LOGAN FIXED INCOME MARKET COMMENTARY Q3 | 2021 REVIEW

MARKET ENVIRONMENT

In his post-meeting press conference, Powell emphasized that the criteria for tapering—substantial further progress on the FOMC's maximum employment and price stability goals—was cumulative. It seems widely agreed upon that the inflation side of that benchmark had been met. The labor market, however, has been the bigger question. Yet even with August's disappointing jobs report, the labor market is still moving in the right direction. In the press conference, Powell shared that, in his view, substantial further progress on employment "is all but met." When pressed on what he would need to see in the September jobs report, the only one to be released between now and the November meeting, he said he would need to see a "reasonably good" jobs report, and that for him, "it wouldn't take a knockout, great, super strong employment report."

All told, it seems like economic conditions would have to deteriorate meaningfully between now and the November meeting for the FOMC not to announce the start of tapering at its next meeting. However, the chance of conditions worsening enough to make the FOMC hold off just a bit longer are far from zero, given the ongoing pandemic, the potential for a government shutdown and the debt ceiling standoff over the next six weeks.

Tapering is not tightening, it is one precursor, not the precursor. Even as it gets underway in the next few months, the Fed will still be growing its balance sheet, just at a slower rate. There is no reason to think tapering causes long yields to rise, but there is reason to think shorter maturity coupon yields will rise as we get closer to liftoff. Curve flattening is a Treasury market constant in the run-up before and during every Fed tightening, whether a QE taper is in play or not.

The "dot plot" now has nine members looking for a rate hike by the end of next year, which is up from seven members in June. But the commencement of tapering, should it begin in November, does not indicate that rate hikes are around the corner. Most Committee members would want to see the economy return to "maximum" employment before hiking rates.

Regarding the dot plot, we know where the median is, but we should not confuse median with consensus. There is no consensus in 2022 or 2023. The wide range of dots reflects a wide range of views on growth, inflation and unemployment. The dot plot obviously suggests liftoff, but it just as obviously suggests uncertainty at the Fed. This business cycle is unique in so many ways compared to the past. Don't make the mistake of thinking the Fed is signaling 2.5 rate hikes by the end of 2023 when the real signal is the Fed is pretty sure fed funds will have lifted off by the end of 2023, but it is anyone's guess how many hikes will have occurred by then.

PORTFOLIO REVIEW

Treasuries- The end of the period saw a yield breakout spurred by a dovish Fed and rising energy prices. For the third period, the 5-year Treasury increased approximately 10 bps, whereas the 30-yr Treasury had no change in yield (source: Bloomberg).

Corporates- Companies will continue the aggressive borrowing seen through most of 2021, helped by the low-rate environment and driven by the necessity of funding a growing pipeline of M&A activity. We observed especially strong issuance immediately after Labor Day.

Municipal- Federal stimulus helped issuers take advantage of low rates and continued high demand.

With rainy day funds near record highs, local governments went into the pandemic in solid shape. With the tremendous increase in house values, and thus property taxes, municipal credit has strengthened over the past year.

An increase in the individual income tax rate to 39.6% should not move spreads materially as we believe it's already priced in. An increase in the corporate tax rate to 28% or higher could have a bigger impact. A repeal of the SALT deduction limit would modestly widen spreads in high tax states.

PORTFOLIO OUTLOOK

Treasuries- Treasuries ended the period with a "rate hike premium" priced in especially after St. Louis Fed President Bullard said he expects two rate hikes in 2022 (source: Reuters interview, Tuesday September 28). He is squarely focused in inflation which he expects to remain at 2.8% through next year. We expand our outlook to include commodities (global indicators). The example of oil prices increasing goes in tandem with rising Treasury yields as investors move out of bonds and into commodities. Higher oil prices can drive up inflation and therefore lower the attractiveness of government bonds and their fixed income stream. In a testimony to the Senate Banking Committee on Monday, September 27, Fed Chairman Powell said, "As reopening continues, bottlenecks, hiring difficulties, and other constraints could again prove to be greater and more enduring than anticipated, posing upside risks to inflation." Glad to be short duration across all of our composites.

Corporates- October should produce strong corporate issuance once companies get past earnings releases. Changes in the Fed outlook usually bring "get in now" corporate supply increases, and that we would expect to see higher rates to maintain sufficient demand. Spreads are coming off the lows YTD as seen in early August.

Around the Globe- The euro area is facing another month of surging inflation as higher energy and travel costs add to constraints in global supply chains.

The story of the U.S. economy this year is one of robust demand that crashed into a pandemic-scarred economy that didn't have the capacity available to meet the challenge. That led to rising prices, inventory shortages, supply chain problems and reduced growth expectations today compared with the start of the year.
But companies have now had months to diagnose problems, make adjustments and plan for next year, when the supply chain and production outlook looks brighter. As long as demand holds up — and household wealth and income levels suggest it should — the economy in 2022 should feel better and run more smoothly than it has for much of 2021.

The longer the Fed's timetable to the first hike, the more time there is for major new developments (good or bad) to change its calendar. The Fed always sounds authoritative about the future….until the future changes.

Evictions are impending for millions of renters and slow rental aid disbursement isn't helping. The danger of eviction is not going away as the funds from the government's rental assistance program are being disbursed at an incredibly slow pace. As of August 31, only 11% of the available funds had been distributed (source: U.S. Treasury Department). The end of the federal eviction moratorium means there is no longer a backstop to prevent landlords from initiating the eviction process against non-paying tenants. So far, landlords have filed relatively few eviction cases, but that could change. Many of the smaller multifamily owners have lost significant amounts of rental income they need to pay down their mortgages and pay their staff.

Finally, an interesting consumer trend is when people flock to the hard discounters, such as Aldi and Lidl, which have already conquered Europe and are now expanding across the U.S. Many customers stayed away from these smaller supermarkets during COVID, when they switched back to doing a weekly shopping at a big-box store.

Up until now, grocers haven't had a bad pandemic. That may be about to change.

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U.S. TREASURY YIELDS	12/31/2020	3/31/2021	6/30/2021	9/30/2021	YTD Change
2 YR	0.121%	0.160%	0.251%	0.289%	-0.168%
3 YR	0.165%	0.343%	0.452%	0.524%	-0.359%
5 YR	0.361%	0.936%	0.878%	0.991%	-0.630%
7 YR	0.643%	1.411%	1.220%	1.323%	-0.680%
10 YR	0.913%	1.738%	1.450%	1.528%	-0.615%
20 YR	1.440%	2.422%	1.994%	2.034%	-0.594%
30 YR	1.645%	2.324%	2.064%	2.091%	-0.446%
10S MINUS 2S	79.2bps	157.8bps	119.9bps	123.9bps	

Source: FactSet