

# The Bond Bulletin

What's happening in fixed income markets

UBS Asset Management | April 2023

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## Highlights

### In March US municipal bond prices down 2.26%, up 2.78% YTD

- This March was everything but typical in the muni market, investors now have a seasonally driven entry point to the market
- Many investors lose focus on markets as they turn their attention to paying the "Tax Man"
- March's positive performance almost completely erased the negative performance the market experienced in February

### US corp investment grade total returns up 2.78% in March, US high yield up 1.12%

- YTD total return for US investment grade up 3.50%, US high yield up 3.67% at month end
- Volatility remains elevated with still heightened uncertainty around the Fed's ability to get inflation under control without a hard landing.
- Fixed income investors continue to deal with elevated Fed uncertainty in terms of the timing and level of the terminal rate for Fed funds

# Fixed income month in review

Worries over the health of the banking system on both sides of the Atlantic were the main preoccupation for investors in March. Market sentiment was undermined early in the month by the collapse of two mid-sized lenders in the US, followed by news a week later that UBS would acquire Credit Suisse, in a move that Swiss regulator FINMA said would “ensure stability for the bank’s customers and the financial center.” These events led to a rally in treasuries and pressure on credit spreads especially for the financial sector. As we moved through the month, risk appetite returned and the tone improved which we would attribute to a quick policy response and no other failures. US Investment-grade and high yield closed the month at a spread level of +138bps and +418bps, 14bps wider and 36bps wider, respectively. For March 2023, the total return for US investment grade credit was up 2.78%, while US high yield was up 1.12%. The first quarter 2023 total return for US investment grade and US high yield are 3.50% and 3.67%, respectively.

The yield on the 2-year US Treasury fell 79 basis points to 4.03%, while the 10-year yield fell 45bps to 3.47%. The total return for the US Treasury index was up 2.89% with the long-end (20yr+ posting a 4.75% return) outperforming the short-end (3-5yr posting a 2.65% return). The flight to quality helped alleviate some of the 2yr vs 10yr US treasury curve inversion which peaked at -107 bps on March 8<sup>th</sup> and fell to -56 bps at month-end.

In terms of commodities, banking stress and concerns about the economic growth outlook weighed on the sector in the first half of March, though broad commodity indexes regained ground toward the end of the month. The UBS Bloomberg CMCI (constant maturity commodity Index)<sup>1</sup> was almost flat in March (+0.1%), but lost 1.1% in the first quarter. The more cyclical commodities like energy underperformed, while gold outperformed thanks to its safe-haven status, and reached a 12-month high in March.

## Macro outlook

In the US and for March, economic releases continued to point to a strong labor market, while rate sensitive sectors and inflation moderate. ISM Manufacturing PMI fell to 46.3 in March from 47.7 in February. The Services PMI was slightly weaker in March at 52.6 down from 53.8 reported in February. Non-farm payrolls was 236,000 in March which moderated from the 311,000 reported in February. The unemployment rate fell to 3.5% in March from 3.6% in February, still one of the lowest readings since 1969. Jobless claims ticked higher from 198,000 reported in February to 228,000 in March which was slightly above the consensus estimate of 200,000. While

headline inflation continues to moderate from a peak of 9.1% reported in June 2022, it remains elevated relative to the Federal Reserve target of 2%. For March, CPI ex food and energy on a year-over-year basis was 5.6% in-line with expectations but slightly higher than 5.5% reported in February. Over the same time period, core inflation came in at 5% a full percentage point lower than February’s print but slightly higher than the consensus of 5.1%. Retail sales ex auto and gas slowed 0.3% month over month and was below the consensus estimate of -0.6%.

## Municipal fixed income

### Performance Backdrop

The month of March has historically been a varied bag of results for the municipal bond market. Typically, reinvestment needs dissipate at exactly the same time the municipal new issue bond issuance machine kicks into high gear. These conflicting technical factors (light demand vs. heavy supply) will cause municipal bonds to underperform and thereby drive municipal vs. treasury ratios higher (cheaper). Investors now have a seasonally driven entry point to the market. This March was everything but typical.

The Bloomberg US Municipal Index<sup>1</sup> rallied 2.22% in March and municipal vs treasury ratios maintained a rich bias. While reinvestment needs were seasonally light, supply remained largely muted as issuers held back bringing new issue deals to market. March’s positive performance almost completely erased the negative performance the market experienced in February (-2.26%). The month-to-month push-pull

performance the market has experienced thus far in 2023 has been extremely difficult to predict as seasonal factors have not played out as is typical and the guessing game for the Federal Reserve’s intentions has been just that, a guessing game. So, if you were steady in your convictions and remained invested in the market for the entire first quarter of 2023, you enjoyed a Bloomberg US Municipal Index<sup>1</sup> return of 2.78%. Thus, our continued advice to look at this asset class as a long-term investment that provides a steady stream of tax-advantage income, when if managed correctly can also contribute to asset growth.

Looking a little deeper into the index, the best performing sub-indices in March were:

- The long bond (22 years+) generating a positive return of 3% while the 1 year was up only 1.06%. Investors appear more comfortable with the actions of the Federal Reserve and may foresee and

<sup>1</sup>See last page for further information

end to the rise in interest rates. Long duration positions typically benefit from this environment. This contrasted with last year's strongly active Federal Reserve and fears of continued rate increases which caused the long bond (22 years+) to generate a negative return of -3.33% while the 1 year held in best with just a -.85% return.

- Within Investment grade, BBB debt reversed course in March erasing all its negative performance in February posting a 2.47% return this month. We believe this positive performance reversal was driven by the longer duration (7.60) of this sub-index and not a statement of willingness to take on credit risk. High quality paper trailed BBBs but not by much with AAA paper returning 2.23% and AA bonds returning 2.22%. Still the rising tide of March lifted all rating categories.
- High Yield and taxable municipals sub-indices both posted positive returns for March but demonstrated a mixed degree of results. Taxable municipal securities kept pace with the broader market returning 2.49% while high yield municipal debt lagged with a return of just 1.55%.
- General obligation bonds performed better than revenue bonds but only slightly as general obligation debt was up 2.30% vs 2.23% for revenue bonds. Leading the revenue sector higher was housing at 2.87% while the IDR/PCR sector was the worst performers returning just 1.42%. Only slightly worse than Pre-Refunded bonds which returned 1.48%. At this point in the credit cycle it does not appear the market has yet begun to differentiate between these two distinctly different credit fundamentals (general obligation vs. revenue).

The municipal curve bull steepened in March as yields rallied across the curve but decreased most in the front end. As has been the case for most of this year, municipal investors have been crowding the early maturities over paying for bonds maturing in 5 years and shorter. We have been actively selling into this over-valued demand as our analysis indicates future returns from this area of the curve represents little value. Municipal yields rallied almost 60 basis points in two-year maturities, 43 basis points in five-year maturities 32 basis points in 10-year maturities and 26 basis points in the 30 year maturities. Municipal VRDNs (variable rate demand notes) continued to offer elevated yields throughout the month of March. Demand in the beginning of the month forced SIFMA to reset weekly rates lower at 2.80% followed by even lower rates of 2.21%. But gradually investor demand waned. Treasury bills were certainly more attractive with taxable yields exceeding 4%. Dealers found themselves with large balances of securities they wanted to clear from holdings. They were forced to capitulate (raise yields) to clear these holdings at

higher and higher rates. Eventually VRDN rates climbed to hit a high for the year at a 4.35%. Further rewarding investors who made the effort to stay liquid without owning the short maturity area of the curve or utilizing a barbell strategy to maximize yield and manage duration. SIFMA has averaged a yield of 2.93% YTD and 3.19% in March.

Prior to March, municipal bonds maintained a bias to being viewed as rich. March's positive performance of the municipal market in the face of treasury market volatility extends this theme of richness. Every maturity of municipal bond has richened relative to its Treasury counterpart. There existed a brief period of cheapness mid-month as the safety of treasury securities drove treasury yields lower as the market experienced the effect due to the banking crisis, municipal yields did not move (lower). As reported by TM3 as of 3/31/23 the market sits with AAA municipal vs. treasury ratios at 58.5% in 2-year maturities, 61.4% in 5-years, 64.9% in the 10-years and 89.5% in the 30 years. However, the mid-month's flight to quality due to the banking crisis had municipal securities significantly cheaper and while it may not have set new 1 year ratio highs, the market easily hit 2023's cheapest municipal vs treasury ratios. During this time, we were very active selectively investing despite the volatility expecting the return to normalcy that has now occurred.

### **Market outlook**

As we look ahead we expect the municipal market to maintain its positive trend. Tax season is another period requiring a steady investing hand. Many investors lose focus on markets as they turn their attention to paying the "Tax Man". Many municipal investors liquidate portions of their portfolio to make that tax payment. Fortunately, unlike March, which historically brings softer performance for municipal bonds, April has experienced only four losing months since the great financial crisis. Investors will be challenged to find bonds as the month of April ranks as the lowest for municipal issuance. Most dealers expect supply to remain light until we enter the summer months.

<sup>1</sup>See last page for further information

# Taxable fixed income

## Taxable fixed income performance

US corporate investment grade total return (as measured by the Bloomberg US Corporate Bond Index<sup>1</sup>) posted a 2.78% return for the month of March. There was performance dispersion across ratings and maturities for investment grade issuers. BBB-rated credit returned 2.74% for the month relative to A-rated credit at 2.68%. From a maturity standpoint, three-to-five-year maturities were up 1.79%, while 10+ year maturities were up 4.32%. Investment-grade spreads widened 14bps in March from 124bps to 138bps. During 2022, the average investment grade spread was 134 bps with a wide of 165 bps (10/12/2022) and a tight of 91 bps (1/5/2022). For context, the average investment grade spread during 2021 was 89 bps with a wide of 101 bps and a tight of 80 bps. At the sector level, the best performers were restaurants, wirelines, food & beverage, pharmaceuticals, and aerospace/defense, while life insurance, REITS, brokerage & asset managers, gaming, and airlines underperformed.

US short duration high yield (as measured by the ICE BofA 1-3 year BB-B Cash Pay High Yield Constrained Index)<sup>1</sup> returned 0.56% for March. During the month, the OAS for the index widened 51 bps to close at a level of 340 bps. Double B credits posted stronger performance than single B issuers in March as spreads widened less 32 bps while B's widened 71 bps. Translating spread widening to performance across the major ratings buckets for the short-dated high yield index, BB's were up 0.71%, while B's were up 0.40%. On a total return basis and for the broader high yield index, BB's were up 1.8%, B's were up 0.89%, and CCC's were down 1.32%. In March the best performing sectors were Restaurants (3.13%), Electric Utilities (2.83%), Lodging (2.74%), Home Construction (2.71%), and Supermarkets (2.61%). Laggards on a relative basis were Banking (-3.18%), Wirelines (-3.07%), Retailers (-1.48%), Pharmaceuticals (-1.32%), and Media Entertainment (-1.17%).

Emerging market sovereign bonds (as measured by the J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI Global Diversified)<sup>1</sup> and EM corporate bonds (as measured by the J.P. Morgan Corporate Emerging Markets Bond Index Diversified (CEMBI Diversified)<sup>1</sup> returned 0.96% and 0.78%, respectively, during March. Over the month, the OAS for the sovereign index widened by 37 bps to 484 bps and the corporate OAS widened 42 bps for the month to 367 bps. During the month, high yield issuers underperformed their investment grade counterparts. From a regional standpoint, issuers in Europe and Latin America outperformed those in the Middle-East, Asia, and Africa. Sovereign debt underperformed quasi-sovereign debt over the month. From a sector perspective, Transport, Industrial, and Metals & Mining were the best performing sectors. On the other hand, Real Estate, Financial, and Oil & Gas were the worst performing sectors. From a regional standpoint, issuers in Europe and Asia outperformed those in the Middle East, Africa and Latin America.

## Taxable fixed income market update

The investment-grade corporate bond market saw spreads move tighter over the last few weeks. The strength in the market was led by the banking sector where bank spreads tightened 17 bps from the wide we saw in late March (currently 167 bps from 184 bps). In addition, the investment grade yield has been hovering between 5%-5.20%, which has attracted investors into the asset class. The Fed raised the Fed funds rate 25 bps at the March 22 meeting, but implied only one more hike was likely before a pause would occur. This would put the terminal Fed funds rate between 5.0%-5.25%. Overall, the corporate bond market continues to be driven by a positive technical environment with cash inflows. With economic growth projections remaining positive and corporate fundamentals relatively stable, many investors still believe corporate bonds are attractive from both an income and total return perspective. The Bloomberg Investment Grade Corporate Index<sup>1</sup> is currently yielding 5.00%, which historically has been a very attractive entry point for long-term investors.

While banks aren't a big part of the US high yield universe, negative sentiment did spill over to the high yield market. Credit spreads widened by approximately 150bps as the SVB, regional banks and Credit Suisse stories were developing. Part of the pressure was driven by the sharp drop in treasury yields which leads to spread widening (flight to quality) as bond prices tend to be sticky. Over the last 2-3 weeks markets have settled down thanks to no new bank headlines hitting the tape. This has led investors to become more comfortable with the idea that a tail risk scenario seems less probable. Higher carry segments of the high yield market underperformed this month as investors shed risk. CCC and below underperformed higher quality credits while short duration high yield underperformed the broader high yield market. Spreads widened 36 bps in March from 418 bps to 454 bps which is slightly wide to the 2022 average of 427 bps. While we saw gappy spread moves in 2022, US High Yield continues to trade within its historical range relative to investment grade. The current spread difference between high yield and investment-grade is +295bp which is wide relative to the five-year average of +278bps. Worth noting, this historical average includes the pickup of +742 bps at the onset of the COVID-19 pandemic – without the COVID move, the pick-up is approximately +250bps.

Unlike investment grade, the high yield new issuance calendar has been relatively quiet and therefore supportive from a technical supply/demand standpoint. March new issuance volume was \$6.8bn. On a year-over-year basis, new issuance was down 33% from the \$10.2bn reported in March 2022. The high yield universe shrank by around 10% in 2022 driven by less new issue supply, down around 80% compared to last year, as well as a strong year for upgrades as rising stars outnumbered fallen angels by a ratio of 12:1. Our expectation for 2023 is for the high yield universe to shrink -10% driven by another anemic new issue calendar. Thus far we are on track with this expectation as first quarter US high yield new issuance is down 13% 1Q23 vs 1Q22. New issues continued to

<sup>1</sup>See last page for further information

trickle in but the theme, thus far since the start the year, has been smaller non-benchmark type names, lower quality, shorter maturity (generally 5 year versus the 8 year standard in our market) with high coupons.

While high yield fundamentals are likely to deteriorate going forward, investors should keep in mind we are normalizing off of an exceptional period. Interest coverage ratios are at record highs and leverage is at a decade low, so even in a weaker economy, these metrics provide some cushion. In addition, companies have made a lot of progress refinancing near-term maturities. By doing so, issuers have more breathing room to maneuver any difficulties ahead. It's not until 2025 that we see a pick-up in debt coming due. This is one of the main reasons why we expect default rates to remain manageable in the low 3% range compared to historical averages of 4.3%. That said, we believe volatility will continue and we expect dispersion amongst credits to increase, especially for lower quality credits as economic growth slows and uncertainty increases. Participants remain focused on down side risk and the implications for global growth. Volatility remains elevated with still heightened uncertainty around the Fed's ability to get inflation under control without a hard landing.

### **Taxable fixed income strategy**

Market expectations of Fed rate cuts have moved forward into the second half of 2023 as slower economic growth and recession probabilities have increased for this year. We continue to believe corporate bonds are attractive from both an income and total return perspective. As we get closer to the targeted fed funds rate, we have become more comfortable adding credit exposure for our active accounts.

In terms of sectors, we are overweight the financial sector, as we believe the sector offers attractive relative value. The creation of the Bank Term Funding Program, (BTFP), by the Fed provides additional liquidity to depository institutions to help assure that banks have the ability to meet the needs of all their depositors. We believe this is a positive driver for the financial sector. We are maintaining our overweight to US money center banks & large US regional banks. The banking sector has maintained solid fundamentals, and capital levels remain strong. We are, however, reducing exposure to Japanese banks as we are becoming more concerned over increasing evidence of inflation pressures, and increased interest rate volatility in Japan. We are overweight the utility sector as we added exposure to take advantage of attractive new issue

concessions. We remain underweight issuers that have poor ESG scores. We continue to have an underweight position in the industrial sector, but have added exposure in the energy, media, and chemical sectors. We are overweight the energy sector, as we believe China's decision to end the zero-Covid policy, and OPEC's decision to cut oil production will be supportive for the energy sector. We continue to have an overweight to the pipeline/midstream sector. We are maintaining an underweight in the technology sector, (regulatory risk & increased M&A risk). We are underweight the non-cyclical sector, but within the non-cyclical sector we continue to favor healthcare & pharmaceuticals. We have reduced our exposure in the food/beverage sector due to limited relative value opportunities. We remain overweight the telecom & cable sectors, and have added exposure to the media sector. The media space continues to recover with theme park, movie, and event attendance reporting strong increases yoy.

From a credit curve perspective, we continue to favor the short-end of the credit curve (2-4 yrs.), due to the Treasury curve being inverted, (currently the 2 year Treasury is 4.03% and the 10 year Treasury is 3.47%). We continue to look for opportunities in the belly of the credit curve (4-10 yrs.), and have a slight underweight to the long-end of the credit curve (10+ yrs.). We continue to take advantage of the new issuance calendar to add exposure into the portfolios with a focus on the financial sector and the utility sector.

In our high yield portfolios, from an industry perspective, we are seeing opportunities in financial services, leisure, and energy industries. From a ratings perspective, we have a quality bias with a focus on fundamentally-driven security selection. We are currently overweight BB-rated credit relative to B in our short duration high yield SMAs. We have been holding onto our rising stars as we still see them offering attractive risk adjusted returns. In terms of maturity focus, we have been investing primarily in the two-to-four-year part of the curve.

In our emerging market ladder portfolios, we have no direct exposure (sovereign, corporate and quasi-sovereign) to Russia or Ukraine. From a regional perspective, we are seeing attractive relative value opportunities in Latin America especially in markets such as Brazil, Mexico, Panama, Peru, Turkey and Uruguay. We continue to prefer sovereigns to quasi-sovereigns and corporates. Within corporates, we have allocations to the energy, basic materials and industrial sectors.

## Outlook

Fixed income investors continue to deal with elevated Fed uncertainty in terms of the timing and level of the terminal rate for Fed funds. At the start of April and looking out to year-end 2023, a divergent view for the Fed Funds terminal rate exists. The recently released Fed dot plot shows a consensus Fed Funds rate of 5.125%, while Fed Fund futures show that the market expects a terminal rate of 4.375% or an easing of approximately 100bps over the same time period. Regardless of the terminal rate, the market continues to believe we are

<sup>1</sup>See last page for further information

getting closer to the end of the Fed rate hiking cycle.

We remain encouraged yet cautious in credit markets. We remain steadfast in our premise that US rates are likely rangebound, hemmed in on either side by sticky inflation and yet a potentially deteriorating economic backdrop already showing material constraints from tightened conditions. While additional idiosyncratic events in the financial sector remain plausible, swift policy response measures that have lent to

relative tranquility in late March warrants further optimism. Economic data continued to paint a picture of consumer resilience with little evidence of imminent, severe recession, and along the same vein, the Atlanta Fed's GDP Nowcasts

released throughout the month continued to posit Q1 growth well-above 2%.

Municipal Fixed Income	Taxable Fixed Income	US Multi sector	SMA Fixed Income Advisory
<p><b>Charles Grande</b> Managing Director, Portfolio Manager, Head of Municipal Fixed Income</p>	<p><b>Craig Ellinger</b> Managing Director Head of Fixed Income, North America</p> <p><b>Matt Iannucci</b> Managing Director, Senior Portfolio Manager US High Yield</p> <p><b>David Vignolo</b> Executive Director, Senior Portfolio Manager US Investment Grade</p> <p><b>Robert Martin</b> Executive Director, Fixed Income Specialist</p> <p><b>Federico Kaune</b> Managing Director, Senior Portfolio Manager Emerging Market Fixed Income</p>	<p><b>Patrick Matijevich, CFA</b> Director, Portfolio Manager</p>	<p><b>Anthony Liotti</b> Managing Director, Head of SMA Fixed Income</p> <p><b>Steve Canter, CFA</b> Executive Director, Fixed Income SMA Advisory Specialist</p> <p><b>Neil Talbot</b> Executive Director, Fixed Income SMA Specialist</p>

<sup>1</sup>See last page for further information

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**The Bloomberg US Corporate Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

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**The ICE BofA 1-3 year BB-B Cash Pay High Yield Constrained Index** tracks the performance of non-investment-grade corporate bonds with a remaining term to final maturity less than three years and rated BB-B and limit individual issuer concentrations to 2%.

**J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI Global Diversified)** tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities. It limits the weights of constituent countries with larger debt stocks by only including specified of their debt outstanding.

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