A Pivot for Rate Cut Pricing

INVESTMENT GRADE TAXABLE

Following Q4's incredibly robust total returns, performance in the first quarter was somewhat underwhelming. A moderate move up in Treasury yields drove total returns into negative territory. The higher rate move, however, was barely half of Q4's decline. This shift in Treasury yields across the curve can be seen below.

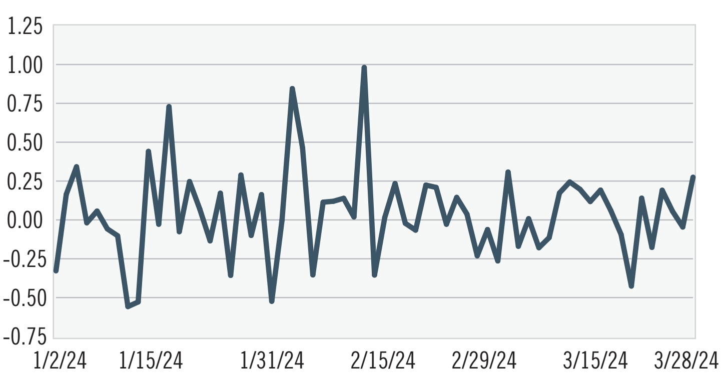
	12/29/23 (%)	03/28/24 (%)	Q124 basis points (bps)
2 Year	4.25	4.62	+0.37
5 Year	3.85	4.21	+0.36
10 Year	3.88	4.20	+0.32
30 Year	4.03	4.34	+0.31

Source: Bloomberg.

At the core of this move to higher rates was the removal of the market's pricing of an aggressive easing cycle, which market participants anticipated to start as early as March. Market pricing at the beginning of the year anticipated approximately six rate cuts in 2024. Entering the second quarter, that expectation has been halved. Revised market pricing now concurs with the Federal Reserve's (Fed's) guidance offered via its quarterly Summary of Economic Projections (SEP), which includes a compilation of each Fed participant's estimation for the target rate path over the next three years (aka the "dot chart").

The "dots," as published in December, offered a median outcome for three rate cuts in 2024. Exuberance in the market following the Fed pivot back in December, however, doubled down on that unofficial forecast. As the first quarter evolved, that more aggressive rate cut expectation slowly dissipated. Both the fundamental growth path of the economy and the initial two months of inflation data gave the market reason for pause. The previous exhibit shows the price action over the first quarter where expectations for six cuts slowly became three.

Q1 PRICE ACTION LOWERED EXPECTATIONS



Source: Bloomberg.

"Higher for longer" has been a policy theme since the Fed returned the target rate back to a level that predates the global financial crisis (GFC). Given the challenge of inflation in the post-pandemic world, the Fed often referenced the need to keep rates higher for longer to ensure a return to its price stability target of 2% core inflation.

The market's performance over the final two months of 2023 saw Treasury yields decline to a degree that "higher for longer" became a policy backdrop with an expiration date, as the Fed opened the discussion around rate cuts. The interest rate environment that persisted for most of the time from the GFC to the pandemic conditioned market participants for a term structure of interest rates that was artificially low. Suddenly rates above 4% were seemingly very high—maybe even too high for such a highly levered economy to grow.

The shift by the Fed to discussing rate cuts offered a path to ending this restrictive policy backdrop, thereby ending the "higher for longer" era. That lasted until inflation data and near-term growth expectations offered some evidence that the restrictive policy settings were perhaps not that restrictive.

Q1 Total/Excess Return Summary

Using Bloomberg Index data, Q1 2024 total returns were mixed, but modestly negative for the Bloomberg Aggregate Bond Index (Agg) and the primary spread sectors (Corporate and RMBS):

	Q124 (%)
Bloomberg Aggregate Bond Index	-0.78
Investment Grade (IG) Corporates	-0.40
Residential Mortgage-Backed Securities (RMBS)	-1.04
Commercial Mortgage-Backed Securities (CMBS)	+0.85
Asset-Backed Securities (ABS)	+0.68

The Agg saw its total return remain negative over most of the quarter, as it only had a brief positive print in early February. The move to higher rates in the Treasury market took place predominately in February. January and March saw more muted moves.

Excess returns were also mixed, with outperformance for the investment grade corporate sector, CMBS, and ABS, while the RMBS sector failed to keep pace in Q1:

	Q124 (bps)
IG Corporate	+89
RMBS	-14
CMBS	+145
ABS	+54

Within IG Corporate credit, the gains for Q1 were driven by lower quality and longer spread risk. Performance for corporate credit over the quarter is all the more impressive, considering the incredibly robust supply backdrop. The first quarter of 2024 saw the strongest first quarter of any calendar year, and it ranks as the second strongest issuance quarter overall, behind only the COVID-fueled supply rush of Q2 2020. The robust demand for yield feels insatiable, and the new issue calendar is responding accordingly.

> Lower quality BBB credits outperformed in Q1 with +108 bps of excess return versus single-A credits at +73 bps.

> Long credit outperformed in Q1 with +125 bps of excess return versus intermediate credit at +70 bps.

> Financials outperformed with +115 bps of excess return; utilities followed with +101 bps of excess, while industrials earned +72 bps of excess.

> At the broad investment grade corporate sector level, spreads tightened with the index option-adjusted spread (OAS) ending at +90 bps versus +99 bps at the end of 2023.

RMBS had another challenged quarter. The lower coupon risk of the sector generated negative excess returns, while the higher coupon risk generated positive excess returns. The overall spread change for the production coupon was only slightly wider.

> Perfect current coupon (PCC—a generic spread proxy for the "production" coupon only—widened +2 bps to +139 bps.

CMBS/ABS both generated solid excess returns in Q1. ABS sector performance was even more impressive, given the robust supply backdrop seen thus far in 2024. CMBS seems to have experienced a wave of optimism from yield-seeking investors, given a backdrop that offered little fundamental improvement to a very challenged commercial real estate market. These are small sectors within the Agg (only ~2% total in market value terms), and as such are typically smaller contributors to overall excess returns for strategies benchmarked to the Agg.

"Plus" sectors offered another solid quarter in both total and excess returns.

> High Yield delivered a Q1 total return of +1.47% and excess return of +159 bps.

> Emerging Markets Debt (EMD) delivered a Q1 total return of +1.53% and excess return of +253 bps.

Economic Resilience Persists

Just as 2023 was a year for economic resilience and positive growth surprises, the start to 2024 has followed suit. Since the turn of the new year, the final estimate (until benchmark revisions next summer) for Q4 gross domestic product (GDP) came in at 3.4%. As a result, the second half of 2023 saw a robust 4.1% annualized growth rate. Using the Bloomberg economic survey of late December, expectations for GDP in 2024 anticipated a considerable slowdown to around 1.4%.

As the first quarter evolved, those expectations were revised up considerably. A Bloomberg survey of economists in late March showed a consensus expectation for 2.4% GDP. For Q1 alone, the GDP consensus expectation rose from 0.5% to 2%. Despite the "restrictive" monetary policy settings, following the +525 bps rate hike cycle that ended last July, the economy's resilience and ability to outperform most economic forecasts remains the overriding theme. While not a talking point at the Fed yet, perhaps the monetary policy settings are not that restrictive?

Despite the Fed hiking its target rate an additional 100 bps in 2023, broad financial conditions still eased over the year—easing by 93 bps according to the Goldman Sachs Financial Conditions Index. While the first quarter saw Treasury rates move higher, typically tightening financial conditions, this was broadly offset by robust stock market returns and slightly tighter credit spreads. Using Goldman's Index, Q1 experienced another 13 bps of easing. Nothing massive, but consistent with an overall picture of broader financial conditions remaining easier than what had been implied by the Fed target rate alone.

Stock market performance was again a driving force behind this easier backdrop, as it was in 2023. The S&P 500® Index rose 10.6% over the quarter, an impressive follow-up after gaining 11.7% in Q4 2023. That marks the first time in over a decade that it's seen back-to-back quarterly gains of double digits. Even more impressive, there was a streak that ended in Q1 where the S&P 500 was up 16 out of 18 weeks, a stretch of weekly gains not seen since 1971!

Inflation: Higher for a Little Longer?

The glide path to the objective of 2% price stability encountered some turbulence over the first quarter. Both January and February core inflation data came in above expectations, and short-term annualized rates moved up

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since year-end. The table below shows the January and February details for both core inflation and super-core inflation, the two primary inflation data sets the market follows. The core PCE (personal consumption expenditures) deflator is the Fed's preferred metric. The super-core components were created by the Fed this cycle to exclude the housing/shelter components of inflation, which isolates core services inflation trends.

	Dec. 2023 (%)	Jan. 2024 (%)	Feb. 2024 (%)
Core CPI	**+0.3**	**+0.4**	**+0.4**
3 Months Annualized)	+3.3	+4.0	+4.2
6 Months (Annualized)	+3.3	+3.6	+3.9
12 Months	+3.9	+3.9	+3.8
Super-Core CPI	**+0.3**	**+0.8**	**+0.5**
3 Months (Annualized)	+4.0	+6.5	+6.7
6 Months (Annualized)	+4.4	+5.5	+5.8
12 Months	+3.9	+4.3	+4.3
Core PCE Deflator	**+0.2**	**+0.5**	**+0.3**
3 Months (Annualized)	+1.6	+2.8	+3.5
6 Months (Annualized)	+1.9	+2.6	+2.9
12 Months	+2.9	+2.9	+2.8
Super-Core PCE Deflator	**+0.3**	**+0.7**	**+0.2**
3 Months (Annualized)	+2.2	+4.4	+4.5
6 Months (Annualized)	+2.8	+3.5	+3.8
12 Months	+3.3	+3.5	+3.3

Source: Bloomberg, U.S. Bureau of Labor Statistics (BLS), U.S. Bureau of Economic Analysis (BEA).

Focusing on the Fed's preferred PCE deflator series, the core PCE deflator saw the three- and six-month annualized rates increase from December lows, while the year-over-year rate remains just shy of 3%. A similar dynamic can be seen for the super-core series as well. The Fed has decided to characterize this unfriendly shift higher as just a "bump in the road." Given the challenges around forecasting inflation over this very unique cycle, a little more humility would seem warranted, particularly from a Fed that would prefer not to lose credibility again, as it did with the characterization of inflation as "transitory" earlier in the cycle. Perhaps it is more indicative of the overall pressure the Fed is under to cut rates again.

A new level of attention is being paid to the U.S. Treasury's interest expense, and on a trailing 12-month basis this expense has eclipsed $1 trillion. With each passing quarter, more lower-cost debt rolls off the Treasury's balance sheet, only to be refinanced at much higher rates. Without an extremely aggressive easing cycle, this dynamic may be here to stay. The growing interest expense will likely remain a point of contention. By extension, the ever-expanding supply of Treasuries that fund ongoing deficit spending will likely return as a concern for the market.

Looking Forward

The market remains firmly in "Fed Watch" mode. The data remains challenging for a Fed that wants to embark on rate cuts this year. Labor market strength, higher than expected inflation outcomes, and higher growth expectations argue against rushing into a new easing cycle. Federal Reserve Chair Jerome Powell, however, has stuck to the rate cut storyline. In the short run, that is what risk markets will pay attention to. Given that the dual mandates of price stability and full employment have moved into a closer balance, the emphasis on inflation has diminished, allowing Chair Powell to stop channeling his inner Paul Volcker. Powell has gone so far as to indicate that a downturn in the labor market could elicit a response from the Fed in the form of rate cuts, absent any further progress on inflation. That's a less restrictive policy posture than the Fed has exhibited over most of this tightening cycle. It will be interesting to see what becomes of the Fed's reaction function should the inflation data continue to surprise on the high side. This will have critical implications for both the absolute level of rates and the shape of the yield curve over the balance of 2024.

The investment grade market, and corporate credit in particular, has been supported by the presence of absolute yield buyers since rates normalized in 2023. This year has seen no changes. The performance of the corporate bond sector amidst the strongest first quarter of issuance ever ($500+ billion) is a testament to this support.

The typical yield buyer is less concerned with corporate spreads—the incremental yield offered for assuming corporate default risk—and more focused on the all-in yield offered by the sector. The Bloomberg US Corporate Index yield ended the quarter at 5.3%, nearly spot-on its average of 5.29% for the quarter. Content with that overall yield, and with the expectation that the Fed will be cutting rates at some point this year, yield buyers have been aggressive. They kept corporate spreads tight and the new issue market nearly void of any new issue concession. (A new bond issue typically offers some additional yield enhancement over current secondary market trading prices of bonds from the same issuer). That backdrop offers little in the way of the typical performance incentive for corporate bond investors.

Should rates continue to go higher, the total return, or some magnitude of negative total return, may give all-in yield buyers reason for pause. Back in October of 2023, the Agg

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hit its worst negative drawdown in total return terms at -3.44%. The Bloomberg Corporate Bond Index max drawdown was only -2.53%. The significant rally in rates (lower rates from mid-October to year-end), in addition to tighter spreads, provided a solid positive total return for 2023 for both indices. So far in 2024, the max drawdown for both came in around -2.3%. Higher rates going forward will likely produce worse total return outcomes. The current insatiable demand for corporate credit, and investment grade bond exposure more generically, may encounter a far more challenging backdrop.

Valuations across the investment grade spread sectors are rich over varying historical time periods. Given the degree to which these sectors have performed, despite the Fed's aggressive tightening cycle and restrictive policy settings, the compensation on offer for taking significant spread risk is simply not worth it. The macro backdrop of higher leverage, higher refinancing costs, and an uncertain inflation backdrop is a flashing yellow light for risk-taking. As is too often the case, aggressive risk-taking is more a function of anticipating the generosity of the Fed. This cycle may prove particularly challenging for that playbook to work yet again.

INVESTMENT GRADE TAX-EXEMPT

The first quarter saw rates move higher across fixed income markets as inflation fears resurfaced and economic growth remained strong. Consequently, many investors began to discount the number of rate cuts that the Fed would be able to achieve this year. As a result, municipal bonds (munis) finished with a negative return for the quarter, but dramatically outperformed Treasuries. With this move, municipal/Treasury ratios were marginally higher in the 2-, 5-, and 10-year spots, but slightly lower in the 30-year, making munis generally more attractive versus Treasuries on a quarter-over-quarter basis.

The broad market index, as represented by the Bloomberg Municipal Bond Index, returned -0.39% for the quarter. Total return performance was somewhat uneven in the first quarter, with the 1-year performing the best, followed by the 15-year. The worst performing part of the curve was the long bond, followed by the 10-year.

Revenue bonds returned -0.27% and outperformed general obligation (GO) bonds, which returned -0.70%. Broadly, local GOs outperformed state GOs. The best performing subsectors of the Bloomberg Municipal Revenue Bond Index included industrial revenue bonds, tobacco, and hospitals, while the worst performing subsectors were resource recovery and special tax. There was significant dispersion among sectors, with industrial revenue returning 0.72% at the high end and resource recovery returning -0.82% at the low end.

Relative to other fixed income markets, municipal bonds performed in line with the Bloomberg Corporate Bond Index (-0.40%) and outperformed the Bloomberg US Aggregate Bond Index (-0.78%), Bloomberg US Aggregate Gov/Credit Index (-0.72%) and the Bloomberg US Treasury Index (-0.96%).

Municipal Treasury ratios were generally higher than in the previous quarter. The 2-year increased by 5.3 percentage points (pp) to 64.4%, the 5-year by 1.1 pp to 60.5%, and the 10-year by 0.7 pp to 59.9%, while the 30-year was down by 1 pp to 84.8%.

Yields were significantly higher by the end of the quarter, increasing more at the short end and resulting in a flatter yield curve. The slope of the 2-year to 30-year tax-exempt curve flattened to 71 bps from 90 bps. The 2-year yield increased by 45 bps, the 5-year by 26 bps, the 10-year by 23 bps, and the 30-year by 26 bps. The municipal 2-year to 10-year curve inversion persists with no indication of a reversal. It was tightest in early January at -16 bps and slowly widened through the rest of the month, reaching its high at the end of the quarter at -46 bps.

We ended the quarter at $102 billion in issuance, the highest level seen since 2007. Monthly issuance for January, February, and March was up on a year-over-year basis. In January, volume rose by 49% year-over-year to $32 billion. In February, volume rose by 57% to $32 billion, and in March, volume rose by 17% to $38 billion. The three states with the highest volume of municipal issuance so far this year are New York ($14.1 billion), Texas ($11.6 billion), and California ($10.5 billion).

For the quarter, municipals saw strong inflows, as mutual funds gained $6.3 billion in inflows, with ETFs seeing $100 million in outflows, according to Lipper. This notably reverses the trend of last year, aiding the market in the digestion of significant supply without causing underperformance.

Reversing the trend of the prior quarter, credit spreads tightened during the first quarter. The yield differential between the Bloomberg BBB Municipal Index and the Bloomberg AAA Municipal Index went from 124 bps at the end of December to 96 bps at the end of March. The spread between high yield (HY) munis and high grade (HG) munis was tighter, as well. The differential between HY and HG Indices was at 201 bps at the end of March, down from 235 bps at the end of December.

Credit is little changed since the beginning of the year and remains generally strong across most sectors. We observed positive rating actions continuing to exceed negative ones on the part of the major rating agencies. Both the states of New Hampshire and Louisiana saw their general obligation ratings upgraded by Standard & Poor's. Overall, credit quality remains sound across the investment grade space.

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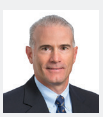
The municipal bond sector remains well positioned as we head into the second quarter. Credit quality remains high, and yields remain above their five-year average levels. Municipal bonds may provide investors with important diversification due to their historically low correlation with other asset classes. In addition, munis are typically highly defensive in the case of a recession, and we believe they will maintain high credit quality given the current strong positioning of many credits. With these benefits in mind, we believe investors should maintain an allocation to the asset class.

Authored by:

Investment Grade – Taxable



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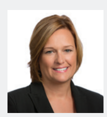
Investment Grade – Tax-Exempt



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