LOGAN FIXED INCOME MARKET COMMENTARY
Q3 | 2020 REVIEW

MARKET ENVIRONMENT

We like to start off our commentary with a summary of where have we been? We feel the Beige Book release on September 2 tells the story. The Beige Book was a study in gloom, though there were a few rays of life. "Economic activity increased among most districts, but gains were generally modest and activity remained well below levels prior to the Covid-19 pandemic," according to the summary. "Continued uncertainty and volatility related to the pandemic, and its negative effect on consumer and business activity, was a theme echoed across the country." One surprise in the book, given an unemployment rate above 10%, was employers finding it difficult to attract workers because childcare is a concern.

The biggest event in bond markets recently was the Fed's shift toward a regime of average inflation targeting. Treasuries sold off in the days following this announcement. We view this market reaction as sensible, since it seems clear that the Fed's new commitment to tolerate an overshoot of its 2% inflation target will be bearish for bonds in the long run. However, for this bond bear market to play out, the U.S. economy must first generate some inflation. This will take time. Despite the drop in the headline U3 unemployment rate, August's employment report showed that permanent job losses continue to rise. (BCA Research) This is a clear sign that the economic recovery is not yet on a solid footing.

The 30-year U.S. Treasury has increased its importance in the fixed income landscape. Not because of size, although all auctions are big – but because auctions are now weekly barometers for the tone of the entire bond market. That's particularly true of the 30-year even though it is well outside the maturity parameters of 90% of portfolios generally. When there's little real suspense about central bank policy or inflation, auctions reveal the clearing level at each point on the curve. No question this month that technical pressure on 30s are the weakest in a strong bond market. It is the only segment where yields are higher than their mid-August spikes. 10s are essentially sideways, and everything shorter is still controlled by bullish fundamentals and investor demand. If the market as a whole is going to break above the 4-month range, it will happen in 30s first.

With that in mind, our base case outlook calls for continued economic recovery during the next 6-12 months, but we do see a significant risk that the failure to pass a follow-up to the CARES act will lead to a deflationary shock during this period.
for a number of years.

Please refer to the table below for quarter end U.S. Treasury yields.

PORTFOLIO OVERVIEW

Treasuries

Bond yields were steady throughout the period, even as the stock market sold off sharply.

The 10-year U.S. Treasury maintained a range between 0.50% and 0.75%. This leads us to conclude that long-maturity Treasury yields have room to fall in the near-term if progress towards a fiscal stimulus package moves too slowly. We continue to increase duration in the portfolios when the opportunity arises.

Corporates

Corporate spreads widened significantly in September, but they still implied a relatively optimistic default outlook. Corporate leverage has peaked due to the tremendous amount of issuance throughout the investment grade landscape. With the economy's strength still in question, we are watching for an uptick in defaults, especially in the bloated BBB credit level. We feel the sector still will contribution to relative performance over the intermediate time frame, but are cautious over adding exposure to lower rated credits.

Municipals

The sector has performed well since yields peaked early in the second quarter. As measured by "% of Treasury", yields are halfway back to their pre-COVID levels. Even with the heavy issuance, positive flows every week into mutual funds during the quarter placed technical downward pressure on yields within the sector as a whole. Although credit concerns have attracted attention due to the stress placed on local government's budgets, we feel states have flexibility to adjust finances accordingly and will continue to meet debt servicing obligations. States that entered the downturn with credit strength should be resilient while those that entered with material stress may see that stress compounded.

Depending on timing and magnitude of changes to the rate of income taxes, demand could materially increase for municipals as the value of tax-free income will become more valued. This change in demand would be beneficial to performance over the next few years.

PORTFOLIO OUTLOOK

In response to the economic fallout from COVID, the Fed cut rates and ramped up asset purchases, which expanded the monetary base like it did after the Great Recession. However, thus far the fiscal response has overwhelmed compared to 2008-2009, as the CARES Act put trillions of dollars directly into the hands of households and businesses, and the money supply has skyrocketed as a result. While a large portion of that money continues to sit idly, another sizable round of fiscal stimulus followed by a faster-than-expected end to the pandemic, should it occur, could create the dry tinder and spark needed for a jump in inflation expectations and thus bond yields.

At present, fiscal stimulus is fading and the pandemic looks likely to drag on well into next year. And while slack may not matter as much as it once did for inflation, there is still quite a bit of it. Household inflation expectations remain near historic lows and show signs of plateauing. And the Fed is still likely a ways off from being tested on its higher tolerance of inflation. Therefore, we are sticking with the old recipe of subdued inflation as our base case for now.

U.S. TREASURY YIELDS	12/31/2019	3/31/2020	6/30/2020	9/30/2020	YTD Change
2 YR	1.569%	0.246%	0.149%	0.127%	1.442%
3 YR	1.609%	0.293%	0.173%	0.157%	1.452%
5 YR	1.691%	0.380%	0.288%	0.277%	1.414%
7 YR	1.831%	0.541%	0.491%	0.470%	1.361%
10 YR	1.917%	0.669%	0.656%	0.684%	1.233%
20 YR	N/A	N/A	1.174%	1.224%	N/A
30 YR	2.390%	1.321%	1.411%	1.455%	0.935%
10S MINUS 2S	34.8 BPS	42.3 BPS	50.7 BPS	55.7 BPS	

Source: Bloomberg

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