Domestic Investment Grade Fixed Income
Monthly Market Summary

December 2020

Treasury Market

A tumultuous year ended with the Treasury yield curve steepening slightly in December as renewed optimism for an economic recovery buoyed by the start of COVID-19 inoculations helped push inflation expectations as well as intermediate and long-term rates higher. Specifically, yields on maturities beyond five years rose 3-8 basis points while rates on shorter issues were flat to slightly lower. The month began with a sharp increase in longer-term rates due to a confluence of developments. Fiscal stimulus talks that had stalled throughout the fall resurfaced with a bipartisan group of senators reportedly discussing a $900 billion plan. Further, Fed Chairman Powell displayed a brief and rare optimistic tone during comments to the Senate Banking Committee. Specifically, he characterized the economy as “more resilient” than expected to COVID-19 spikes before adding the caveat that “we do have a long way to go” and noting the large number of people that remain unemployed. Also optimistic was Vice President Pence, who serves as Head of the White House’s Coronavirus Task Force, stating that COVID-19 vaccine distribution would likely begin before Christmas. These factors pushed 5+ year Treasury yields higher by 6-10 basis points on the first day of the month with longer rates increasing the most. Meanwhile, economic data was generally benign, particularly with respect to market impact. The Institute for Supply Management (ISM) indicated expansion in both the manufacturing and service sectors of the economy for November, the sixth consecutive month of growth. However, the survey also showed that employment contracted within manufacturing, as the ISM noted that absenteeism and short-term shutdowns “are causing strains that will likely limit future manufacturing growth potential.” Indicative of labor market challenges was the Bureau of Labor Statistics’ (BLS) report that only 245,000 jobs were created in November, the fewest since the recovery began in May and well below estimates for 460,000. In fact, the pace of job creation has slowed each of the past five months, a concerning trend given that 9.8 million of the 22.2 million jobs that were lost in March and April have not yet returned according to BLS data. Politicians continued to garner headlines as prospects for fiscal stimulus in the U.S. faded once again, and Brexit negotiations fell apart with U.K. Prime Minister Boris Johnson stating that Britain could call off talks with just three weeks until departure from the European Union (EU). Meanwhile, the European region also grappled with surging COVID-19 cases, leading the European Central Bank (ECB) to approve an expansion of bond purchasing authority, adding €500 billion to the existing program; however, ECB President Lagarde stated that the incremental amount may not be deployed in full. Domestically, virus cases also grew at an alarming rate as a feared post-Thanksgiving surge started to emerge and resulted in a return of restrictions in many states across the country. Additional assistance in the fight against COVID-19 came shortly thereafter, as vaccinations started to be administered in the U.S. While U.S. government officials set a goal to have 20 million people receive the initial dose prior to year-end, the Centers for Disease Control and Prevention estimated that only 3 million had been administered by the close of December. Despite lack of fiscal aid and a resurgence of COVID-19 infections, risk assets continued to perform well amidst relatively low volatility and optimism that the vaccine will soon result in a return to more normalized conditions. That trend continued through year-end due to other positive developments. At their December meeting, the Fed made no changes to monetary policy and vowed to maintain the current $120 billion of monthly bond purchases until it sees “substantial further progress” in both employment and inflation, continuing to set a high bar to reduce accommodative measures. Further, a Brexit deal for an amicable split that appeared dead was revived, and the U.K. and EU agreed to terms on a trade agreement that avoided a hostile breakup just days before the separation. Finally, the long and winding path to a second fiscal aid package reached a conclusion but not without a couple of final twists. Shortly after Congress approved a bill that included $900 billion of pandemic-related relief, President Trump surprisingly called the legislation a “disgrace,” demanding larger stimulus payments for individuals and the elimination of what he deemed “wasteful and unnecessary items.” The shocking development was further complicated by the fact that the package also included $1.4 trillion to fund government operations without which a partial shutdown would begin in less than a week. While Democrats attempted to seize upon the President’s call for $2,000 stimulus payments to individuals compared to the $600 provided in the bill, Republican members of Congress were unrelenting. With a standoff yielding no additional progress, President Trump abruptly reversed course and signed the legislation into law. After the initial advance higher, Treasury yields moved in a narrow range throughout the remainder of the month, and the curve bear steepened slightly as 5+ year rates rose 3-8 basis points in December while shorter yields were largely unchanged.

Treasury Market (continued)

The 10-year Treasury rate ended 2020 at 0.92%, having declined 100 basis points on the year, while the 2-year yield fell 145 basis points in 2020 to 0.12%. Intermediate-term inflation expectations continued to rebound following a March pandemic-induced low of 0.55%, ending the year at 2%, matching the Fed's targeted price level and the highest implied outlook in more than two years. In December, the Bloomberg Barclays Intermediate Government Credit Index returned 0.21% as income and credit spread tightening offset higher benchmark rates. For the year, the index posted a total return of 6.43%.

Taxable Credit

The credit market continued to perform well in December, as low volatility and optimism surrounding vaccinations caused spreads to grind tighter. Investment grade corporate bonds outperformed Treasuries by 87 basis points for the month, pushing the class into the green for the year with 54 basis points of alpha over government bonds in 2020. Lower rated BBB issues again provided the most excess return at 112 basis points over Treasuries compared to 61 basis points for more highly rated corporates; however, the latter earned slightly more alpha for the year at 56 basis points compared to 51 basis points for BBB. Taxable municipal bonds also performed well in December, as the significant 2020 new issue supply that was a headwind to performance earlier in the year dissipated over the final two months. Specifically, taxable municipals outperformed Treasuries by 164 basis points in December but underperformed government bonds by 76 basis points for the year, largely due to the supply uptick which was driven by the sharp decline in absolute rates as well as the inability for municipalities to refinance higher rate issues with tax-exempt debt via an advance refunding.

Municipal Market

Municipal yields were little changed in December, falling just 1-2 basis points across the curve with the yield spread between 2-year and 10-year AAA municipals unchanged versus last month at 57 basis points. Despite only a modest rally, tax-exempt debt outperformed its taxable counterparts in all maturities of greater than 2 years, depressing municipal-to-Treasury yield ratios back to pre-pandemic levels for maturities of 5 years or more. The 5-7 year relative value measure slipped to the low-60% range while 10+ year yield ratios slid into the high-70% to mid-80% range. Despite the low absolute yields, less attractive relative valuations, and fiscal aid uncertainty, investors continued to pour cash into the municipal market throughout the month. According to Lipper data, weekly reporting municipal funds experienced inflows of more than $5 billion during the month. The result was a strong bid side in December, a month that can occasionally be susceptible to year-end selling pressures. On the supply side, while rebounding from a sharp drop in November, primary volume for the month declined versus last December with new money issuance dipping 10.7% and refunding deals declining 46.2%, according to Refinitiv data. The lack of significant price volatility during the month was evidence of the healthy bid side support, as yields were unchanged in 18 of 22 trading sessions. The overall market stability was notable in the context of continued uncertainty with respect to fiscal stimulus. Throughout the month, members of Congress debated a second round of fiscal stimulus, the passage of which swung from inevitable to dead on arrival during December before an agreement was ultimately reached at the end of the year. Despite what were described as "tragic" consequences of a Congressional failure to offer additional economic support to the public according to Fed Chair Jerome Powell, municipal investors barely blinked as legislation was debated. Further, investor appetite persisted despite ongoing uncertainty heading into the early-January Georgia Senate run-off elections, which will ultimately tip the balance of power in the Senate and will likely determine how much of President-elect Biden's platform can be enacted. A Democratic victory would likely pave the way for large and much-needed fiscal stimulus via direct federal aid to state and local governments, which is a positive for municipal credit spreads, as well as new tax proposals, including the restoration of the top marginal tax rate to a pre-Tax Cuts and Jobs Act rate of 39.6%. With municipal-to-Treasury yield ratios at richer levels versus last month, albeit near equilibrium fair value, benchmark municipals will likely be more highly correlated to the Treasury market. In the near-term, however, yield ratios should remain supported by seasonally light supply and elevated reinvestment demand ("January Effect") but are at risk of reflating if investor appetite wanes due to idiosyncratic issues or a rotation into risk-assets ensues. In fact, according to JP Morgan data, net supply is projected to dip to -$13 billion in January and February before flattening in March. For the month, the 10-year AAA municipal yield declined 1 basis point to close the year at 0.71%. Municipal debt outperformed Treasuries in December, as the ICE BofA 1-12 Year Municipal Index posted a total return of 0.42% thanks to the strong technical environment. After experiencing sharp losses in March due to the pandemic, the municipal index rebounded thereafter, posting a solid total return of 4.02% for the year.

Maturity	AAA Muni 11/30/20	AAA Muni 12/31/20	Monthly Muni YTM Change	Treasury 11/30/20	Treasury 12/31/20	Monthly Treasury YTM Change	% of U.S. Govts. 12/31/20
2-Year	0.15%	0.14%	-0.01%	0.15%	0.12%	-0.03%	116.67%
5-Year	0.23%	0.22%	-0.01%	0.36%	0.36%	0.00%	61.11%
7-Year	0.42%	0.40%	-0.02%	0.61%	0.65%	0.04%	61.54%
10-Year	0.72%	0.71%	-0.01%	0.84%	0.92%	0.08%	77.17%
15-Year	0.99%	0.97%	-0.02%	1.05%	1.13%	0.08%	85.84%
20-Year	1.19%	1.17%	-0.02%	1.36%	1.44%	0.08%	81.25%
30-Year	1.41%	1.39%	-0.02%	1.57%	1.65%	0.08%	84.24%

Source: Bloomberg; Refinitiv