LOGAN FIXED INCOME MARKET COMMENTARY Q3 | 2022 REVIEW

MARKET ENVIRONMENT

It's All About the FOMC

Fed officials aren't explicitly projecting a recession, but Fed Chair Jerome Powell's rhetoric about the rate hikes likely causing pain for workers and businesses has gotten progressively sharper in recent months. In his FOMC post-meeting press conference on September 21, Powell said a soft landing with only a small increase in joblessness would be "very challenging."

It's also notable that the Fed sees rates higher at the end of 2023 vs. 2022; consistent with holding the terminal Fed Funds rate in place longer. Fed Funds at 3.9% by the end of 2024 is sending a similar message.

Fed Chair Powell's attempt to stabilize prices has gone from a 'soft landing' early this year to 'softish landing,' which became 'some pain,' and finally Powell said, "No one knows whether this process will lead to a recession or if so, how significant that recession would be." Powell can no longer sugarcoat the tough reality that a hard landing is the most likely scenario. Investors no longer question how strong the Fed's resolve is to bring inflation under control, and what is required to get the job done. We do not think the Fed will cut rates at the first sign of weakness to ensure that inflation is moving convincingly back toward its 2.0% target.

PORTFOLIO REVIEW

Treasuries

We have seen a remarkable range of yields in the global haven U.S. Treasury market this year. The 10-year yield surged above 4.0% (if only briefly on September 28) towards the end of the quarter for the first time since 2010 (Bloomberg), having been as low as 1.53% in early January. The two-year yield has moved in range of 0.75% to 4.35% this year. Selling pressure has caused bond dealers to increase bid/ask spreads wider to slow the accumulating bonds on their balance sheets which marginally reduces liquidity. Yields have marched higher since August 1, which translates to a continuation of negative performance.

Corporates

We have observed new issuance greatly slow down to end the quarter, as the broad selloff has dampened corporate sentiment, keeping borrowers sidelined. Spreading global fears have overlaid with a slowing economy here and abroad to widen credit spreads. We are closely monitoring if interest rate risk will morph into more extensive credit risk.

Municipals

The tremendous selloff in the sector has created an excellent entry point for crossover buyers. Improved income and total return is available in a market where many state and local governments have healthy balance sheets and strong income from sales and property taxes.

Technical pressures of redemptions from muni funds and ETFs have added to the upward pressure originating from the Treasury market. We are also watching a decrease in new issuance, as the higher interest rates make it less attractive for municipalities to borrow for new projects or to refinance existing debt. These two offsetting forces will have a huge impact on the direction and performance of the sector for the remainder of the year and into 2023.

PORTFOLIO OUTLOOK

From a global perspective, higher rates in the U.S. increase the U.S. dollar and devalue other currencies around the globe. When these other nations attempt to protect the value of their own currency by increasing interest rates locally, their economies slow. When nations (both developed and developing) simultaneously raise interest rates, it's easy to see how this will result in a severe global economic slowdown.
From the consumer's perspective, higher interest rates impact different segments of consumers in fundamentally different ways:

- For consumers that typically borrow as the economy slows, tougher access to credit reduces demand supported by debt (example: credit cards & HELs).

- For consumers that typically do not borrow, higher carrying costs of risk assets depress the price, eroding the wealth cushion and lowering spending sentiment. Specifically, the value of future cash flows is eroded by higher rates today and in the intermediate future.

Some of the impact of higher rates have already surfaced (the housing market), while some effects are still to come, such as lower employment & lower consumer spending.

Consumer spending has shown resilience this summer mostly due to healthy household balance sheets. However, with gas prices falling more slowly, borrowing rates rising and the jobs market cooling, we expect the staying power of the consumer to fade over the remainder of the year. Retail spending is likely to feel the pullback to a disproportionate extent, after many goods purchases were pulled forward during the pandemic while spending on experiences was put on hold. The unwinding of supply chain issues and lower commodity prices will not save the day here. Currently, we see the current consumer strength directly influencing additional Fed tightening in order to suppress the current elevated inflation. The terminal Fed Funds rate may reach 4.75%-5.00% by the end of the first quarter of 2023.

U.S. TREASURY YIELDS	12/31/2021	3/31/2022	6/30/2022	9/30/2022	YTD Change
2 YR	0.726%	2.286%	2.931%	4.200%	-3.474%
3 YR	0.955%	2.464%	2.978%	4.210%	-3.255%
5 YR	1.265%	2.422%	3.001%	4.040%	-2.775%
7 YR	1.436%	2.404%	3.035%	3.940%	-2.504%
10 YR	1.512%	2.324%	2.975%	3.800%	-2.288%
20 YR	1.935%	2.598%	3.382%	4.070%	-2.135%
30 YR	1.905%	2.453%	3.121%	3.770%	-1.865%
10S MINUS 2S	78.6bps	3.7bps	4.4bps	-40bps	

Source: FactSet