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Domestic Investment Grade Fixed Income
Monthly Market Summary

August 2020

Treasury Market

Treasury yields rose over the past month in a bear steepening fashion as intermediate and longer-term rates increased more than short-term yields, reversing July's rally. Higher inflation expectations, optimism for a Covid-19 vaccine, and a formal shift in Fed policy objectives all contributed to the move. The Institute for Supply Management indicated greater expansion than expected in both the manufacturing and services sectors in July, the second consecutive month of growth following multiple months of contraction earlier in the summer. Increases in new orders helped boost both sectors of the economy while inventory readings declined. Meanwhile, initial jobless claims fell below 1.3 million for the first week since the pandemic-induced surge in March despite economist projections for a 1.4 million increase. However, these encouraging economic data points were initially offset by lack of progress in negotiations for additional relief measures, as a self-imposed deadline for Congressional leaders and White House officials to finalize a deal came and went. During the first few days of the month, Treasury yields drifted slightly lower, and the 10-year note touched a historic low yield of 0.50%. Shortly thereafter, yields pushed higher into the middle of the month. The Bureau of Labor Statistics reported an increase in nonfarm payrolls of nearly 1.8 million new jobs in July compared to expectations for fewer than 1.5 million. All major industries saw improvement with particularly large increases in pandemic-stricken sectors like leisure and hospitality as well as retail. Additionally, the unemployment rate moved lower than expected to 10.2%, and average hourly earnings rose 0.2% for the month versus an anticipated -0.5% change. Further potential indication of renewed pricing pressure came from the latest Consumer Price Index (CPI) report. Both the headline and core CPI rose 0.6% in July, exceeding projected increases of 0.3% and 0.2%, respectively. A large portion of the rise came from gasoline, apparel, and transportation prices. Notably, much of the strength was realized within categories that are rebounding from sharp decreases during the depths of the pandemic (e.g., airfare prices), which may be transitory rather than the start of sustained price pressures. The stream of better than expected economic data improved investor sentiment and caused yields to move higher. Additionally, optimism over a possible Covid-19 vaccine also grew as companies appeared ready to begin more stringent and comprehensive phase 3 trials with Russia even going as far as claiming success in developing the first vaccine. The combination of economic data and vaccine optimism pushed Treasury yields higher with a more pronounced increase in longer-term maturities. At around the middle of the month, the 10-year Treasury rate had risen 19 basis points to 0.72% compared to an increase of only 5 basis points to 0.16% for the 2-year Treasury note. Thereafter, yields trended lower as economic reports disappointed. Specifically, retail sales increased by only 1.2% in July, returning to pre-pandemic levels, but slower than an expected 2.1% month-over-month growth. Sentiment also showed signs of fading as regional manufacturing surveys within New York, Philadelphia, and Texas showed expansion but at a slower pace compared to the previous month. Additionally, consumer confidence, as measured by the Conference Board, fell to the lowest level since May 2014 with responses citing deteriorating business and employment conditions and a declining short-term outlook. After retracing roughly half of the yield increase that occurred through mid-month, the 10-year Treasury rate reversed course again, rising into month-end on higher inflation expectations and a revised monetary policy strategy from the Fed. Following a comprehensive review of strategies and tools that began in early 2019, the Fed outlined a different approach to achieving its dual mandate of 2% inflation and maximum employment. In comments during the central bank's Economic Symposium at Jackson Hole, Chairman Powell referenced "flexible average inflation targeting," which includes temporary overshoots of the 2% inflation target following periods of subdued pricing pressures. Furthermore, Chairman Powell's comments detailed how the Fed will view maximum level of employment, specifically that "a robust job market can be sustained without causing an outbreak of inflation," a concession that the oft-referenced Phillips curve has become increasingly flat and preemptive tightening may not be necessary. In short, revisions to both aspects of the Fed's dual mandate point to the central bank maintaining its near 0% funds rate for an extended period, anchoring short-term yields, while allowing inflation to potentially exceed the 2% target and steepening the Treasury yield curve going forward. This scenario played out in August, as Treasury rates increased 3-28 basis points with the greatest increases in longer maturities. The 10-year Treasury yield increased 18 basis points to 0.71% compared to the 2-year Treasury rate rising only 2 basis points to 0.13%. Income and continued credit strength offset a portion of the rise in benchmark rates, and the Bloomberg Barclays Intermediate Government Credit Index returned -0.12% in August.

Taxable Credit

Despite a spike in new issue supply, investment grade credit has continued to rebound from a dismal first quarter. Corporate bonds outperformed Treasuries by 28 basis points in August, the fifth consecutive month of alpha but the smallest amount of excess return over that time, led by BBB rated issuers and financial credits. Taxable municipal bonds, which are on pace for a record-setting supply year, provided greater alpha than corporate debt by outperforming Treasuries by 126 basis points in August.

Municipal Market

Municipal yields drifted higher in August, roughly mirroring the move of their taxable counterparts. The municipal yield curve steepened, as longer-term rates rose at a faster pace versus short-term yields given the Fed's newfound tolerance for an inflation overshoot above their 2% target level. While the 2-year AAA municipal yield increased only 3 basis points in August, the 10-year AAA municipal rate rose 16 basis points, resulting in a bear steepening of the curve to the most attractive term spread levels since May. August initially represented a continuation of July's price rally as a favorable technical environment pulled rates to historic lows by mid-month with the 10-year AAA municipal yield declining to just 0.58%. However, as Treasury yields rose thereafter on Fed guidance, tax-exempt yields eventually followed suit in a slow-and-steady manner with yields unchanged to slightly higher in each of the 15 trading sessions following the lows observed mid-month according to Bloomberg data. The summer reinvestment season provided a technical tailwind supported by continued healthy retail demand. According to Refinitiv Lipper weekly fund data, municipal funds added assets for sixteen consecutive weeks with August inflows totaling nearly $20 billion. Demand remained voracious despite budget concerns at the state and local government levels caused by the pandemic and growing apocalyptic warnings from pundits regarding municipal credit. In August, Barron's published a piece titled "Cities and States Are Facing Horrific Budget Holes. There Will Be More Trouble Ahead." The article paints a dire picture for municipalities across the country due to the pandemic citing "uncertain and horrific" revenue shortfalls and questioning "how many municipal bond issuers won't be able to repay investors?" but also acknowledging "the muni market on the whole remains a relatively safe port in the world of bonds." We expect low default rates within the investment grade municipal sector, as state and local governments have various levers to pull to offset sharp revenue declines such as tax hikes and debt issuance in addition to the Fed's Municipal Liquidity Facility backstop. Already faced with one of the worst financial conditions among the 50 states, New Jersey Governor Phil Murphy pushed forward with plans to issue $9.9 billion in municipal debt to fill their budget gap despite legal challenges from the governor's opposition. In August, the state's highest court upheld the New Jersey Covid-19 Emergency Bond Act, ruling that the pandemic qualifies as a "disaster" exception to the constitutional debt limitation clause. However, we still think uncertainty risk remains with potentially negative outcomes for weaker sectors and issuers to the extent this multi-month pandemic pushes the global economy into a deep and lengthy recession. As such, we continue to actively monitor portfolios from a top-down perspective, taking advantage of the low rate environment and strong demand in the municipal market by triaging higher risk sectors and issuers where appropriate. We are approaching the current credit environment with a defensive posture given the current uncertainty risk with compensatory return spreads highly variable based on the pandemic's duration and longer-term socioeconomic impacts. We remain "up-in-quality" in the core bond portfolio with a preference toward durable credits like pre-refunded debt, high quality state and county issues, local GOs less reliant on state aid and/or economically sensitive tax revenues, and essential service revenue bonds. However, we are monitoring for pockets of opportunity to offensively extend duration, particularly if negative headlines induce an outflow cycle. Heading into September, the summer reinvestment season appears set to dissipate with municipal net supply expected to turn positive based on JP Morgan data. Price weakness in Treasuries pushed municipal yields higher in August, resulting in the ICE BofA ML 1-12 Year Municipal Index posting a -0.15% total return for the month.

Maturity	AAA Muni 07/31/20	AAA Muni 08/31/20	Monthly Muni YTM Change	Treasury 07/31/20	Treasury 08/31/20	Monthly Treasury YTM Change	% of U.S. Govts. 08/31/20
2-Year	0.13%	0.16%	0.03%	0.11%	0.13%	0.02%	123.08%
5-Year	0.23%	0.26%	0.03%	0.21%	0.27%	0.06%	96.30%
7-Year	0.43%	0.48%	0.05%	0.38%	0.49%	0.11%	97.96%
10-Year	0.65%	0.81%	0.16%	0.53%	0.71%	0.18%	114.08%
15-Year	0.97%	1.15%	0.18%	0.70%	0.95%	0.25%	121.05%
20-Year	1.17%	1.36%	0.19%	0.97%	1.24%	0.27%	109.68%
30-Year	1.37%	1.56%	0.19%	1.19%	1.48%	0.29%	105.41%

Source: Bloomberg; Thomson Reuters