Logan Fixed Income

LOGAN FIXED INCOME MARKET COMMENTARY
Q1 | 2022 REVIEW

MARKET ENVIRONMENT

Where are we going? We hear about supply chain issues every day. When will this cease?

Demand has already downshifted. Last year's first half was marked by 8.5% final sales growth and a huge drop in inventories as logistics failed to keep up. The second half was marked by 1% final sales growth (0.1% in Q3 and 2.0% in Q4) and a huge surge in inventories. (Bloomberg) Final sales, not inventories, determine the direction of GDP growth in the medium term.

The Treasury yield curve has been impacted by powerful push/pull forces. While inflation expectations drive the long end, the Fed is just part of the total story on the front end. The tensions between central bank policy, global conflict and the dominance of commodity gains in the inflation picture point to eventual inversion with 2-3 year maturities as the pivot. While we all want a better understanding of how things will unfold, previous cycle templates do not apply to this year's supply-shock fundamentals.

The safe haven aspect of Treasuries coupled with the relative "cheapness" vs other sovereign debt (such as France, Germany, Japan, and Switzerland), has helped stabilize yields as buyers are more than happy to take advantage of higher yields.

The Fed is having to walk a fine line by tightening policy enough to cool inflation but not so much that it drives the economy into a recession. The jump in the price of oil and other commodities has added further uncertainty by threatening to both slow economic growth and add to inflation.

Powell's speech on March 22nd did not move the goal posts in the sense that the Fed's communication, including the dot plot, encompassed a range of views from moderately hawkish — five quarter point hikes this year — to extremely hawkish — 12 quarter point hikes. The speech indicated a willingness on the part of the group to act within that range, including at the high end of the range, if the data sends them in that direction.

In other words, what was new was the commitment by the FOMC as a whole to follow the lead of its most hawkish members, if necessary to contain inflation, including raising rates in bigger increments than quarter-point hikes.

PORTFOLIO REVIEW

Treasuries

Yields surged primarily in the front end causing a flattening (or slightly invert) from the 3-year out to the 30-year (Bloomberg). Distortions in the Treasury market caused by quantitative easing (and now tightening), is not a foolproof indicator that our economy will fall into a recession over the coming year or two. Demand for safe, liquid Treasury bonds by pension funds and international investors such as central banks and insurance companies have offset (on the margin) pressure on increasing yields. All communications from Fed officials have skewed hawkish.

Corporates

This sector's performance has severely lagged Treasuries as spreads have widened as a slowing economy and higher cost of servicing debt (after the prior two year's

debt binge) raises credit risks. We had been positioned for this change as we felt the near historic low spreads for the past two years were not significant compensation for purchasing longer corporates. New issuance has remained strong throughout the quarter.

Municipals

Municipals cheapened versus Treasuries in the last weeks of the quarter. Fund flows were negative (Bloomberg), and new issuance will need to be priced to sell. The credit fundamentals are still strong, as tax receipts (property and sales) in addition to federal aid have left balance sheets better positioned versus 2019. An increase in credit rating in New Jersey and Connecticut occurred amongst this volatility. Historically, municipals have outperformed Treasuries and corporate bonds in periods of rising interest rates. We will continue monitoring the relative value as the year progresses.

Commodities

The banning of Russian oil and gas exports has caused WTI to soar. More recently, the release of strategic reserves will assist consumers on their trips to the gas station (more below). Increases in metals, grains and other commodities threaten to slow global economic growth and add to inflation.

PORTFOLIO OUTLOOK

Treasuries

Treasuries will get their direction from the Fed. Already baked in are a handful of 50-basis point rate increases, with the first one possibly occurring May 4th. Whether the curve inverts more severely than its current shape, it's ramification will be a continued topic for economists, academics, and investors alike.

Corporates

Usually, investors can "hide" in shorter maturities during rising rates to protect principal. In this instance the combination of investors liquidating holdings and the tremendous move in higher yields in the front of the Treasury curve negatively impact safe/short/liquid credits. This sector is much more fairly valued versus 2021, and we expect it to be additive to performance in the year ahead.

Municipals

We expect municipals to perform well the remainder of the year due to technical support, as a greater amount of bonds mature compared to new issuance. Investors pulled muni assets from funds earlier in the year, cheapening the sector and creating an attractive entry point going forward.

There's always uncertainty about how high rates have to go. Treasuries overshoot, with selling continuing until something in the economy breaks, indicating interest rates are too high to be sustained. Watch housing, where sales are already slowing, and watch the stock market. A couple of weeks with stocks dropping as if traders expect a recession is the kind of signal yields don't have to go as high as one might think, allowing bonds to stabilize and eventually rally.

We conclude our commentary with thoughts on the consumer and the direction of consumer spending. We expect consumer spending to slow sharply in the face of higher inflation and in the absence of income boosters like stimulus payments this year. But we anticipate only a slowing not an outright retrenchment in real consumer spending. Higher inflation has pushed real disposable income significantly below its pre-pandemic trend, and with inflation showing little signs of easing, this presents a growing concern for the spending outlook. A silver lining for the hit to spending is that it could eventually provide some needed relief on the inflation front. Soaring demand fueled by income windfalls last year are partly to blame for today's high inflation. The Fed's ability to achieve a "soft landing" could end this chapter without having to engineer a solution to a recession.

Observations

New consumer behavior at the gas station. We are hearing more frequently of drivers filling up in round dollar amounts, such as $20, rather than fill the whole tank. This can be a leading indicator of consumer discomfort. A soft landing never sounded so good.

This material represents an assessment of the market and economic environment at a specific point in time and is not intended to

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Investments in commodities may have greater volatility than investments in traditional securities, particularly if the instruments involve leverage. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Use of leveraged commodity-linked derivatives creates an opportunity for increased return but, at the same time, creates the possibility for greater loss.

U.S. TREASURY YIELDS	12/31/2021	3/31/2022	YTD Change
2 YR	0.726%	2.286%	-1.560%
3 YR	0.955%	2.464%	-1.509%
5 YR	1.265%	2.422%	-1.157%
7 YR	1.436%	2.404%	-0.968%
10 YR	1.512%	2.324%	-0.812%
20 YR	1.935%	2.598%	-0.663%
30 YR	1.905%	2.453%	-0.549%
10S MINUS 2S	78.6bps	3.7bps	

Source: FactSet