FIXED INCOME STRATEGY HIGHLIGHTS

June, 2022

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

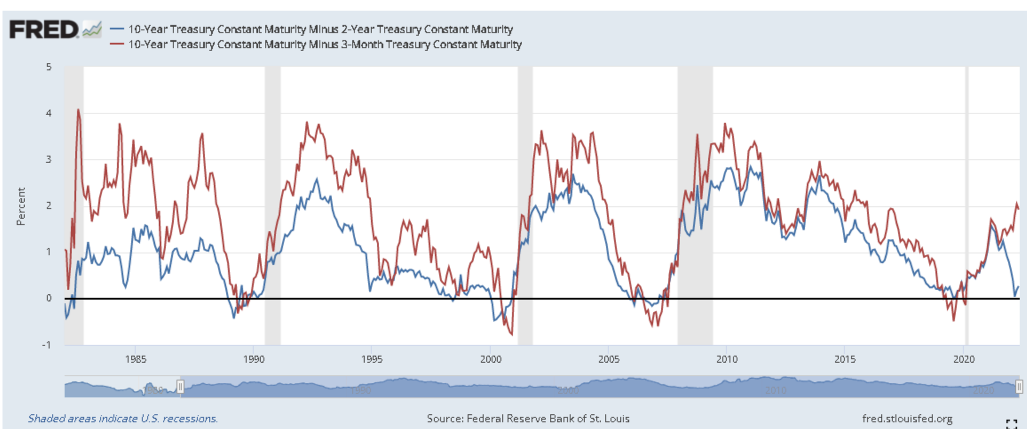
Bonds sold off sharply in Q1, bringing the ML Domestic Master index 12-month total return down ~4.4%. High yield outperformed over the last year, although they sold off in step with the aggregate during the quarter. The market appears to be trading on the expectation of a hard landing, bracing for steep inflation and perhaps even stagflation, when growth and employment slow alongside rising inflation.

Fixed Income Sector Performance – Q1 2022

	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing 12m TR
Treasury (Intermediate)	Aaa/AAA	3.98	3.77	2.33%	N/A	$96.61	-3.95%
Agency	Aaa/AA+	3.62	3.31	2.36%	0.03%	$99.57	-3.59%
MBS	Aaa/AAA	7.61	6.3	3.00%	0.67%	$97.30	-5.10%
Municipal	AA2	7.13	3.27	2.08%	-0.25%	$107.41	-3.80%
Corporate (Intermediate)	AA2	5.73	5.12	3.01%	0.68%	$97.88	-4.85%
High Yield	B1	6.19	4.45	5.93%	3.60%	$97.05	-0.29%

Source: Altman Investment Management Research and Bloomberg Finance

The 3-month to 10-year spread, the Fed's preferred recession indicator, continues to trend higher and is now close to 192 basis points. This suggests that the Fed's posture remains dovish by historical standards - with room to shift more hawkish via more aggressive tactics as they relate to interest rates hikes and shrinking of its balance sheet. The 2-year and 10-year yield spread bounced out of negative territory in April, and currently registers in around 27 basis points. No longer inverted, the steepening curve is no longer indicating a recession, at least for now.



Source: St Louis FRED

What we'll be looking for as the year plays out is solid evidence that the Fed is able to successfully reduce demand in order for supply to come back into balance. The Fed chairman recently acknowledged the challenges ahead in engineering this type of soft landing. Fed policies are meant to control demand and what is driving prices higher today is more supply driven, thereby the outcome may very well be reliant upon "factors that we don't control". For now, the Fed is actively considering 50 basis interest rate rises at its next two meetings. However, if the economic data or expectations about the economy change materially, they are prepared to do more.

We still see low odds of a U.S recession in the next 12 months. The U.S. economy entered the year with considerable momentum. The health of household balance sheets, strong labor demand, and the lack of excessive incorporate spending should provide a large cushion against stress - keeping recession risks muted.

However, the pace of the rise in bond yields over the past six months has exceeded even our sanguine forecasts for the government bond market. Long-term interest rates remain low by historic standards, but sharp rises in the cost of capital in short periods can nevertheless be disruptive to economic activity, especially when investors start extrapolating these rises in yields and policy rates. If the government bond market does not calm down in the months ahead, rapidly rising bond yields could lead to a more exaggerated slowdown in economic growth - especially if Europe lapses into a recession, although this is not a forgone conclusion. While our constructive economic outlook does come with some risks, we expect the uptrend in corporate earnings to persist, albeit at a more moderate pace than in the past 18 months. The combination of rising earnings and easing downward pressure on valuation multiples, as inflation peaks, should enable equities to produce modest gains on a 6–12-month horizon. Against this backdrop, we remain biased with a modestly pro-growth stance.

The longer-term implication of economic resilience, however, is that it ultimately will sow the seeds for another up leg in bond yields. For now, the risk-off phase has potentially capped the rise in bond yields, and easing U.S. inflation data should allow bond markets to calm down. We, however, are still reticent to trade a countertrend move in bond yields, and still remain cyclically bearish on fixed income. We are still concentrating on credit spreads to add to total return as recession concerns ease and allowing spreads to flatten or narrow.

In terms of the recent risk-off environment, the equity de-rating that has occurred over the past six months has been quite severe, especially for the U.S. The rebound in global bond yields broke a very long-term downtrend and has profoundly challenged the complacency that developed during the free money era when all assets inflated massively. The end of this era will remain difficult for some assets, especially those that did not have a solid profit picture over the longer term. Corporate earnings are still supportive for equites and credit, although we would expect the growth rate in profits will slow, especially since margins are already very elevated and cost pressures will continue to worsen. As we noted last year, to the extent that many businesses were able to successfully pass on rising costs to end-users, this has spurred higher inflation in most of the developed markets and parts of the emerging markets as well. Higher inflation, in turn, sparked both the breakout in bond yields and an end to the buy & hold phase for risk asset markets. We expect bond investors will have to be attuned to credit risk in order to achieve decent absolute returns going forward, and lower their long-run expected returns. Such a tough backdrop will persist until the valuation distortion in government bond markets is fully unwound and inflation is tamed.

Although we expect the deceleration in inflation will be primarily due to base effects, rather than a profound easing in underlying inflation pressures; for example, the unprecedented boom in used car prices is not going to be repeated. Yet any relief will be welcomed after a long stretch of persistent high-side misses for U.S. inflation. However, a return to a low inflation world is unlikely, absent a sizable economic slowdown.

It is noteworthy to recognize that the U.S. service sector inflation has been strengthening, and is now decisively adding more to core CPI than goods inflation. Much of the initial rise in bond yields was driven by the headlines focusing on supply chain problems and surging goods prices, which have lingered due to the war and Chinese economic lock-downs. However, the more worrisome longer-term trend has been rising service sector inflation, despite still-constrained activity in the sector.

Service sector inflation tends to be stickier, especially in important components like rent. Moreover, higher service sector inflation has leaked into rising wage demands and inflation expectations. These latter trends are much harder to reverse absent much weaker demand, in comparison to goods markets where better functioning supply processes can ease price pressures.

The U.S. small business sector (NFIB) survey recently showed that inflation pressures remain at cyclical or even record highs. It also showed that underlying conditions are still robust, especially with regards to employment, despite various headwinds from higher borrowing costs, angst about external growth and soaring energy prices. Conditions are not as healthy in the Euro area, but the re-opening service sector should more than offset drags from the war, or related hesitancy due to elevated geopolitical tensions

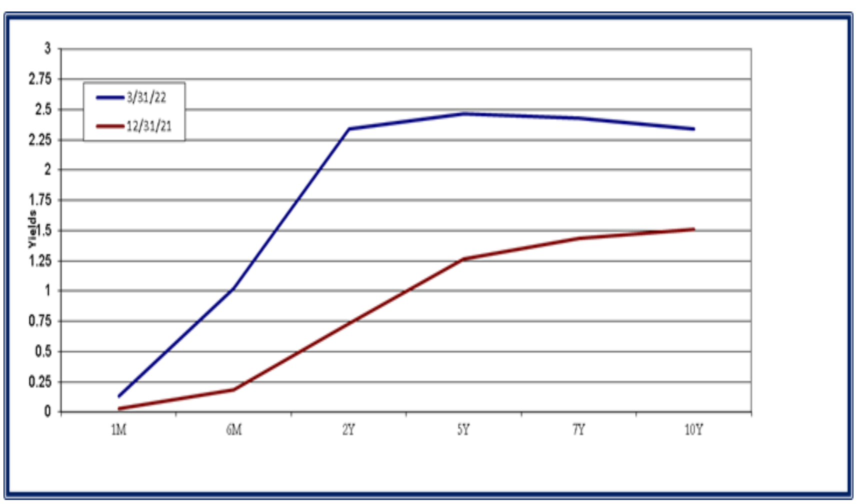
Keep in mind that a positive economic growth outcome is only bullish for risk assets if it does not spur higher inflation and bond yields, and thus causing de-rating pressures. Such conditions have been intensifying over the past six months. From a longer-term perspective, lasting relief for risk asset markets relies on evidence that inflation can be brought under control without central banks having to trigger a recession - and the jury is still out that such a benign outcome will occur.

The Fed stressed at the last FOMC meeting that it hopes to bring inflation under control by quickly raising the policy rate to neutral or modestly higher which, combined with its shrinking balance sheet, it believes should cause U.S. demand and supply to align. We are skeptical that such an outcome will occur, and expect another period of capitulation later in the year by the Fed and disappointing bond bulls down the road. Having so badly misjudged the inflation outcome, investors are wary of making a bet on a benign soft-landing outcome, although perhaps three to six months of cooling inflation data could rekindle some optimism. It will be difficult to achieve a benign outcome, and we remain concerned that the Fed is underestimating how high interest rates will ultimately need to rise in order to lower inflation. Thus, we remain bearish on bonds, and expect yields to eventually undergo another up wave beginning later this year or in 2023.

Fixed Income Strategy:

The bump up in the two-to-five-year range of the Treasury curve tells us that investors are growing more concerned with cyclical economic conditions and inflation.

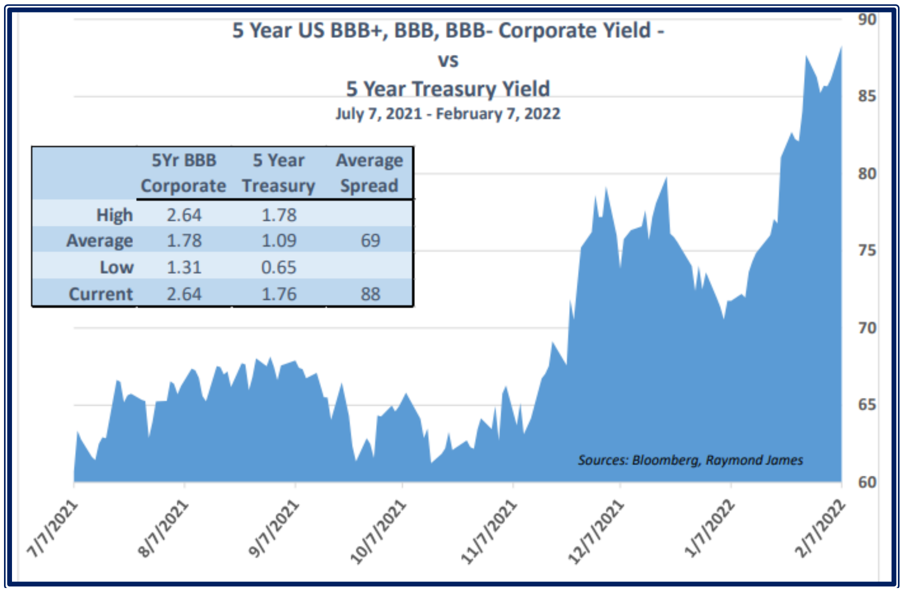
Intermediate Bond Yields Climbed at Faster Pace



Source: Altman Investment Management Research and Bloomberg Finance

Favoring cash in balanced accounts as a bond alternative has proven a successful strategy through Q1. Now that yields have made a big move up, we have begun to establish positions in lower quality, albeit still investment grade, intermediate corporate issues. A laddered strategy is a way to smooth interest rate risk by staggering maturities. In particular, five-to-seven-year corporate issues have attractive relative yields in select sectors such as food and beverage or financials.

Attractive Yields in the 5 YR Corporate Bond Space



Source: Raymond James Fixed Income Quarterly

Municipal bonds have also experienced a significant rise in yields, most notably in durations between three-eight-years. Should interest rates continue to rise, value is likely to be found in premium issues and those that include a call feature.

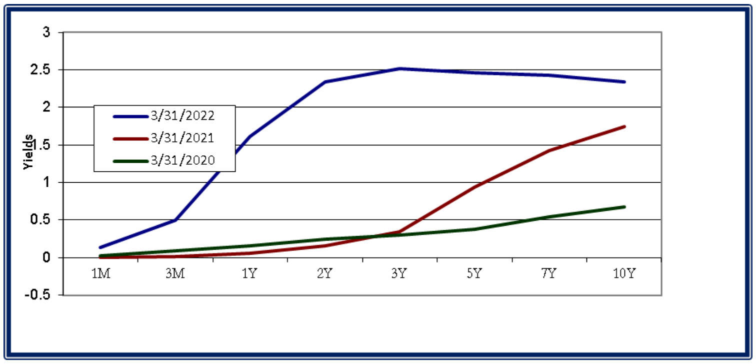
FINAL COMMENTS:

The cyclical outlook is still bearish for bonds, but a temporary pause in the yield uptrend is probable. Sequential U.S. inflation data should improve in the coming months, and recession worries could help government bond market sentiment for a time. The odds of a recession are still low, given the powerful economic tailwinds in the developed world heading into 2022 and the further re-opening of service sectors. Equities have been significantly de-rated and will "benefit" from firming corporate profits, suggesting a reprieve in the equity selloff should also develop, although it hinges on a calming in bond markets. The longer-term outlook, however, remains a concern, as the odds of a benign soft economic landing and return to low inflation seem unlikely. Government bonds are still overvalued (even after the rise in yields over the past year or so), and have further to adjust to reflect the new higher underlying inflation world.

At this point, we estimate the probability of recession this year as rather low. Inflation data has been easing somewhat after peaking in March and should cap bond yields which appear to be oversold. The Fed is prepared to step up tightening should economic conditions warrant. Yet, it's still too early to predict whether the Fed will be successful in harnessing inflation around 2% while also maintaining growth and a strong labor market.

APPENDIX: Some Relevant Charts

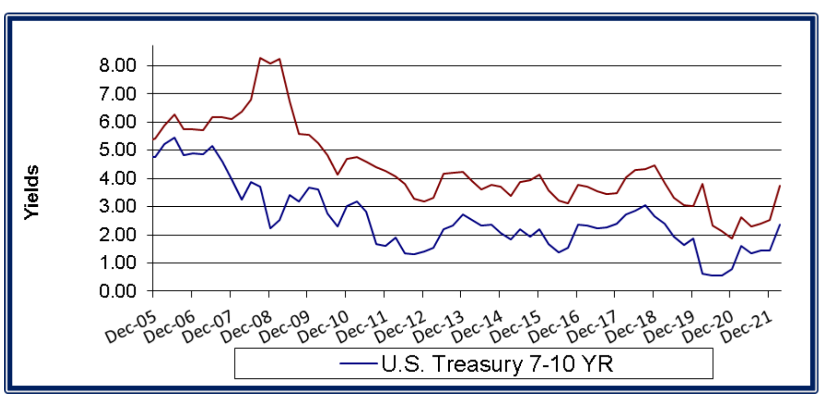
Treasury Yield Curve



Source: Altman Investment Management Research and Bloomberg Finance

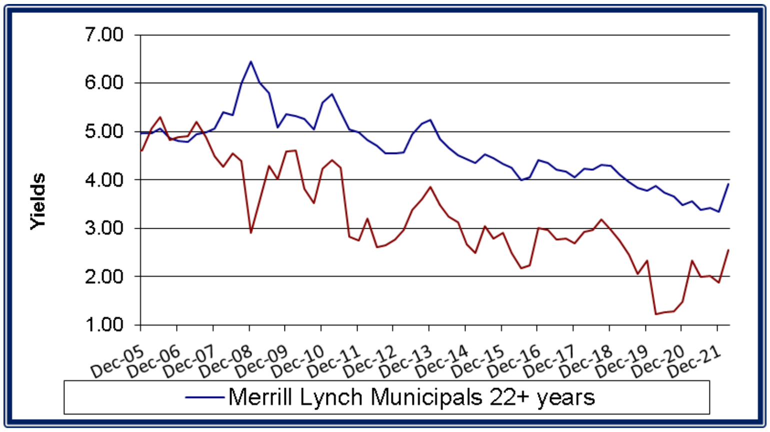
Ten-Year Generic Treasury Yield

Long Term Corporate to Treasury Spreads



Source: Altman Investment Management Research and Bloomberg Finance

Long-Term Municipal to Treasury Spreads



Source: Altman Investment Management Research and Bloomberg Finance