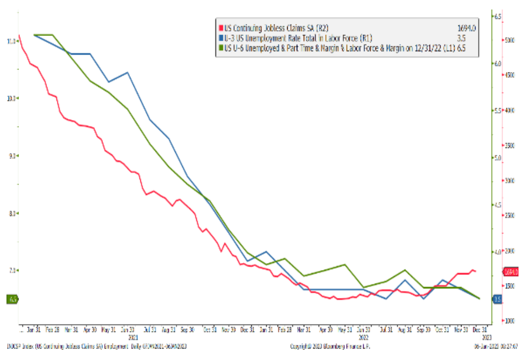
BOND MARKET UPDATE

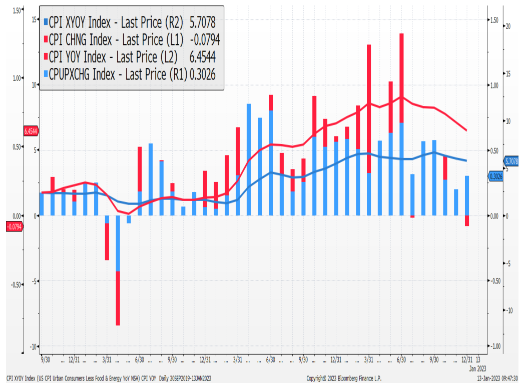
As of 12/31/22 | Volume 11, Issue 4 | FFTAM.com

In the 4th Quarter of 2022, total returns for both taxable and tax-free investments were positive for the quarter. For taxable portfolios in the 4th Quarter, the Barclays Aggregate generated a total return of 1.87%. For tax-free portfolios in the 4th Quarter, the Barclays 1-10yr Muni generated a total return of 3.12%. YTD returns are -13.01% and -4.84%, respectively. The economy's growth trajectory continued to slow, inflation is starting to disinflate, and the Fed continues to raising the cash target rate.

Economy

GDP in the 3rd Quarter of 2022 came in with a final Q/Q reading of 3.2%. GDP Projections for the 4th Quarter sit at an estimated growth rate of +1.1% Q/Q. Current estimates for 2023 GDP Y/Y continue to get ratcheted down, Y/Y growth rate projections are now 0.3%. US Unemployment and US Continuing Jobless Claims have leveled off at very low levels, and the economy is displaying signs of weaker positive momentum. Expectations are that employment numbers should start to weaken lead by increases in continuing claims. Job openings, while still elevated, are clearly in a downtrend. Current job openings sit at 10.4M versus a peak of 11.8M in March of 2022. Inflation continues to remain elevated on an Year over Year (YoY) basis; however, we are starting to see signs of disinflation in some 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. The energy component of the CPI has fallen quite drastically, airfares and used vehicles have started to decline, however, food, shelter, and medical care continue to remain elevated. Shelter (the largest core component) has a massive lag and, unfortunately, this will continue to keep the core component of the CPI elevated. Housing prices and rents have declined for several months in a row, this will influence the shelter component of the CPI in the future. At some point (if not now), the depletion of savings in conjunction with higher prices will cause overall demand to weaken.





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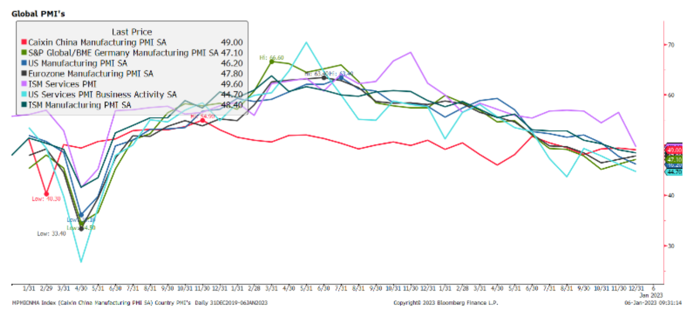
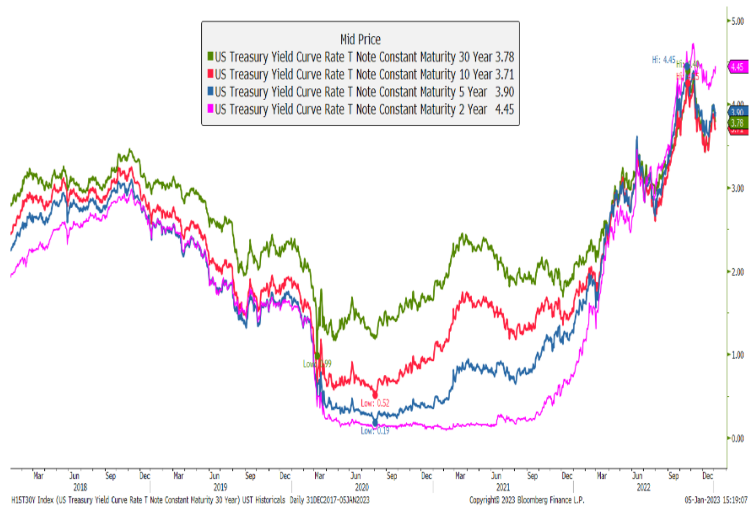
Since the 3rd Quarter of 2021, we have seen a steady downward trajectory of manufacturing and services PMI's from very elevated levels. All manufacturing PMI's are now at levels signaling that growth is contracting. Services PMI in the US has also tailed off and is clearly in a downtrend, however, it remains at levels still indicative of modest growth. Throughout 2022, the consumer has shifted from goods to services and this trend is still intact for now.



Rates

Year to date 2yr, 5yr, and 10yr U.S. risk free rates (nominal) are up approximately 370bps, 265bps and 220bps, 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 -75bps. Real rates have also risen substantially in 2022. Currently, 10yr TIPS are pricing at 1.50%. 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 started the year at 3.45% and currently sit at 6.55%, briefly piercing 7% in the back half of September.



The Fed

The Fed, at the November and December FOMC meetings, raised the cash rate by 75bps and 50bps, respectively. The current target rate for Fed Funds is 4.25% to 4.50%. It is widely expected that the Fed will raise the target rate again at the February and March meetings in 2023. Per the press conference after the December meeting, Powell communicated all FOMC members agreed that the cash rate will still need to rise over the next several meetings, however, they feel they are close to getting the cash rate to a point where it should be sufficently restrictive to lower inflation. In addition, Powell expressed his continued desire for the job market to ease, the unemployment rate rise, and the housing market to cool. Powell also communicated a very high likelihood of much slower growth moving forward and that achieving a soft landing will be challenging. The Fed is now projectiong 2023 GDP growth of 0.50%. Quantatative 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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Credit

Credit risk was positive versus risk free in the 4th Quarter of 2022. Spreads tightened for Investment Grade (IG) and High Yield (HY). IG spreads tightened by roughly 29bps and HY spreads tightened by roughly 83bps. YTD, IG has widened 37bps and HY has widened 186bps. Risk premiums in IG and HY eased quite a bit in the final quarter of 2022 as the Fed communicated a desire to pause on rate increases in the near future. Considering the move in risk free and credit risk premiums, IG funding has gone from roughly 2.25% at the beginning of the year to roughly 5.50% today. HY funding has gone from roughly 4% at the beginning of the year to roughly 9.00% today. Financial conditions have tightened significantly.

Looking Forward

YTD, the market has absorbed a substantial amount of Fed tightening in a short amount of time. With a 2yr UST at 4.45% and a cash rate at 4.50%, the market and the Fed have started on converge with similar pricing. The Fed has made it clear that they intend to raise rates at the next two meetings, and they want to see more clear evidence of deceleration in the CPI and employment conditions deteriorate. Financial conditions have tightened significantly this year. QT is still a wild card; the economy is slowing/stalling, and the effects of QT (less liquidity) are only starting. 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. 2022 has been a very challenging year. However, we are finding very attractive opportunities that we haven't seen in a while. Forward returns 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.