Logan Fixed Income

LOGAN FIXED INCOME MARKET COMMENTARY
Q1 | 2023 REVIEW

MARKET ENVIRONMENT

We conclude the (tumultuous) period with fed funds at 4.75% to 5.00%, the highest since September 2007 (source: Bloomberg), when rates were at their peak on the eve of the financial crisis. We are on the lookout for additional cracks in our economy as the most aggressive monetary policy tightening cycle in 40 years leaves economist less certain of what is around the corner.

Fed Chair Powell emphasized in his March 22 press conference the U.S. banking system is sound and resilient. Investors will continue to be on the lookout for trouble in small and regional banks that are not under the same capital and liquidity requirements as larger banks and are thus seen as riskier. Overall, there will be tighter credit restrictions as banks loan volume will decrease which will contribute to the slowing of the economy—the same impact as increasing the fed funds rate.

Powell continued to stress that Fed officials do not expect rate cuts this year. As of this writing, fed funds futures are priced for rate cuts by the 4th quarter of this year after a possible final increase in May (source: Bloomberg). Recent testimony about the FOMC seeing the need for more tightening is supported by the new FOMC forecast (the dot plot). The Fed sees a little more inflation this year and next and continues to see a need for a higher unemployment rate to slow the economy and thus inflation. We will have a better understanding of the direction of the Fed's mandates by the 3rd quarter of this year.

PORTFOLIO REVIEW

Treasuries

The yield curve has steepened the most this final month of the period since October 2008 (source: Bloomberg). Investors lowered the anticipation for further interest rate hikes this year and ramped up their expectations for rate cuts. Fed Chair Powell indicated last week that rate reductions are not his base case this year are not expected until 2024. The period ended with yields increasing slightly due to reduced jitters regarding contagion from the banking sector.

Corporates

We had seen issuance ramp up immediately in front of the March 22 Fed meeting. Firms are locking in rates before a perceived hike in rates. From an investors perspective, higher rates and falling profits will increase the importance of monitoring credit risk. Before Silicon Valley Bank hit the headlines, investors had not been attentive enough to the consequences of this higher rate environment.

Municipals

State revenue collections continue to increase as both sales and property tax collections remain strong. Relative value within the sector has held in all along the curve, ending the period at less than 68% of Treasury yields. As the calendar approaches April 15, we are observing outflows from municipal mutual funds. This is seasonal as investors liquidate these funds to pay income taxes. The flight-to-quality has benefited performance in the sector as volatility has negatively impacted every sector except municipals and U.S. Treasuries. Municipals continue to be seen as a haven asset class, with low default rates and high credit quality.

Oil

Oil hits a 15-month low as banking turmoil has shaking confidence that a recovery in China will be enough to reinvigorate global demand. There are fears that near-term demand will be diminished due to rising recession concerns. This sentiment is in direct contradiction to the bullishness expressed by traders. Cheaper oil will benefit consumers in the near term and should reduce pressure on inflation and ease the Federal Reserve's job of getting broader price increases under control.

PORTFOLIO OUTLOOK

Markets will remain focused on the banking crisis and threats to economic growth from the most aggressive pace of rate tightening in decades. Last quarter, we heard "pause & pivot" across headlines, while some have been hopeful of a soft landing. The plummeting of rates in the front-end of the Treasury curve signals that a severe economic slowdown is just around the corner. This is in direct contradiction to the Fed's Summary of Economic Projections which projects more rate hikes, as inflation has not decreased, and unemployment has not increased appreciably.

One area we are watching is the amount of lending by local and regional banks over the coming months. The transfer of deposits from small local banks to banks deemed too-big-to-fail will impact the scale and distribution of overall lending. This could become a big issue for local communities, regions and sectors that fear their access to loans will be cut because their traditional banking partners will have to shrink their balance sheets after losing deposits.

Ultimately, tighter lending standards could have as big an impact as any move by the Federal Reserve. Sentiments at the end of the period were slightly higher as fears of contagion within the banking sector eased amid renewed prospects of further U.S. support for the industry. As is usually the case, the next few months will shed additional light on the Fed's thoughts and any change in direction.

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U.S. TREASURY YIELDS	12/31/2022	3/31/2023	YTD Change
2 YR	4.420%	4.065%	0.355%
3 YR	4.236%	3.830%	0.406%
5 YR	4.004%	3.608%	0.396%
7 YR	3.968%	3.563%	0.405%
10 YR	3.878%	3.495%	0.383%
20 YR	4.142%	3.822%	0.320%
30 YR	3.970%	3.688%	0.282%
10S MINUS 2S	-54.2bps	-57.0bps	

Source: FactSet