VERITABLE

Domestic Investment Grade Fixed Income Monthly Market Summary

September 2020

Treasury Market

Treasuries were virtually unchanged in September, as yields moved within a narrow range during the month despite equity market weakness, marginal credit spread widening, and a slight decrease in inflation expectations. The month began with a stronger than expected reading regarding the manufacturing sector as the Institute for Supply Management (ISM) survey indicated its third consecutive monthly growth, buoyed by new orders and production but remained relatively weak on employment. Meanwhile, the ISM survey for the services (non-manufacturing) sector also showed expansion for August but at a slower pace compared to July, as growth slowed for business activity and new orders while the employment component continued to contract. Other labor market reports were more encouraging, however, as weekly initial jobless claims unexpectedly fell below 900,000 for the first time since before the pandemic. Additionally, the Bureau of Labor Statistics reported that nonfarm payrolls increased by 1.37 million in August, slightly exceeding the 1.35 million average estimate, and the unemployment rate declined sharply from 10.2% to 8.4%, well below an anticipated 9.8% rate. All major industries saw an uptick in jobs with professional and business services as well as leisure and hospitality leading the way. Notably, the government sector added 344,000 jobs in August due mainly to hiring of temporary 2020 Census workers. The mostly optimistic economic data as well as Treasury supply overhang were offset by a selloff in equities, driven by tech stocks, that pulled 7+ year Treasury yields lower by 3-6 basis points. Inflation expectations, which had steadily risen from late April through August, moved slightly lower in September, also contributing to the slight move lower for longer-term rates. At the same time, the Consumer Price Index indicated a 0.4% increase for both the broad and core indices for August compared to 0.3% and 0.2% estimates, respectively. Used car and truck prices had the largest increase at 5.4% for the month, while apparel and energy-related commodities also had positive impacts. Over the last twelve months, headline inflation increased 1.3%. Market participants were also taking note of developments overseas as U.K. legislation aimed to break portions of the Brexit Withdrawal Agreement, which was met with stern response from the European Union and could result in a lengthy and uncertain legal process. By month-end, however, the two sides had reportedly made progress toward a resolution. Additionally, rising Covid-19 cases were sounding second-wave alarms throughout Europe with parts of the region headed into new lockdown restrictions. Despite the headlines, Treasury yields generally moved within a narrow range of a few basis points with rates on issues maturing within five years unchanged at the mid-month point, while yields on intermediate and longer-term issues were lower by around three basis points month-to-date. The Federal Reserve (Fed) also provided headlines but did little with respect to market impact. At its latest meeting, the Federal Open Market Committee (FOMC) left central bank policy unchanged and provided expectations that the benchmark funds rate will remain near-zero through at least the end of 2023. Additionally, the FOMC adopted explicit inflation-linked forward guidance, specifically stating that the funds rate will remain unchanged until there is “maximum employment and inflation has risen to 2% and is on track to moderately exceed 2% for some time.” While the Fed has targeted 2% annual inflation for some time, the central bank has also preemptively tightened monetary policy in the past to get ahead of inflationary pressures before they arrived, a mistake they seem committed to not repeat. The remainder of the month was similar in that equity weakness and lower inflation expectations failed to pull Treasury rates materially lower. Additionally, economic indicators were mixed, as retail sales grew at a slower than expected rate, consumer confidence improved but remains below pre-pandemic levels, while the housing market showed no signs of distress. In fact, new home sales hit the highest level since September 2006 in August, while pending home sales (i.e., under contract) rose to a record high level during the same month. Treasury rates were nearly unchanged across the curve in September. The 2-year yield was flat at 0.13%, 3-5 year rates increased one basis point, and 7+ year yields declined two basis points with the 10-year ending the month at 0.69%. Marginal credit spread widening offset income generation, and the Bloomberg Barclays Intermediate Government Credit Index posted a -0.01% total return in September, bringing the year-to-date return to 5.92%.

Taxable Credit

For the first time since March, investment grade credit failed to outperform Treasuries as weakness in broker-dealer issuers and the energy sector pushed credit spreads on broad corporate indices wider. Corporate bonds returned 46 basis points fewer than Treasuries with performance generally steady across the ratings spectrum. The Fed, which had placed dividend and share buyback constraints on large domestic banks in June, extended the restrictions through the end of the year. Banks are currently undergoing a second round of stress tests for 2020 given the unprecedented economic environment, the results of which will likely influence the central bank’s decision on future shareholder distributions. Similar to corporate debt, taxable municipal bonds underperformed Treasuries in September but to a lesser degree, falling short of government bonds by 27 basis points. Year-to-date excess return for the two segments are now virtually identical as both have underperformed Treasuries by nearly 400 basis points in 2020.

Municipal Market

Municipal yields were little changed in September, as short-term yields were anchored down by Fed policy while longer-dated rates moved slightly higher as net supply normalized from the summer seasonal reinvestment season. The front end of the municipal curve was supported by strong demand from investors seeking higher yields versus near-zero money market rates as well as from those seeking shelter against potential negative price volatility in longer-term maturities. The preference for short-term debt resulted in municipal outperformance in the 1-5 year maturity sector with 2-year AAA municipal and Treasury yields down 3 basis points and unchanged, respectively, to 0.13% for both. Meanwhile, longer-dated tax-exempt yields moved higher late in the month as the technical environment eased and retail demand decelerated, resulting in 7+ year tax-exempt rates rising 2-6 basis points compared to a 1-4 basis point decline in comparable Treasury yields. Accordingly, the yield curve steepened with the spread between 2-year and 10-year AAA municipal yields widening 9 basis points to 74 basis points, the highest term premium since the summer of 2018. Over the next few months, we are guarded against a bear steepening caused by longer-term yields rising due to higher inflation expectations and/or spreads widening from a negative sentiment shift as a result of renewed municipal credit concerns.

September initially kicked off as a continuation of August with the retail sector providing demand-side stability while new issue volume provided healthy tax-exempt bond supply. According to Lipper data, strong retail demand helped generate 19 consecutive weeks of municipal fund inflows totaling $42.1 billion before investors pulled $117 million out of these funds over the final week of September. We continue to monitor fund flows for a negative feedback loop, as a round of retail selling could be induced by factors such as election uncertainty, especially with the low rate environment offering little incentive to hold and brace for the fallout. The tax-exempt market was in a sideways-drifting stasis state for much of the month with municipal yields unchanged in 16 of the 21 trading sessions according to Refinitiv data. Specifically, the 10-year AAA municipal yield traded in a range of 2 basis points for the majority of the month before rising 4 basis points in the final day of September, ending the month 6 basis points higher at 0.87%. With the 10-year Treasury yield declining 2 basis points over the month to 0.69%, the relative yield ratio ended September at an attractive 126%. Municipal-specific credit risks and a strong bid for Treasuries should keep relative valuations elevated until COVID-19 uncertainty wanes upon which the relative cheapness should help cushion downward price volatility during flight-to-quality unwinds in the U.S. government bond market.

The summer reinvestment season provided a performance tailwind in July and August but reversed in September. Based on data compiled by JP Morgan, net supply is projected to remain in positive territory in October before returning to negative levels for the remainder of the year. Net supply could plunge deeper into negative territory if election uncertainty causes market volatility and a corresponding reduction in new issue volume. Longer-term, the presidential election could have a lasting impact on the value of the municipal tax exemption. Some factors that may result in a decline in municipal yields include, but are not limited to: an increase in the top marginal income tax rate, a rise in the corporate tax rate thereby increasing the attractiveness of municipals among banks and insurance companies, as well as a substantial fiscal stimulus package that offers timely federal aid to state and local governments that leads to improved credit fundamentals/tighter credit spreads. Factors that could push municipal yields higher include, but are not limited to: lack of a meaningful pandemic relief package for state and local governments that causes spread widening, repeal of the state and local tax (SALT) deduction, and an infrastructure plan that leads to greater municipal issuance. Against this uncertain backdrop, we are positioning core high-grade municipal portfolios defensively, but monitoring for pockets of opportunity to play offense. Within core high-grade fixed income portfolios, we remain on the higher-end of the credit scale preferring durable credits like pre-refunded debt, high quality state and county issues, local general obligation bonds less reliant on state aid and/or economically sensitive tax revenues, and essential service revenue bonds. Although the low yield environment offers much less than historical levels from an income generation perspective, high-grade municipals still offer portfolio ballast in terms of equity diversification (especially long duration) and capital preservation. For the month of September, the ICE BofA ML 1-12 Year Index was unchanged with a year-to-date total return of 2.97%.

Maturity	AAA Muni 08/31/20	AAA Muni 09/30/20	Monthly Muni YTM Change	Treasury 08/31/20	Treasury 09/30/20	Monthly Treasury YTM Change	% of U.S. Govts. 09/30/20
2-Year	0.16%	0.13%	-0.03%	0.13%	0.13%	0.00%	100.00%
5-Year	0.26%	0.26%	0.00%	0.27%	0.28%	0.01%	92.86%
7-Year	0.48%	0.50%	0.02%	0.49%	0.47%	-0.02%	106.38%
10-Year	0.81%	0.87%	0.06%	0.71%	0.69%	-0.02%	126.09%
15-Year	1.15%	1.20%	0.05%	0.95%	0.91%	-0.04%	131.87%
20-Year	1.36%	1.41%	0.05%	1.24%	1.23%	-0.01%	114.63%
30-Year	0.16%	0.13%	-0.03%	0.13%	0.13%	0.00%	100.00%

Source: Bloomberg; Refinitiv