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Domestic Investment Grade Fixed Income Monthly Market Summary

January 2021

Treasury Market

For the second consecutive month, the Treasury curve bear steepened as intermediate and long-term yields increased due to economic recovery optimism and rising inflation expectations, while the short-end remained anchored by accommodative Federal Reserve (Fed) monetary policy. The Institute for Supply Management (ISM) surveys indicated that both the manufacturing and service sectors of the U.S. economy expanded for the seventh consecutive month in December and did so at a greater than expected pace. However, the immediate manufacturing outlook may be peaking as the ISM statement noted that survey members continue to report that operating in reconfigured factories with absenteeism and short-term shutdowns to sanitize are “causing strains that are limiting manufacturing growth potential.” Last month, we commented that while the labor market continued to add jobs, the pace of creation had slowed during each of the past five months with November’s 245,000 increase to payrolls representing the fewest since the recovery began in May with nearly 10 million jobs lost due to the pandemic still having not returned. That concerning trend got even worse in December, as the economy lost 140,000 jobs during the month compared to expectations for an increase of 50,000 payrolls. Not surprising given the reinstatement of COVID-19 related restrictions on restaurants and bars in various parts of the country, the leisure and hospitality sector (-498,000 jobs) pulled the overall number lower in a report that was otherwise encouraging. Other COVID-19 sensitive sectors like retail (+121,000 jobs), construction (+51,000 jobs), and manufacturing (+38,000 jobs) were accretive, providing optimism beyond the headline number. The most significant development of early January was the Georgia Senate run-off elections in which the Democratic candidate won both seats, resulting in an even split in the chamber with Vice President Harris holding tie-breaking votes. Having already reclaimed the presidency and retained majority of the House of Representatives in November, the results provided the Democratic party with control of all three branches of government, albeit by a slim margin. The development pushed Treasury yields sharply higher, as investors projected more expansive fiscal stimulus and repriced expectations for inflation and near-term growth. Higher recovery optimism also led to greater speculation of central bank monetary policy change, specifically regarding the size and composition of bond purchases, which also pressured intermediate and long-term rates. Meanwhile, President Trump’s insistence of an unfair election and tensions associated with such claims came to a head with an insurrection as Congress convened to certify election results. While images of citizens breaching security and gaining access to the Capital building were surreal, financial markets remained calm as President Trump finally toned down the rhetoric and promised a peaceful transfer of power. Through nearly mid-month, 5+ year Treasury yields rose 15-24 basis points with the 10-year note reaching 1.15%, the highest since March. The swell of positive sentiment reached a crescendo, however, and rates trended lower for the remainder of the month as Fed comments, fiscal policy uncertainty, and pandemic concerns (e.g., vaccine distribution challenges) pulled yields slightly lower from intra-month highs. In a discussion sponsored by Princeton University, Fed Chairman Powell downplayed the potential for a near-term reduction in bond purchases, stating “now is not the time to be talking about it [bond tapering],” while adding, “The economy is far from our goals.” At its late January Federal Open Market Committee meeting, the central bank unsurprisingly left policy unchanged but downgraded its assessment of the economy and labor markets, stating the recovery had “moderated in recent months.” As then President-Elect Biden neared inauguration day, he released details of a $1.9 trillion fiscal stimulus proposal that included, among other things, $1,400 direct payments to individuals, $400 per week supplemental unemployment benefits, $350 billion of aid for state and local governments, and a minimum wage increase to $15 per hour. Political pundits and market participants questioned the ability to pass this ambitious piece of legislature, particularly since some portions would require 60 votes in the Senate, with the possibility of a delayed or watered-down final version. Meanwhile, the fight against COVID-19 continued as new and more contagious variants ripped through parts of Europe and South Africa and eventually landed in the U.S. Domestic vaccination efforts also continued to pose challenges meeting strong demand. Treasury yields declined 5-9 basis points over the latter half of the month, offsetting a portion of the earlier rise. Overall, the yield curve steepened with the 5-year rate rising six basis points to 0.42% while the 10-year yield increased 15 basis points to 1.07%. The Bloomberg Barclays Intermediate Government Credit Index posted a -0.28% total return in January as income was not enough to overcome the increase in benchmark rates.

Taxable Credit

Despite the slight risk-off sentiment at month-end when global equities declined 4% during the final week, credit markets held up well in January. The fact that corporate bond spreads, now tighter than both pre-pandemic and historical average levels, did not quickly widen at the first sign of potential weakness is quite notable. Overall, corporate bonds marginally outperformed Treasuries by 10 basis points with BBB rated issuers leading the way. Taxable municipal bonds, which underperformed in 2020 due to a supply headwind, provided 190 basis points of alpha in January as spreads tightened given the relative value compared to corporate debt at year-end.

Municipal Market

Municipal yields were little changed in January despite the reflation-related sell-off in the Treasury market, ranging from a decline of 3 basis points in the front-end to a rise of 2 basis points in the longer-end of the curve. Municipal debt outperformed its taxable counterparts in every maturity with performance supported by the January Effect, characterized by seasonally light supply and robust demand, and fiscal stimulus hopes with a Democratic sweep in Washington D.C. January traditionally represents a period of technical strength for tax-exempt bondholders as issuers slowly reemerge from their holiday slumber only to be confronted by a wave of strong reinvestment demand via principal and interest payments recycled back into the municipal market. As evidence of the seasonally strong technical environment, the ICE BofA 1-12 Year Municipal Securities Index has provided a positive monthly return in 9 of the last 10 Januarys. Over the first month of the year, reinvestment capital totaling $27 billion faced tax-exempt new issuance of just $18.7 billion, 19.4% lower than January 2020 according to JP Morgan research, creating a negative net supply environment. In addition to seasonal demand support, tax-exempt debt also encountered voracious appetite from retail investors via mutual fund purchases. According to Refinitiv Lipper weekly fund data, inflows into municipal bond funds totaled nearly $9 billion in January including $2.8 billion over the final week, the 12th consecutive week of inflows and the second largest weekly inflow on record. Despite many municipalities experiencing sharp revenue declines due to the pandemic, investors are increasingly confident in the likelihood of ample fiscal stimulus for state and local governments to help bridge the gap until the vaccine is widely distributed. In addition, state and local governments continue to pull various levers in order to offset budget shortfalls such as utilizing rainy-day funds and implementing spending cuts. According to an analysis from Bloomberg, to prepare for budget shortfalls, state and local governments have eliminated more than 1.3 million jobs since March, and public employees represent the smallest share of working Americans since 1966. The municipal supply-demand imbalance resulted in a further collapse of relative valuations across the curve. While the 10-year Treasury yield rose 15 basis points in January as the recovery trade gathered momentum, the comparable maturity AAA municipal yield ticked up by only 1 basis point to 0.72%. As a result, the 10-year relative valuation collapsed below 70% to just 67.3%, the lowest level in the two decades since Bloomberg began tracking the data. Indicative of the rich municipal-to-Treasury yield ratios, the relative value metric fell to the lowest point on record for each maturity of 5 years or longer as price weakness in longer-term Treasuries failed to disrupt the strength in municipals. As for term premium, while the 2-year and 10-year Treasury yield spread widened 16 basis points to 96 basis points in January, the widest spread at month-end since April 2017, the comparable AAA rated municipal yield spread rose merely 4 basis points to 61 basis points. Despite the stretched valuations, the supply-demand imbalance will likely continue in February, as JP Morgan estimates monthly reinvestment capital of $33 billion (+6 billion versus January) and another month of negative net supply before normalizing in March. For the year, net supply is forecasted at -$50 billion (-$7 billion in 2020) with the brunt of supply-demand imbalance over the summer months. However, we are monitoring for a potential supply surge if tax-exempt advance refunding deals are reinstated as part of President Biden's tax plan. Although the technical environment appears supportive in the near-term, municipal investors will likely have to navigate several potential headwinds including rate fatigue at expensive valuations, a further rise in benchmark Treasuries, and a potential supply surge due to expansive infrastructure spending. Buoyed by the tailwind of the January Effect despite rising benchmark Treasury yields, municipal debt continued its strong performance for the month of January, as the ICE BofA 1-12 Year Municipal Securities Index posted a 0.44% total return.

Maturity	AAA Muni 12/31/20	AAA Muni 01/31/21	Monthly Muni YTM Change	Treasury 12/31/20	Treasury 01/31/21	Monthly Treasury YTM Change	% of U.S. Govts. 01/31/21
2-Year	0.14%	0.11%	-0.03%	0.12%	0.11%	-0.01%	100.00%
5-Year	0.22%	0.22%	0.00%	0.36%	0.42%	0.06%	52.38%
7-Year	0.40%	0.41%	0.01%	0.65%	0.76%	0.11%	53.95%
10-Year	0.71%	0.72%	0.01%	0.92%	1.07%	0.15%	67.29%
15-Year	0.97%	0.99%	0.02%	1.14%	1.32%	0.18%	75.00%
20-Year	1.17%	1.19%	0.02%	1.44%	1.64%	0.20%	72.56%
30-Year	1.39%	1.38%	-0.01%	1.65%	1.83%	0.18%	75.41%

Source: Bloomberg; Refinitiv

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