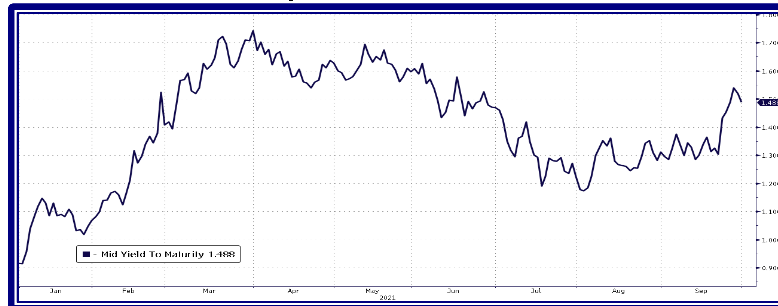
ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS — OCTOBER, 2021

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

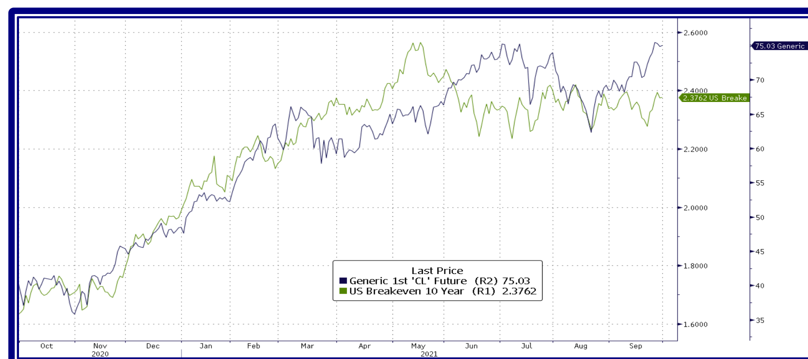
10-Year Treasury Yields Make a Comeback



Source: Bloomberg and Altman Investment Management Research

Over the summer the 10-year Treasury yield sank to a level of 1.2% in July before climbing back towards 1.5% at quarter end. Low to negative global interest rates fueled demand for U.S. bonds where rates are higher by comparison. This kept yields in the U.S. lower until investors began to look beyond Covid 19, as vaccination rates increased. As the price of oil rebounded off August lows, inflationary concerns began to take hold. Treasury breakeven (the spread between 10-year Treasury and Inflation Protected Treasuries (TIPS)) tends to expand when oil prices rise due to a sell-off in Treasuries in favor of TIPS.

WTI Crude Prices V 10-Year Breakeven



Source: Bloomberg and BofA Global Research

The stability of the economic recovery, the status of Covid 19, consumer sentiment, inflation and oil prices are some of the factors that will influence bond performance in the months ahead. It is our opinion that the price of oil will remain relatively flat and supply bottlenecks should ease, both of which could help tap down inflation next year. While still fragile, consumer sentiment should stay healthy, as more restrictions are lifted and the economy continues to grow - albeit at a more moderate pace next year. We continue to favor high quality, liquid corporate bond issues as borrowing costs remain low. To combat rising yields, we prefer durations of less than five years for new money. We have expected bond yields to move up in waves, but the interest rate pause has lasted longer than we would have anticipated given the strength in the global economic and inflationary data. Central Banks remaining in the transitory inflationary camp have given the bond vigilantes some breathing room before resuming further declines in aggregate prices.

Fixed Income Sector Performance – Q3 2021

	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing 12m TR
Treasury (Intermediate)	Aaa/AAA	4.08	3.89	0.73%	N/A	$102.09	-1.37%
Agency	Aaa/AA+	4.03	3.71	0.74%	0.01%	$105.00	-0.43%
MBS	Aaa/AAA	6.01	5.39	1.66%	0.93%	$104.26	-0.46%
Municipal	AA2	7.1	3.49	0.60%	-0.13%	$113.60	0.77%
Corporate (Intermediate)	AA2	6.01	5.41	1.49%	0.76%	$105.95	-0.29%
High Yield	B1	6.71	3.79	4.08%	3.35%	$104.59	11.46%

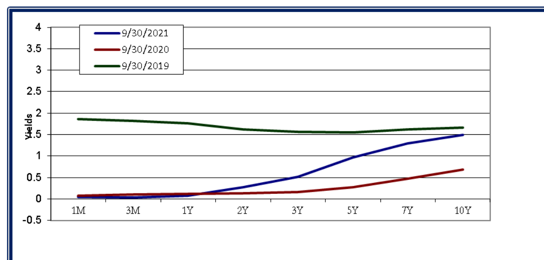
Source: Altman Investment Management Research and Bloomberg

Sector Close-Up:

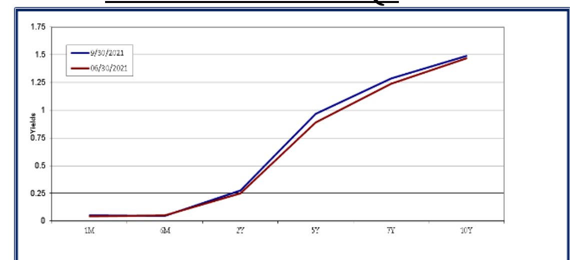
➢ Government Bonds

The yield curve steepened modestly, particularly in the intermediate range in Q3, on encouraging economic data, inflation concerns and the subsequent tapering by the Fed of bond purchases while maintaining low interest rates for the near future. Treasuries underperformed other fixed income sectors during the year and again in the most recent quarter lifting the 10-year yield into a new trading range of 1.40%-1.75%.

Long Term U.S. Treasury Yield Curve

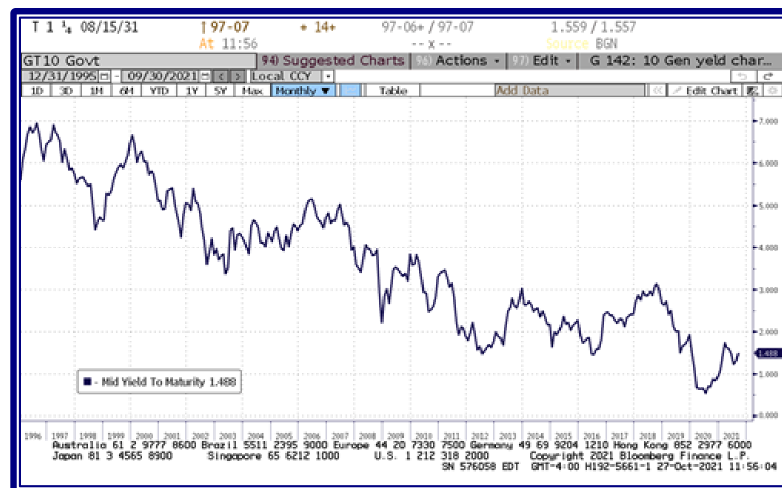


The Short Term U.S. Treasury Yield Curve Has Flattened Since Q1



Source: Bloomberg and Altman Investment Management Research

The 10-Year Treasury Yield



Source: Bloomberg and Altman Investment Management Research

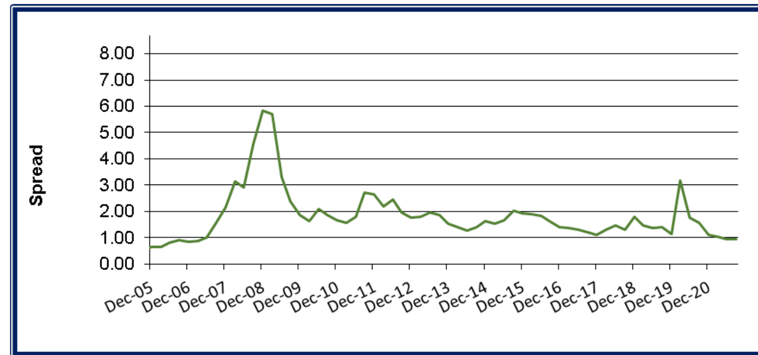
Treasury supplies have been robust since the Fed stepped in to support the market in 2020. The question now is, as tapering continues, will there be enough buyers on the sidelines to pick up the slack and support bond prices. The Fed's significant balance sheet expansion helped support a waning economy during a pandemic. The question on bond investors' minds now is will the cyclical recovery continue once the Fed takes a back seat, and will their management of interest rates be successful in avoiding stagflation.

➢ Investment-Grade Corporate Bonds

Fundamentals in the credit sector along with low borrowing costs and balance sheet liquidity puts high quality corporate issues in the preferred category. Net leverage has retreated to pre-Covid levels, while at the same time interest coverage is at a multi- year high. These improving balance sheet trends on corporate debt offer investors a lower beta option to equities. Improving fundamentals suggest the overall risk of default has been reduced making lower quality issues, within the investment grade spectrum, a viable option for yield seekers.

The expectation for higher interest rates next year was responsible for a jump in corporate issuance this year, as corporations rushed to lock in low rates. Conversely, supply is likely to pull back in 2022, as the Fed unwinds accommodative policies and bank loan supplies normalize. Corporations are in better positions to service their debt due to higher liquid assets on their balance sheets - this is being reflected in improving upgrade/downgrade ratios and narrowing credit spreads.

Corporate Credit Spreads



Source: Bloomberg and Altman Investment Management Research

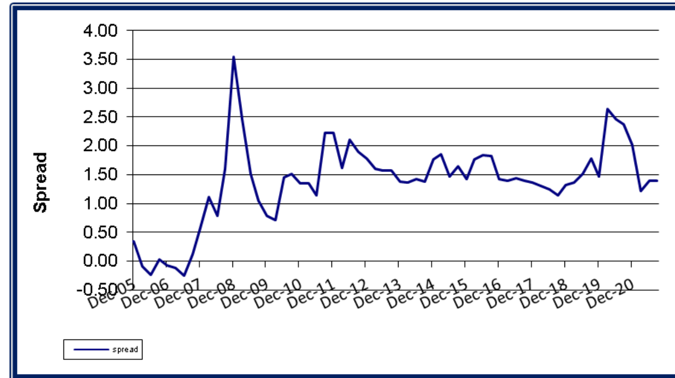
➢ Municipal Bonds

Advance refunding was originally slated for inclusion in the proposed Infrastructure bill but now looks to have been sidelined. The tax exemption for the refinancing and restructuring of debt at the state and local level was eliminated in 2017. This was an attempt for its reinstatement given that infrastructure is often financed by municipal debt. The Build American Bonds (BABs 2.0 – taxable municipal bonds subsidized by the federal government) also appears to have been dropped from the original bill.

President Biden's recently updated plan includes a 15% corporate AMT plus several surtaxes on higher income earners which would bring the top rate to 51.4% - thus increasing demand for municipals. The current draft also includes funding for various social and climate programs as well as a range of other infrastructure projects such as public transportation, bridges and roads. All projects would reduce pressure on state and local balance sheets and support overall economic growth, thus boosting demand for tax exempt municipal bonds.

Municipal spreads have reverted back to historical average levels, after peaking in early 2020 when the pandemic began. Accommodative fiscal and monetary policies helped support municipal revenues and reserves, while more recent concern over rising tax rates sparked a renewed interest in tax exempt securities.

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



Source: Bloomberg and Altman Investment Management Research

Overall, municipal bond credit improved during the quarter as the Standard and Poor's upgrade/downgrade ratio came in at 2.6%. Default rates for both first time debt and newly distressed debt dropped 19% and 12% respectively in Q3 on a year-over-year basis. Municipals underperformed Treasury bonds for the first time since the pandemic began providing a buying opportunity as the outlook improves.

IN SUMMARY:

Overall financial markets have been impervious to both monetary and inflationary signals as well as valuation and sentiment indicators. Fortunately, our technical signals have remained somewhat bullish throughout the summer. There appears to be a disconnect from the spending splurge that the Fed orchestrated that will prove to be transitory - and supply side disruptions that have pushed inflationary targets higher than most market pundits predicted. The tug of war between the short-term Confidence Gap and the long-term Treasury-yield has traditionally correlated to future inflationary expectations. However, the Fed's intervention with the bond market, now greater than ever, has created uncertainty in the path of the current economic recovery.

Investor appetite for yield is apparent in the outperformance of higher-yielding lower-quality fixed income securities this year. As the economic expansion proceeds, we expect Treasury yields to register in the range of 1.40%- 1. 75% through year-end. The Fed's inflation indicator, Personal Consumption Expenditures (PCE), at 3.6% excluding food and energy is running above its 2-year average of 1.91%. We currently view inflation as temporary and expect it to revert back, albeit higher than the Fed's average target range of 2%, next year to a level closer to 3.0%. We conclude that this level is still relatively low given the huge spending and abnormally low interest rates. However, it is important to note that the probability is rising that the Fed may introduce its first rate hike by July of 2022, which is a little earlier than originally estimated.

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