

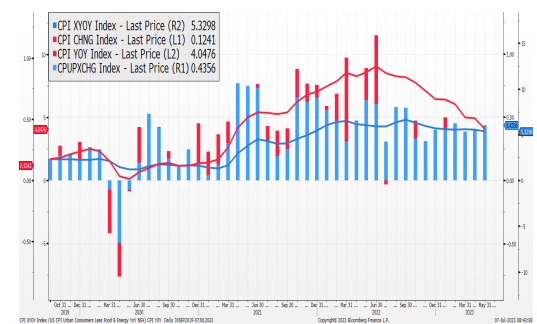
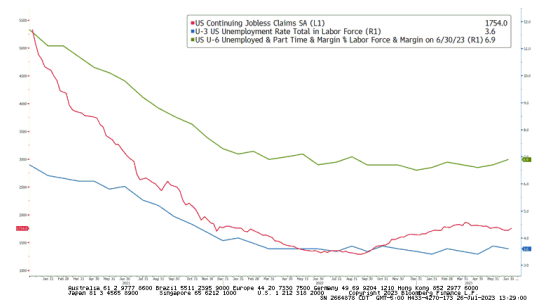
# BOND MARKET UPDATE

As of 06/30/23 | Volume 12, Issue 2 | FFTAM.com

In the 2nd Quarter of 2023, total returns for both taxable and tax-free investments were negative for the quarter. For taxable portfolios in the 2nd Quarter, the Barclays Aggregate generated a total return of -0.84%. For tax-free portfolios in the 2nd Quarter, the Barclays 1-10yr Muni generated a total return of -0.53%. YTD returns are 2.09% for the Barclays Aggregate and 1.45% for the Barclays 1-10yr Muni. The economy's growth trajectory has continued to slow but appears to be showing signs of stabilizing, inflation is dis-inflating, the Fed continues to raise the cash target rate but has hit its first pause, and confidence in regional banking has stabilized.

## Economy

GDP in the 1st Quarter of 2023 came in with a final Q/Q reading of +2.0%. GDP Projections for the 2nd Quarter sit at an estimated growth rate of +1.7% Q/Q. Current estimates for 2023 GDP Y/Y have moved up slightly, Y/Y growth rate projections are now 1.3%. US Unemployment and US Continuing Jobless Claims have leveled off at very low levels, and the economy continues to displaying signs of overall weaker positive momentum with some signs of stabilization. Expectations remain that employment numbers should start to weaken led by increases in continuing claims, however, labor has and continues to be very sticky. It is clear that labor demand is weakening, just not enough to exceed supply. Inflation continues to remain elevated on an Year over Year (YoY) basis; however, we are seeing signs of disinflation in most segments of the CPI on a monthly and quarterly basis. Comps versus the prior year should continue to put a downward bias on the forward YoY print, for now. Shelter (the largest core component) has a massive lag and still has not shown up in the numbers. Over the next few months we will see some large CPI prints roll-off, after that, comparisons will start to get more difficult and will mostly show the stickiness of inflation.



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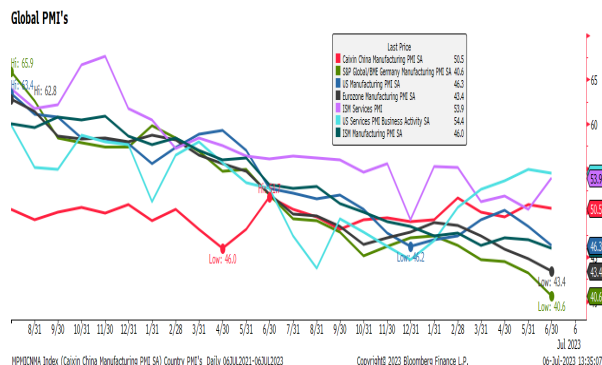
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Since the 3rd Quarter of 2021, we have seen a steady downward trajectory of manufacturing and services PMI's from very elevated levels. Manufacturing (30% of the US economy) has been in contraction now for roughly three quarters, at some point, if not now, manufacturing will stabilize at lower levels and stop contracting. Housing is starting to show signs of this. Services (70% of the US economy) is still expanding but at much slower levels. The consumer with a job continues to buoy the economy, however, depletion of savings in conjunction with higher prices will continue to cause overall demand to weaken.



## Rates

Year to date 2yr, 5yr, and 10yr U.S. risk free rates (nominal) are approximately 4 bps, bps and bps, respectively. This has created an inverted UST yield curve, compressing the 10yr to 2yr UST spread from a high of 160bps early last year to currently an inverted - bps. Real rates have also risen substantially starting in 2022. Currently, 10yr TIPS are pricing at 1. 0%. This validates that market rates are restrictive, and that the Fed's policy will eventually succeed in its fight against inflation. Mortgage rates have also moved substantially higher, 30yr mortgage rates



## The Fed

The Fed had two meetings in the second quarter, May and June. At the May meeting, the Fed raised the cash rate by 25bps to a range of 5% to 5.25%. At the June meeting, the Fed elected to pause and keep rates at the same level as before. At the press conference, Powell acknowledged that a majority of the committee thought it was prudent to resume tightening at some point in the future. The reason for the pause was to see more economic data. The pause is a significant event. First, it says that not all members of the committee are sold that they need to do more. Second, it says that even though there may be more rate hikes, the committee is getting close to the end. Quantitative Tightening (QT) continues to work in the background at \$95B/month, it will stay at this level until further notice. We have never experienced QT of this magnitude, and the effects are still unknown.

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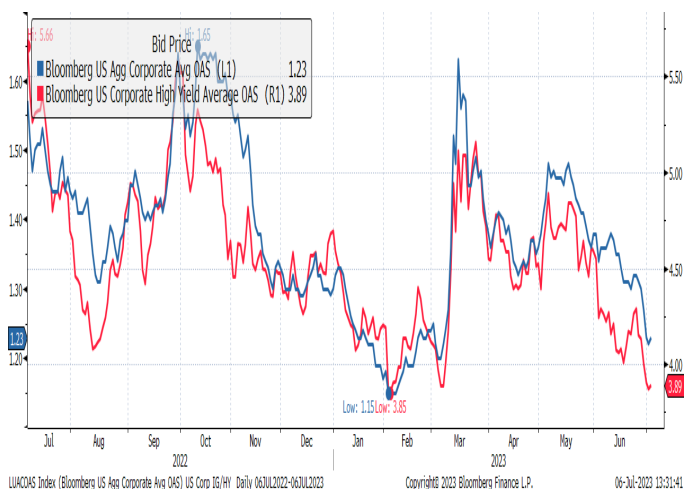
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## Credit

Credit risk was positive versus risk free in the 2nd Quarter of 2023. Spreads were tighter for both Investment Grade (IG) and High Yield (HY). For the quarter, IG spreads tightened by roughly 15bps and HY spreads tightened by roughly 65bps. YTD, spreads have tightened by 7bps and 79bps, respectively. Risk premiums in IG and HY expanded quite a bit on the back of regional bank failures earlier in the year but have recovered nicely as the economy continues to avoid a recession. Overall, financial conditions have tightened significantly since the beginning of 2022 and have the potential to tighten further if labor continues to remain sticky, forcing the Fed's hand to keep raising the cash rate.



## Looking Forward

Over the past 16 months, the market has absorbed a substantial amount of Fed tightening in a short amount of time. With a 2yr UST at 5.00% and a cash rate at 5.25%, the market and the Fed have once again converged on the same rate path outlooks. This by itself, is what we like to see when buying bonds, a balanced risk/reward profile. The Fed will most likely raise the cash rate by 25bps at the next meeting. QT is still a wild card; the economy is slowing/stalling/stabilizing, and the effects of QT (less liquidity) are working in the background. We have found some pockets of IG credit risk that we like, continue to be void of High Yield, and continue to build up our US Treasury and Agency MBS exposure. With a Fed close to the end of tightening, 2023 looks to have the potential to be a much better year than 2022. Forward returns continue to look very enticing, and this is something we haven't been able to say in over a decade. As always, we run a high-quality portfolio that looks to take advantage of opportunities as they present themselves. We have been active in seeking those opportunities and feel good about the changes that have been made.

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