LOGAN FIXED INCOME MARKET COMMENTARY
Q1 | 2021 REVIEW

MARKET ENVIRONMENT

Enormous stimulus plans, rising expectations about inflation due to fiscal stimulus and vaccines, and an unraveling of levered market positions helped send bond yields surging during the period, with the benchmark 10-year rate spiking above 1.77% for the first time in around 12 months (source: Bloomberg). The surge has brought with it sloppy auctions, worsening liquidity and a wider difference between bid and offer prices. At the same time, there is also concern about rates at the front end potentially going too low, with funding markets hovering around zero amid an abundance of cash that's being fueled by monetary policy, fiscal measures and changing bill-supply dynamics.

The FOMC has taken the position that it "expects to maintain an accommodative stance of monetary policy" until "maximum employment" is achieved and inflation runs "moderately above 2% for some time."

Bottom line: Fed policy is in wait-and-see-mode. The new economic forecast shows significant divergence in economic expectations among the committee, but the majority of participants see no rate hikes through 2023 (as of this writing). Changes to growth, unemployment, and inflation forecasts suggest the Fed as a group expects inflation will run a little hot thanks to strong fiscal stimulus, but not enough to be a concern and require a monetary policy response. On March 4, Chairman Powell noted higher yields reflect economic recovery and not disorderly trading that might tarnish financial conditions.
The statement offered the observation that "indicators of economic activity and employment have turned up recently, although the sectors most adversely affected by the pandemic remain weak."

In the choreography of tightening, the first step will be tapering the $120 billion of monthly asset purchases which the FOMC has pegged to "substantial further progress" on employment and inflation. Chairman Powell said that will be a judgment, or in other words, a committee consensus that Powell himself is in charge of forming. "Until we give you a signal, you can assume we are not there yet," he said on March 17.

Powell has been closely focused on the uneven blow delivered by pandemic, and he wants to get the 9.5 million Americans who've lost jobs during the Covid-19 era back to work as quickly as possible.

PORTFOLIO REVIEW

We had kept portfolio duration below index duration and reaped the benefits as this positioning was a contributor to performance as Treasury yields increased, especially outside the 3 year part of the curve. In addition, we noted the shrinking spreads in corporate bonds due to demand for high quality liquid assets with additional yield as compared to Treasuries, as well as optimism that the domestic economy will show increased strength over the coming quarters. The increase in the allocation of corporate bonds over 2018-2020 was also additive to performance.

Municipal bonds performed well during the quarter as expectations are for taxes to increase both for corporations as well as on the highest earning individuals. With this backdrop, the demand for tax-free income will increase. Another factor increasing the attractiveness of the sector is the billions of dollars of aid to state and local governments which increases the credit quality of the sector.

PORTFOLIO OUTLOOK

The simplest form of one critical question for 2022: Does rapid growth this year "burn out" as theory suggests it would or does it kick consumption into a higher gear that can propel the economy the next 2-3 years? The Fed doesn't have that answer – at least currently – and the pandemic governs current economic data, reducing the value of any data trend.

Rates have moved so quickly they appear to confirm the rosiest possible forecasts for the economy and a dangerous outlook for inflation. Yet, the events that drive markets right now offer few answers about the big question that looms as a result of those very events. Will market expectations "force" the FOMC to tighten rates quicker than anticipated.

The Treasury market has moved quickly to price-in expectations of a strong economic recovery, while the Fed has been more cautious about moving its own rate forecasts. We think that the market's expectations are well founded and that the Fed will eventually move its dot plot higher to better align with the market.

We anticipate continuing to extend maturities as rates increase in the near term. The allocation of maturities in most of the accounts will allow us to take advantage of the current interest rate environment.

The municipal sector is currently rich, but the increase in expected demand will allow the ratio to Treasuries to stay low and the spreads to continue to tighten. We do not see the sector cheapening over the coming quarters this year.

Lastly, we are also monitoring a rotation out of equities and into bonds as the increase in yields has two important implications. First, the equity market dislikes an increase in real rates especially when it occurs abruptly. The discounting of future cash flows at extremely low rates has been a tailwind for the equity market for the past year. Second, the recent rise in interest rates places the 10-year Treasury yield above the S&P 500's dividend yield of 1.45% (source: Bloomberg). The relative advantage that the S&P has held versus the benchmark U.S Treasury since the early summer of 2019 seems to have vanished.

U.S. TREASURY YIELDS	12/31/2020	3/31/2021	YTD Change
2 YR	0.121%	0.162%	-0.041%
3 YR	0.165%	0.349%	-0.184%
5 YR	0.361%	0.928%	-0.567%
7 YR	0.643%	1.394%	-0.751%
10 YR	0.913%	1.707%	-0.794%
20 YR	1.440%	2.270%	-0.830%
30 YR	1.645%	2.369%	-0.929%
10S MINUS 2S	79.2 bps	154.5 bps	

Source: Bloomberg

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The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. It is a market value weighted index with each stock's weight in the index proportionate to its market value.