Logan Fixed Income

LOGAN FIXED INCOME MARKET COMMENTARY
Q2 | 2022 REVIEW

MARKET ENVIRONMENT

While inflation has broadened out and surprised to the upside in 2022 (we have not heard the word transitory in quite a while), we maintain the view that it will fall sharply in the year ahead. For one thing, we expect commodity prices to fall. Even if we are wrong about this, prices are unlikely to rise enough to prevent base effects from restraining headline inflation. What's more, goods shortages and logistical bottlenecks have improved in some places, consumer spending is normalizing, and inventories are being replenished. We expect these trends to continue, causing goods price pressures to ease. Central banks will deliver more policy tightening, which should help inflation to settle around targets in the intermediate future. We are cautious that central banks might hike rates too far and trigger disinflationary recessions.

PORTFOLIO REVIEW

Treasuries

We saw Treasury rates increase through most of the quarter, peaking on June 14 (Bloomberg), before rallying the final two weeks of the period. U.S. rates swung sharply lower in the middle of June as traders downgraded their assessments for where the Fed benchmark might peak from more the 4% earlier in June, and expectations for potential Fed Funds rate cuts beyond that horizon have also amped up.

Strong payroll data and moderating wage growth factor in to expectations of the Federal Reserve continuing their tightening program through the summer, before possibly pausing to evaluate their progress in lowering inflation. The high point of yields during the quarter occurred after the June CPI release which has negatively impacted consumer sentiment.

Treasuries are caught in a tug-of-war as expectations for further Fed tightening collide with fears that the world's largest economy may slip into a recession. Chairman Powell said at the last Fed meeting the central bank has an unconditional commitment to restoring price stability.

Corporates

Companies became nervous over the past few weeks about raising additional funds via new issuance. Large IPO and M&A transactions have been placed on hold until market turmoil subsides. Costs have risen sharply across the credit spectrum as years of cheap money looks to have ended.

Along with rates in the Treasury market increasing, we have observed credit spreads widen out during the second quarter. After seeing rich levels throughout the summer of 2021, spreads meaningfully started to increase in early 2022 (FactSet). The combination of high inflation concerns with rising recession fears caused the corporate sector to underperform versus comparable Treasuries. We have not seen this level of relative value in the sector since the fourth quarter of 2020 (FactSet). Where appropriate, we have increased portfolio allocation to the corporate sector, mostly targeting intermediate maturities.

Municipals

The muni sector moved in tandem with

corporates. Although state and local government finances are healthy due to receiving increased personal and corporate income taxes, sales and property taxes, as well as federal stimulus funds, investors pulled assets from municipal mutual funds. The reaction to an aggressive Fed and high inflation levels have caused rates to significantly increase as investors look for a safe haven to protect asset value. This usually defensive sector turned in performance comparable to other spread sectors.

More recently, investor sentiment has shifted away from inflation to slower growth/recession/stagflation. We are watching to see if a rate top was just achieved. The muni sector offers an improved YTM, both on a standalone basis and relative to Treasuries.

Commodities

In June, U.S. President Joe Biden called for a pause in gasoline tax collections. Economics dictate that if supply can't be increased, then high prices will end up depressing demand, causing prices to eventually fall. Cutting fuel taxes may be popular, but that could increase demand and therefore help to keep prices high. California will offer a tax rebate in October to consumers (additionally, the Governor introduced a package that would distribute gas cards to owners of registered vehicles). While great on intention, it may spur greater fuel usage and greater consumer inflation (the opposite of the Fed's goals). Connecticut, Georgia, Maryland, and New York have all temporarily suspended gas taxes. We are certain these state mandates will be scrutinized across the country, especially as we get in our cars, no matter if we are headed for Costco or for vacation.

PORTFOLIO OUTLOOK

We still expect a choppy summer as far as yields go. June's CPI inflation release on July 13 and the Fed's July 27 meeting are the next meaningful events that are expected to point the direction of rates for the remainder of the summer. Fed Chair Jerome Powell signaled that the Fed will press ahead with its planned series of aggressive interest rate hikes, even as evidence mounts that economic growth will be weak in the second half of the year.

We expect weakening economic activity to show up before the end of the year, as the impact of higher food and energy costs spur an economic slowdown. This should equate to a slowdown in Fed tightening later in the year. An underlying concern is will the Fed tighten too aggressively into an economic slowdown. We will be monitoring rate sensitive sectors like housing, cars, and other durable goods bought on credit. Thinking optimistically, supply chain disruptions should ease, bringing supply back into better balance with demand. Price growth would slow, helping the Fed reduce inflation towards its 2.0% target.

Observations

Are consumers in better shape to face a slowing economy?
Officially, at the macro level, strong consumer balance sheets allow households to draw down savings, and increase leverage to support spending. But across all income groups, more borrowers are worried that they won't be able to pay their credit-card balances in full, according to a recent Lending Tree survey. The drop in confidence comes as rising prices spur U.S. consumers to rely more heavily on plastic, piling up credit-card debt.

This material represents an assessment of the market and economic environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. Forward-looking statements are subject to certain risks and uncertainties. Actual results, performance, or achievements may differ materially from those expressed or implied. Information is based on data gathered from what we believe are reliable sources. It is not guaranteed as to accuracy, does not purport to be complete and is not intended to be used as a primary basis for investment decisions. It should also not be construed as advice meeting the particular investment needs of any investor. ***Past performance does not guarantee future results.***

Indices are unmanaged and investors cannot invest directly in an index. Unless otherwise noted, performance of indices does not *account for any fees, commissions or other expenses that would be incurred. Returns do not include reinvested dividends.*

The Consumer Price Index (CPI) is a measure of inflation compiled by the US Bureau of Labor Studies.

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	12/31/2021	3/31/2022	6/30/2022	YTD Change
2 YR	0.726%	2.286%	2.931%	-2.205%
3 YR	0.955%	2.464%	2.978%	-2.023%
5 YR	1.265%	2.422%	3.001%	-1.736%
7 YR	1.436%	2.404%	3.035%	-1.599%
10 YR	1.512%	2.324%	2.975%	-1.463%
20 YR	1.935%	2.598%	3.382%	-1.447%
30 YR	1.905%	2.453%	3.121%	-1.216%
10S MINUS 2S	78.6bps	3.7bps	4.4bps	

Source: FactSet