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Domestic Investment Grade Fixed Income Monthly Market Summary

October 2020

Treasury Market

The Treasury yield curve shifted higher in a bear steepening fashion in October on rising inflation expectations despite signs of resurging COVID-19 infections later in the month. Specifically, 2-3 year rates increased roughly 3 basis points while 7+ year yields rose 17-20 basis points. Economic data initially disappointed, as the Institute for Supply Management (ISM) survey indicated growth in the manufacturing sector for September but at a slower rate compared to both expectations and August activity. Specifically, the new orders and production subsets both showed slowing expansion. The labor market also underwhelmed, as the Bureau of Labor Statistics (BLS) reported that 661,000 jobs were created in September, well below estimates of 859,000, and the unemployment rate declined to 7.9%. Retail trade as well as the leisure and hospitality sector led the job gains, a clear sign that the U.S. economy continues to move towards normalcy. However, after adding more than 3 million total jobs in July and August, the September jobs number indicates a slowing in the recovery process to bring back the more than 22 million jobs lost at the pandemic's onset. In total, 10.8 million jobs have been added back into the economy since April according to BLS monthly releases. Contrary to the manufacturing segment, the service sector of the economy grew at a greater rate than expected in September, according to the ISM. Business activity, new orders, and employment subsets helped drive the overall index higher. In other news, the coronavirus pandemic reached and spread throughout White House staff, as President Donald Trump and First Lady Melania Trump both contracted COVID-19 with the Commander-in-Chief hospitalized for several days. Despite the hospitalization and speculation concerning President Trump's health, financial markets largely shrugged off the news as he returned to the White House a few days later. Optimism surrounding a possible fiscal stimulus deal, which Federal Reserve (Fed) members continued to publicly clamor for, and polls indicating the increased likelihood of a Democratic blue wave election sweep, helped push intermediate and long-term Treasury yields higher with the 10-year rate rising 10 basis points to 0.79%. However, over the subsequent week, prospects for a pre-election fiscal stimulus package faded as House Speaker Pelosi demanded the White House revamp its latest offer while Senate Republican leader McConnell continued to offer small and piecemeal deals that Democratic leadership rejected, reversing half of the previous week's yield rise. On the inflation front, the Consumer Price Index for All Urban Consumers (CPI-U) and the index for all items less food and energy matched market estimates, each increasing 0.2% in September. Core goods increased 0.8% with the index for used cars and trucks jumping 6.7%, the largest monthly increase since 1969. Meanwhile, the housing component ("shelter" includes rent of primary residence and owners' equivalent rent of residences) increased just 0.1% for the second consecutive month. The producer price index was subsequently released with the index for final demand advancing 0.4% in September compared to expectations of a 0.2% increase, as input pricing pressures have started to trend higher. Consumer spending continued to rebound as well with retail sales rising 1.9% in September, easily outpacing the 0.8% estimate and materially higher than growth from July and August. The tug of war between political parties over fiscal policy continued with sentiment again shifting in a positive direction as a pre-election stimulus package once again gained traction, pushing Treasury yields and inflation expectations higher. The front-end of the curve remained relatively stable, but the 10-year rate rose to 0.86%, higher by 17 basis points for the month. Market-implied inflation projections rose to 1.76%, nearly matching the highest level in more than a year. The final week of the month brought heightened concerns over COVID-19 infections. In Europe, government officials imposed new lockdown restrictions in England, France, and Belgium. Domestically, the U.S. reached record high single day cases with 14 states hitting COVID-19 infection peaks according to Bloomberg News. Additionally, the coronavirus spread, hitting the Midwest region hardest in terms of new daily cases, resulted in the most COVID-19 hospitalizations nationwide since mid-August. Concerns over the latest pandemic wave sent risk assets tumbling. The S&P 500 index declined nearly 6%, and oil plunged 11% over the final few days of October. While Treasuries initially rallied in a flight to quality move, they reversed course over the final two days with yields reaching their highest respective levels for the month. Anchored by Fed policy, short-term Treasury rates rose roughly 3 basis points with the 2-year ending October at 0.16%. Meanwhile, the 5-year yield increased 11 basis points to 0.39%, and 7+ year rates moved 17-20 basis points higher due to rising inflation expectations with the 10-year yield ending the month at 0.88%, the highest level since early June. Despite higher volatility and supply, credit spreads tightened slightly in October, helping to offset a portion of the weakness from higher intermediate and long-term benchmark rates. The Bloomberg Barclays Intermediate Government Credit Index earned -0.22% in October, reducing the year-to-date total return slightly to 5.69%.

Taxable Credit

Corporate bonds overcame higher volatility in the financial markets and increased supply to outperform Treasuries by an impressive 104 basis points even with the end-of-month weakness in risk assets. Outperformance was realized across the ratings spectrum, but BBB issuers provided 120 basis points of excess return compared to 88 basis points for more highly rated credits. Meanwhile, taxable municipal bonds were unable to overcome the same headwinds and lagged Treasury performance, providing -25 basis points of excess return for the month, as the sector continues to see elevated supply due to the low absolute yield environment and advanced refunding restrictions in the tax-exempt market.

Municipal Market

Municipal yields moved higher in October, lifted by weakness in Treasuries primarily on heightened expectations of a Democratic sweep of the election leading to sizable fiscal stimulus. In sympathy with their taxable counterparts, tax-exempt yields rose 4-9 basis points across the curve, outperforming in all maturities except the front-end of the curve. Generally, strong demand overcame heavy supply pressures, as state and local governments rushed to the market ahead of potential post-election volatility. In fact, according to Refinitiv data, municipal new issue volume totaled $65.2 billion in October, the second highest monthly issuance on record. Municipal investors preferred the short-intermediate part of the curve for yield enhancement over paltry front-end rates, as the 5-year municipal yield rose only 4 basis points in October compared to an 11 basis point increase in the comparable-maturity Treasury rate. Accordingly, the 5-year AAA municipal-to-Treasury yield ratio declined to just 77%, the lowest level since mid-August. Although the Treasury curve steepened with Fed monetary policy continuing to anchor short-term rates while longer-term yields rose, the municipal curve bear flattened in October led by weakness in the front-end. The term spread between 2-year and 10-year Treasuries widened 16 basis points to 72 basis points, while the municipal term spread tightened 2 basis points to 72 basis points. Despite gyrating Treasury yields and a surge in municipal new issue volume, the tax-exempt market exhibited remarkable stability throughout the month with rates unchanged in 10 of the 21 trading sessions, according to Refinitiv data. The heavy new issue supply was met with healthy demand with investors adding more than $3.5 billion to municipal funds in October, according to Lipper data, as the outflow experienced over the final week of September failed to induce a selling cycle amid election uncertainty. To close the year, net supply could provide a performance tailwind, as new issuance is projected to fall short of coupon and principal payments by around $14 billion, according to JP Morgan data. The election could be a source of price volatility over the final quarter of the year and could shift the supply-demand dynamic over the longer-term. Full Democratic control of Congress and the presidency could lead to a substantial fiscal stimulus package with sizeable federal aid to state and local governments, leading to improved credit fundamentals and tighter credit spreads but could also result in upward rate pressure via greater Treasury supply and higher inflation expectations. In addition, portions of the Tax Cuts and Jobs Act may be repealed, including the $10,000 cap on state and local tax (SALT) deductions, which has buoyed investor demand for tax-exempt debt especially from investors who reside in high-tax states such as California and New York. Furthermore, individual income and corporate tax rates would likely rise under a blue wave government, increasing the attractiveness of municipal bonds, but aggregate tax hikes may be a headwind for risk assets and lead to a flight to safety. Meanwhile, a divided government with split Congressional control could lead to a scaled-down fiscal stimulus package, placing downward price pressure (i.e., higher credit spreads) on vulnerable municipal credits but with less Treasury supply-induced weakness. State and local governments have various levers to pull in order to offset sharp pandemic-induced revenue declines. In addition to utilizing rainy-day funds and federal aid, states can implement spending cuts, raise taxes, issue debt, and/or even suspend their annual pension contributions until revenues stabilize. For the full month, price weakness in Treasuries spilled over to the municipal market. Despite municipal relative outperformance, the ICE BofA Merrill Lynch 1-12 Year Municipal Index declined 0.18% in October (+2.78% year-to-date), the worst monthly performance since April.

Maturity	AAA Muni 09/30/20	AAA Muni 10/31/20	Monthly Muni YTM Change	Treasury 09/30/20	Treasury 10/31/20	Monthly Treasury YTM Change	% of U.S. Govts. 10/31/20
2-Year	0.13%	0.21%	0.08%	0.13%	0.16%	0.03%	131.25%
5-Year	0.26%	0.30%	0.04%	0.28%	0.39%	0.11%	76.92%
7-Year	0.50%	0.58%	0.08%	0.47%	0.64%	0.17%	90.63%
10-Year	0.87%	0.93%	0.06%	0.69%	0.88%	0.19%	105.68%
15-Year	1.20%	1.28%	0.08%	0.91%	1.11%	0.20%	115.32%
20-Year	1.41%	1.49%	0.08%	1.23%	1.43%	0.20%	104.20%
30-Year	1.62%	1.71%	0.09%	1.46%	1.66%	0.20%	103.01%

Source: Bloomberg; Refinitiv