ALTMAN
INVESTMENT MANAGEMENT

# FIXED INCOME STRATEGY HIGHLIGHTS

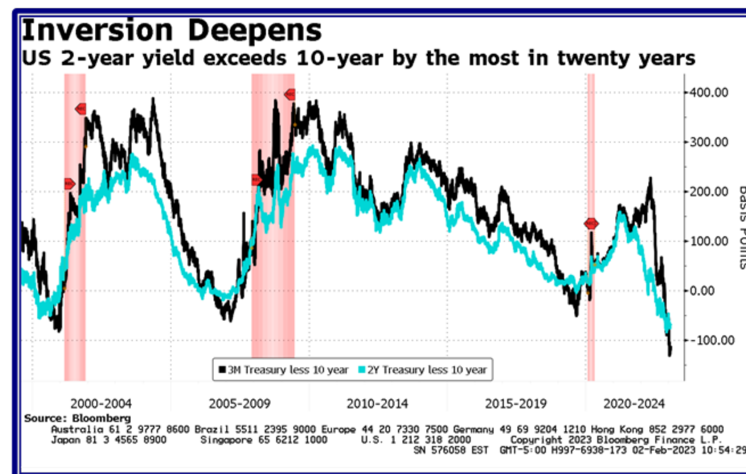
**January, 2023**

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

**During the past year as the Fed officials continued their tightening policies, the short end of the Treasury climbed 370 basis points (bps) alongside a much shorter journey taken by the 10-year that climbed 230 bps.** The longer end is reflecting concerns over rising inflation and an overheating economy coming out of the pandemic. Yield curve inversions historically precede recessions by approximately 6-24 months, and has only falsely signaled a recession one time since the mid 50's, according to Reuters and the Federal Reserve Bank of San Francisco.

**Interestingly enough, while the yield curve inverted in 2019, it took a global pandemic to push GDP growth over into recessionary territory.** Leaving the question, had the pandemic not occurred would a recession have materialized after all? Another ongoing debate is whether or not, and to what extent, the aggressive Fed bond buying program has skewed the shorter end of the curve.

**3-Month and 2-Year Spreads are Sending Clear Signal…**
**But How Much is Skewed by Fed Tightening?**




Source: Bloomberg and Altman Investment Management, LLC

**On the other hand, economic growth is proving to be more resilient, with strong underlying fundamentals remaining in place.** The advanced estimate for Q4 U.S. GDP came in at 2.9%**.** Inventories rose on the manufacturing/wholesale side, as retailers worked to unload inventory builds. This leads us to anticipate some level of reduced investment on the manufacturing side this year in efforts to liquidate inventories. Consumption has held up as spending on services surpassed goods. There is some concern by economists surrounding the decline in the U.S. savings rate. However, improving employment trends could provide an offset if conditions continue. Pent-up housing demand was stifled during 2022 on climbing borrowing costs. Housing costs remain elevated but could be showing some signs of stabilizing this year as mortgages rates and housing prices appear to be rolling over.

**Earnings growth estimates for 2023 remain in the low single digits.** Although we anticipate at least a partial reversion to the mean following extraordinary eps growth out of the pandemic, we are not forecasting a major earnings recession. According to Yardeni Research, the percent of companies with positive 3-month percent changes in revenues and forward earnings has increased to 66% and 56% respectively in January, up from below 50% the prior month. Although the road ahead will be volatile, it sets the stage for market breadth expansion and investor optimism.

**At its most recent meeting, the Fed raised its interest rate by a relatively modest level of 25 basis points recognizing a broadening slowdown.** In his comments following the meeting, Fed Chairman Powell cited the labor market is still out of balance with demand outpacing supply, but noted that the recent tightening has not come at the expense of labor, marking progress. He also commented that financial conditions are loosening and the disinflationary process has begun, yet inflation remains well above its 2% target. With a large portion of the inflationary index not yet in disinflation, it leaves the door open for further cuts, albeit at a slower pace. Visibility into the Fed forecasts is put off until the next Fed meeting in March, allowing time for further digesting of incoming data.

## *Sector Spotlight and Strategy:*

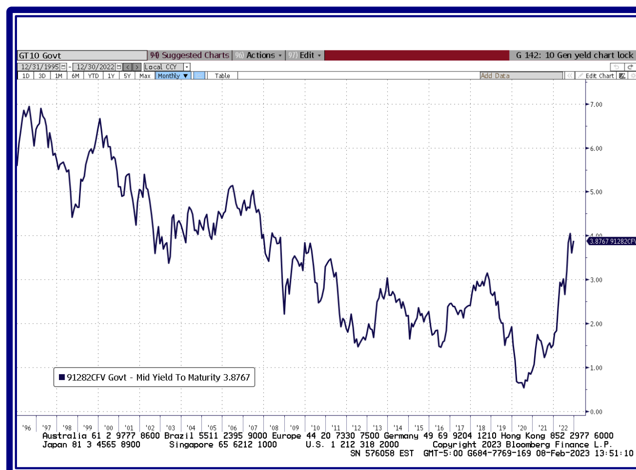
**Overall, bonds fared better against the S&P 500 stock market index with the BofA 1–10-year Corporate, Government, Mortgage index coming in at -9.12% for 2022, outperforming by over 2725 basis points.** Municipals, particularly in the short to intermediate range, held up best despite rising Treasury yields, mutual fund outflows, and tax loss selling into yearend. Fund flows into Treasuries tempered relative declines in the market, as investors pursued reinvestment at the short end of the curve alongside rising yields.

### Fixed Income Sector Performance
**YTD as of Dec 2022**

| | Rating | Maturity | Duration Mod Adj | Yield | Spread | Price | Trailing 12m TR |
|---|---|---|---|---|---|---|---|
| **Treasury (Intermediate)** | Aaa/AAA | 3.95 | 3.67 | 4.21% | N/A | $92.06 | -7.60% |
| **Agency** | Aaa/AA+ | 3.38 | 3.03 | 4.48% | 0.27% | $95.53 | -6.86% |
| **MBS** | Aaa/AAA | 6.88 | 5.36 | 4.65% | 0.44% | $91.01 | -11.41% |
| **Municipal** | AA2 | 7.35 | 3.98 | 3.19% | -1.02% | $104.89 | -4.51% |
| **Corporate (Intermediate)** | AA2 | 5.88 | 5.26 | 4.71% | 0.50% | $90.34 | -10.65% |
| **High Yield** | B1 | 5.48 | 4.27 | 8.97% | 4.76% | $85.88 | -11.22% |

Source: Bloomberg and Altman Investment Management, LLC

### 10 Year Generic Treasury Yield

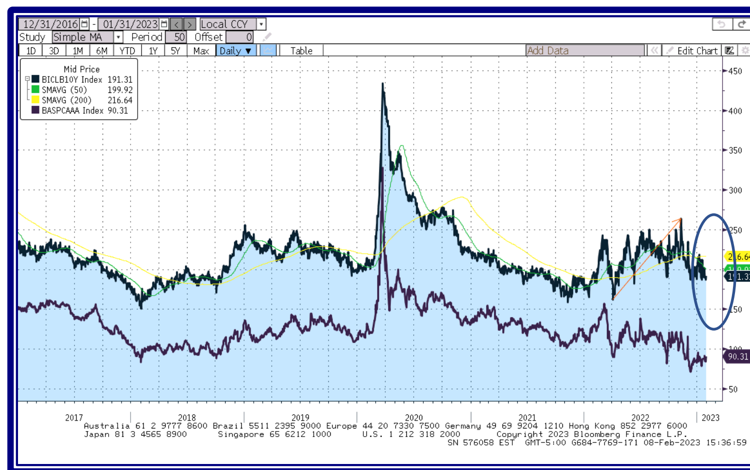



Source: Bloomberg and Altman Investment Management, LLC

## ➢ Corporate Credit Markets

**The story in 2023 is likely to include some pressures on corporate fundamentals, as the economy slows but is being overshadowed by the impending shift in Fed Policy.** While the economy continues to grow, corporate earnings for Q4 are estimated to decline ~-2.2% as margins contract on higher costs. Estimates for Q1 2023 continue to reign in as well. However, consumer price reports are signaling that current tightening policies are beginning to take effect as inflation continues to slow. Anticipation of a Fed policy reversal, whether it be in the form of smaller rate hikes or a temporary pause, appears to be influencing corporate yields more so than negative trends in earnings at this time. This has already begun to reflect positively in investment grade spreads which have narrowed since Q4 (dark blue line). Comparatively, last years' uncertainty didn't impact AAA spreads as much, which peaked much earlier in the year.

**Investment Grade Bond Spreads Have Narrowed Since Q4.**



Source: Bloomberg and Altman Investment Management, LLC

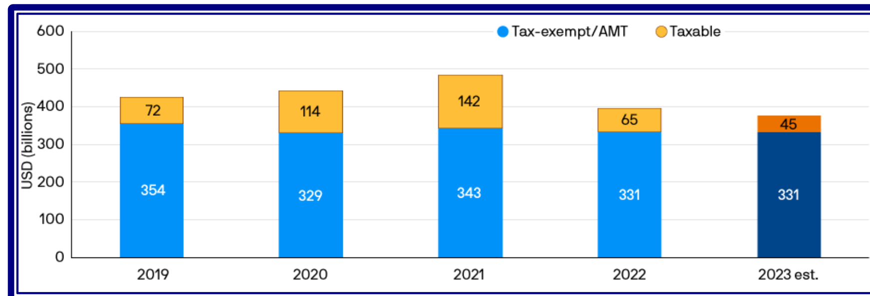
**In addition to a potential shift in Fed policy, other factors are working to offset slowing growth and earnings uncertainty in investment grade credit.** Even as the December Manufacturing ISM report contracted to 48.4% with a rather large drop in new orders, strong fundamentals in high grade credit are offsetting expectations for slower growth. Conservative balance sheets coupled with declining debt are signaling more rating upgrades are on the horizon. Overall, investment grade fund flows are improving, however, outflows are still high by historical standards. We also saw supplies in credit rise in January, in preparation for continued economic uncertainty this year.

## ➢ Municipals

**With prospects for a slowing economy if not a recession on the horizon, concerns are growing over the impact on municipalities, via reduced sales and income taxes collection.** However, fundamentals within the muni space remain firm. Municipal yields have climbed against slowing inflation, carving the way for positive real returns in 2023 after real rates dipped into negative territory a year ago. According to Raymond James' February issue of *Municipal Bond Investor Weekly*, not only are 90% of municipals rated A or better, but default rates for investment grade munis over a 10-year horizon is only 0.09%. While, these issues are not immune to recessions, most states do have cash high balances in their general funds and the budget flexibility to help offset lower incomes during recessionary times providing some downside protection.

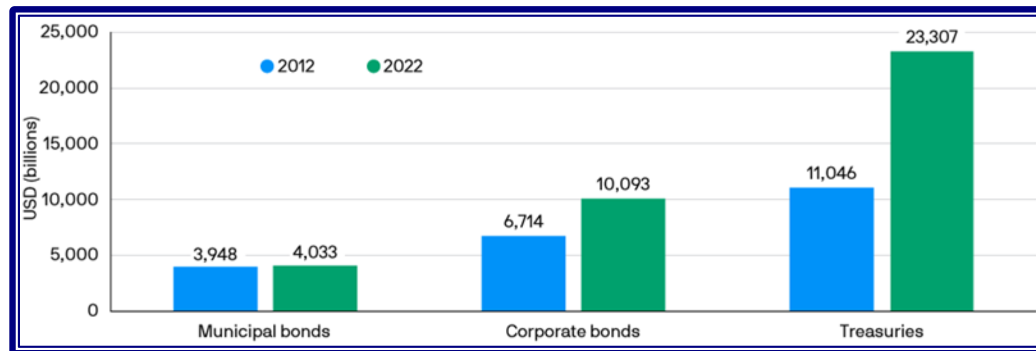
**Municipal bond supplies continue to fall as large federal aid programs from the last several years provided an influx of cash to municipalities.** Lower supplies against what we anticipate to be rising demand in this sector could support total returns in the new year.

**Municipal Issuance Was Down 18% in 2022.**




Source: JP Morgan Asset Management

**Municipal Issuance has Been Relatively Stable Over Past 10 Years.**
**Municipal Debt/Loan Outstanding ($bn)**




Source: JP Morgan Asset Management

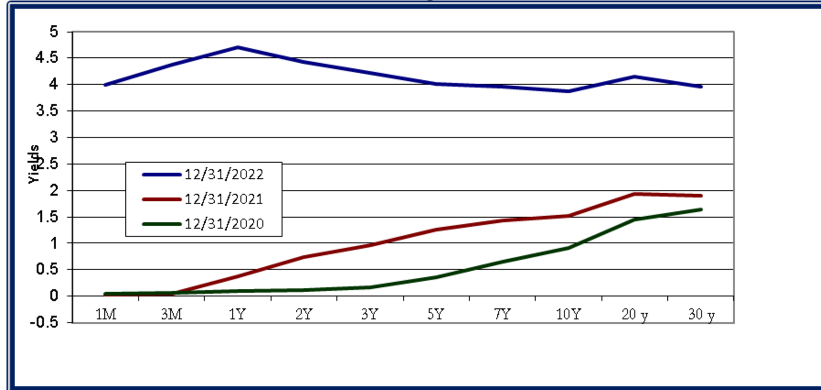
## FINAL COMMENTS:

**We are forecasting a soft landing, with the support of consumer spending, improving labor market and moderating inflation.** These factors could moderate to some degree, however, as tight Fed policies pressure consumption. A soft landing scenario is indeed possible, and could be a net positive for bonds, if inflation continues to reign in throughout the year without significantly disrupting a normal deceleration in labor market activity.

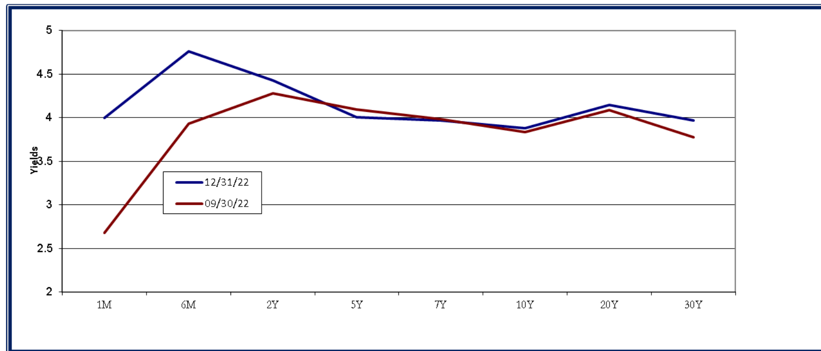
**We prefer higher quality corporate and municipal issues with intermediate to short term duration.** Despite overall municipal spreads widening, in the higher quality AA or greater rated space, spreads have remained relatively moderate by comparison, providing stability during uncertainty.

## APPENDIX:

**Active Government Yield Curve**
**Long Term**




**Active Government Yield Curve**
**Short term**




## DISCLOSURES:

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