Logan Fixed Income

LOGAN FIXED INCOME MARKET COMMENTARY
Q2 | 2021 REVIEW

MARKET ENVIRONMENT

Fed officials have said they want to see "substantial further progress" toward their goals of maximum employment and average 2% inflation before reducing current asset purchases of $120 billion of U.S. Treasuries and agency mortgage-backed securities per month. None are suggesting that they're close to achieving that, though some have pressed for discussions to begin on a plan for tapering that buying in addition to the pace and composition of a reduction in purchases.

As Fed Chair Powell has pointed out more than once, payrolls are still substantially below where they were pre-pandemic – some 7.6 million jobs short, according to the May employment report (Bloomberg). And while inflation recently has proven surprisingly rapid --consumer prices climbed 5% in May from a year earlier – Powell and other Fed officials have argued that the rise is mostly transitory, the result of temporary bottlenecks as the economy reopens and low readings a year ago when it shut down.

The next question becomes, when can investors expect tapering discussions to start and tapering to be initiated and then, when might the first increase in rates occur. We believe there is no way the Fed will taper QE or raise rates for at least a couple of months after pandemic emergency benefits run out on Labor Day. The optics of tightening just as millions of people start looking for work is not something they want to take on. That said, the Jackson Hole Economic Summit in late August has been an event where Federal Reserve members have signaled changes to Fed policy.

With investors waiting to see if inflation is transitory or not, we anticipate Treasuries to be range bound over the coming months.

PORTFOLIO REVIEW

Treasuries-This sector experienced a small sell-off inside of the 5-year point on the curve and a rally outside of the 5-year point on the curve (bull flattening of the curve). Despite the anticipated faster increase in rates as revealed by the Fed's hawkish dot plot that surprised markets, the prior enthusiasm of inflation pricing of last quarter has moderated significantly. Our underweight in longer securities detracted from performance for the period.

Corporates-Issuance slowed YTD compared to 2020 as companies have less need to issue bonds. High cash levels on corporate balance sheets in a strengthening economy is removing the risk of holding corporate bonds. The premium investors receive for the added risk of holding corporate rather than Treasury bonds is the lowest since 2007 (Federal Reserve Bank of St. Louis) due to low default risk and a greater number of expected upgrades versus downgrades over the coming quarters. We selectively added additional corporate exposure as we felt the small additional yield will be additive to performance. The improving economy, stable outlook for interest rates the remainder of the year is expected to be a tailwind for this sector.

Municipal-Good performance as demand remains high ahead of expected increases in tax rates. The sector will continue to be supported by demand for tax-free income by retail investors. The sector also has improving credit fundamentals as the economy reopens, fiscal stimulus is distributed and property taxes continue to increase (in step with housing costs).

We have observed that low absolute rates and spread compression have forced investors down the quality spectrum looking for tax-free income.

Future rising interest rates are a head wind to performance. Often retail investors lower their allocation to the sector, pressuring yields higher and this becomes a self-sustaining cycle. If this occurs, we view this as a buying opportunity (similar to March 2020), as fundamental metrics are strong across the sector.

PORTFOLIO OUTLOOK

Oil-OPEC+ expects to stick to its plan to hike oil output in July, but Saudi Arabia's energy minister kept the market guessing as to whether the group will add more supply later this year to keep pace with the accelerating global recovery.

OPEC and its allies have spent more than a year rescuing prices from historic lows and only cautiously adding supply. Now the story is shifting: the oil market is heading into deficit. Letting the market overheat risks undermining the recovery. But the cartel also has to manage the risk of Iranian supply coming back online.

Commodities -Copper climbed to a record last month as stimulus, low interest rates and a global economic recovery fueled a rally across commodities. Prices have since stumbled on concerns the Fed will pull back support, while China is looking to tap state reserves to accelerate its campaign to rein in surging raw materials cost which are currently slowing demand.

Student Loans-More than 40 million holders of federal loans are due to start making monthly instalments again on Oct. 1, when the freeze imposed as part of Covid-19 relief measures is due to run out. It covered payments worth about $7 billion a month, the Federal Reserve Bank of New York estimated. Their resumption will have a significant impact on household budgets, and a potential drag on the consumer recovery.

Americans now owe about $1.7 trillion of student debt, more than twice the size of their credit-card liabilities. Politicians recognize it's not sustainable. Yet for all the talk of loan forgiveness during last year's election campaign —including from President Joe Biden, who promised to write off at least $10,000 per borrower — there's been no progress toward shrinking the pile of debt.

Treasuries-We anticipate interest rates to be range bound over the coming months as additional data is needed before investors are confident in the strength of the economy and subsequently, the expected path of interest rates.

Corporates-As mentioned in past commentaries, narrow spreads leave very little upside to corporate performance over the medium term. When combined with the unwinding of monetary stimulus, we view the current holdings as defensive due to their shorter maturities, high credit quality and high liquidity due to large issue size.

We conclude our commentary with these two observation. First, while we always feel that fundamentals will come forward and establish itself as the guiding force for the Treasury market, this past quarter, the pressure from reopening/reflation was met with the caution (unknown events) implied by the bull flattening (as shown in the table below) which overshadowed any single data point or headline.

Second, the Fed's faster integration of real-time economic data into its FOMC communication is done to help preserve its credibility for the tricky months ahead. In March, the Fed was planning to leave rates at the effective lower bound unless something changed. Now, the Fed plans to hike unless something changes.

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

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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	12/31/2020	3/31/2021	6/30/2021	YTD Change
2 YR	0.121%	0.160%	0.249%	-0.128%
3 YR	0.165%	0.346%	0.460%	-0.295%
5 YR	0.361%	0.939%	0.889%	-0.528%
7 YR	0.643%	1.419%	1.236%	-0.593%
10 YR	0.913%	1.740%	1.468%	-0.555%
20 YR	1.440%	2.311%	2.018%	-0.578%
30 YR	1.645%	2.411%	2.086%	-0.441%
10S MINUS 2S	79.2 bps	158.0 bps	121.9 bps	

Source: Bloomberg