ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

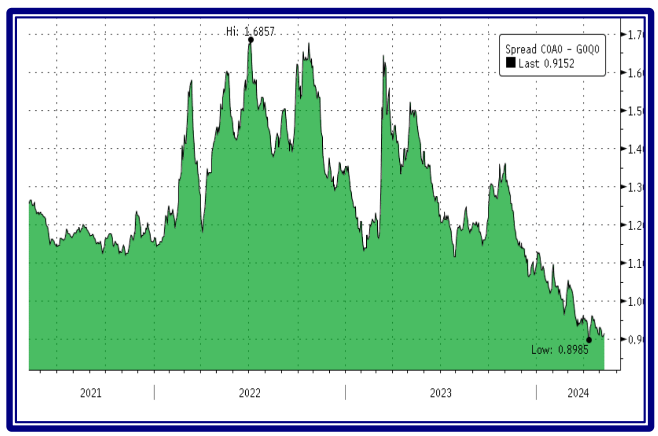
MAY, 2024

IN BRIEF: The U.S. Fixed Income Markets & Strategy

The Fed decided to hold rates steady once again in the 5.25-5.50% range at its April/May meeting until it is confident that "inflation is moving sustainably toward 2%". Chairman Jerome Powell expressed concern over inflation remaining stubbornly high but noted that a rate hike in June is unlikely while delaying expectations for rate cuts until September. Powell pushed back on the threat of stagflation despite slowing GDP growth, citing an inflation rate below 3% and robust domestic demand. The Fed did however approve a vote to slow the pace of its balance sheet reduction. This more gradual approach to quantitative tightening is an effort to avoid drying up liquidity too quickly or over constricting the market.

The less hawkish stance by the Fed at its May meeting initially rallied the bond market sending yields lower. The yield on the 10yr fell to ~4.5%, down from a recent high of 4.7%. Yields will likely fluctuate with new data releases - but ultimately, we expect they could trend higher as the market unwinds its expectations for rate cuts this year.

Corporate/ U.S. Treasury Spreads



Source: Bloomberg and Altman Investment Management

Another factor supporting higher yields is the national deficit which currently stands ~$1.1 trillion. As the level expands, Treasury bond issuance (supply) rises in order to fund debt. The pace at which the Fed unwinds quantitative tightening (demand) is a Fed tool used to maintain some control. Therefore, the potential for a net rise in the supply of Treasuries supports higher yields, at least in the short term.

Corporate bonds outperformed Treasuries by ~530 basis points over the last year on expectations of a soft economic landing. Consequently, corporate yield spreads over Treasuries have narrowed significantly. Given the resilience of economic growth and strength of corporate earnings, it is entirely possible spreads could narrow further from here and stay there for years. That is not to say the upside is without limitation, particularly in higher quality issues. The narrow pick-up in yield does, however, pressure investors further down the quality scale.

The inversion in the Treasury curve has become less pronounced with the 10-year Treasury yield ~4.4% - up from 3.9% at the beginning of the year. Conversely, 1 month to 2-year yields were little changed. We could see the slope of the yield curve steepen at the front end as the market prices in fewer Fed rate cuts. Although yields have rebounded significantly off post-pandemic lows, using the 5yr forward bond minus CPI swap rate as a proxy, yields are not elevated but rather back to normal levels. If inflation remains sticky as we expect, any drop in yields is likely temporary and could ultimately trend higher well into 2025.

The Treasury market got a slight reprieve with the recent CPI print that was in line with expectations, down from the prior month. However, we are somewhat cautious on rates as the economy remains on solid footing, and underlying inflation appears to have leveled off well above the Fed's 2% target. The long-anticipated Fed rate cutting cycle appears to again be delayed as bond sentiment seems to be on the bullish side. The consensus view today concludes that 5% rates on the 10-year Treasury are "unsustainable" and have the potential to undermine the economic expansion.

Municipal supplies for the first 5 months of the year are above their 10-year averages due to attractive borrowing costs and increased funding needs for infrastructure improvements among other factors. Seasonally high redemptions over the summer months will likely offset supply growth but the result should be temporary. Municipal ratios (municipal yield/ treasury yield) are low indicating municipal bonds are expensive at current levels. Valuations get more attractive going out greater than 20 years, but even then, the ratios are low on a multi-year level, and a move out too far on the curve at this stage could prove premature.

AAA Municipal Ratios

BVAL AAA Muni Yield	% of Treasury	2 Year High
2yr	64.9	90
5yr	60.4	94.2
10 yr	59.7	104.5
30 yr	83.8	110.7

Source: Bloomberg and Altman Investment Management, LLC

IN CONCLUSION:

For the first time in a number of years, the recent back-up in yields encourages us to begin to tilt fixed income portfolios a bit further out on the yield curve from our current relative duration underweight. However, we are not expecting any additional central bank rate cuts to materially alter bond prices in today's markets. An economic soft landing with rate cuts potentially on the horizon could be the ingredients for rallies in the asset class. Keep in mind, while some of the appreciation has occurred, cash has certainly built up in money market funds, suggesting that a bond rally can go considerably further once the Fed begins to cut rates. Soft landings are incredibly difficult for central banks to engineer, but for now, we believe they did it and the markets will continue to be a major beneficiary. We therefore emphasize bond portfolios stay the course with quality, BBB or better, and shift duration gradually back towards neutral.