Domestic Investment Grade Fixed Income
Monthly Market Summary

February 2021

Treasury Market

The bear steepening of the Treasury yield curve, in which longer-term rates increase more than shorter-term, not only continued but accelerated in February as reopening efforts, vaccine distribution improvements, and prospects of additional fiscal stimulus buoyed optimism for economic growth. For the month, 5+ year Treasury rates increased 30-40 basis points with the 10-year yield reaching an intra-day high of 1.61% before ending February at 1.41%. By comparison, 2-year and shorter issues were virtually unchanged while the 3-year rate rose a relatively modest 11 basis points as investors began questioning the longevity of the Fed's highly accommodative policy if growth and inflation outlooks improve. The month began with encouraging economic indicators and sentiment. The Institute for Supply Management (ISM) reported that while manufacturing sector activity cooled slightly in January, the overall index level remains near the high of the past three decades, and the employment subset indicated expansion for the second consecutive month. Meanwhile, the services sector of the economy indicated accelerated growth in January according to the ISM, easily exceeding market expectations on improvements from subdivisions such as new orders as well as employment, which rebounded to strong expansion after indicating contraction in December. Additionally, qualitative assessments were decidedly positive as well, further evidence of growing economic optimism. Despite signs of improvement from the ISM regarding employment, the Bureau of Labor Statistics reported that the labor market continued to stall in January, adding only 49,000 jobs compared to expectations for 105,000. Furthermore, December's jobs numbers were revised lower as the U.S. economy lost 306,000 jobs compared to a loss of 140,000 jobs in the month's initial release. Despite the weak employment headline, investors generally attributed the stall, particularly declines in the leisure and hospitality segment, to COVID-19 related restrictions put in place during the holiday season extending into the new year with expectations of improvement in the spring and summer months. Market optimism continued to push global equity prices as well as intermediate and long-term bond yields higher. Additionally, 10-year inflation expectations reached 2.25% around mid-month, the highest level since August 2014 according to the Treasury Inflation Protected Securities (TIPS) market. Despite this inflation outlook, actual pricing pressures remain muted as the Consumer Price Index rose just 1.4% in January compared to one year ago as the pandemic's impact continues to hold down core inflation. At roughly mid-month, Treasury yields had drifted higher by 7-19 basis points, but the move accelerated toward month-end due in part to momentum-driven investors and convexity-hedging. Specifically, the 10-year Treasury yield reached as high as 1.61% during peak selling pressure, a 54 basis point month-to-date move. Negative sentiment also seeped into the 3-year rate, which rose from 0.20% mid-month to as high as 0.39% on speculation that Fed policy could tighten sooner than previously projected. This also represented a turning point in the TIPS market which had been spared from year-to-date weakness to that point, as the increase in intermediate and long-term rates was accompanied by a corresponding increase in inflation expectations, leaving TIPS real yields virtually unchanged in 2021. However, over the final two weeks of February, TIPS real yields moved higher in near lock-step with nominals, pushing the 10-year TIPS yield higher by nearly 30 basis points. Equity markets also reacted to the accelerated move in global bond yields, pulling the S&P 500 index down from an all-time high reached in the middle of the month. While February is one of only four months without a Fed meeting this year, Federal Open Market Committee members certainly took notice of the move in Treasury yields. Chairman Powell continued to pledge support of the economy in the form of a near-0% funds rate as well as bond purchases during his semiannual testimony to the Senate Banking Committee, stating that the economy still has a long path to maximum employment and sustained 2% inflation. The bond market reversed course following remarks from the Fed Chair, pulling yields down from their fresh highs. After a turbulent month that was driven more on sentiment and momentum than specific data points or news, the intermediate and long portions of the Treasury yield curve were 30-40 basis points higher with the 10-year ending February at 1.41%, an increase of 49 basis points year-to-date. Meanwhile, the 2-year rate remains virtually unchanged at 0.13%, resulting in the steepest curve since late 2016. As a result of the rise in benchmark yields, the Bloomberg Barclays Intermediate Government Credit Index returned -0.82% in February, declining for the second consecutive month.

Taxable Credit

Investment grade credit continued to perform well relative to Treasuries in February. Corporate bonds outperformed government debt by 68 basis points despite posting negative absolute returns due to the rise in benchmark Treasury yields. The entire ratings spectrum provided alpha as optimistic sentiment regarding the economy resulted in credit spreads grinding tighter. However, lower quality BBB rated issuers were the strongest relative performers. Taxable municipal bonds continued to rebound following supply headwinds of 2020 that resulted in lackluster relative returns. After 147 basis points of alpha in February, the sector has now outpaced Treasuries by 331 basis points year-to-date compared to 78 basis points of excess return for corporate debt.

Municipal Market

After resisting the selling pressure in Treasuries in January due to a strong technical environment, municipal debt showed signs of weakness in February, as tax-exempt yields rose 9-43 basis points, and the curve steepened. As with the Treasury curve, the longer-end of the municipal yield curve was negatively impacted by growing reflationary sentiment, while the front-end remained anchored by accommodative Fed policy. Accordingly, the yield spread between 2-year and 10-year AAA municipals widened by 34 basis points in February to 95 basis points, the largest term premium since March 2018 according to Bloomberg data. To start the month, ongoing technical strength via reinvestment demand that had inoculated state and local government debt from Treasury selling pressure in January carried over into February. As a result, tax-exempts outperformed their taxable counterparts in the first two weeks of the month with the 10-year AAA municipal yield down 3 basis points to 0.69% versus a 14 basis point increase in the comparable-maturity Treasury rate to 1.21%. With the insatiable investor appetite for tax-exempt bonds, the municipal-to-Treasury yield ratio collapsed below 70% for all maturities of more than 2 years with the 4-7 year maturity sector declining to a paltry 39%-45% range. The tide turned, however, as municipal yields finally capitulated to the building selling pressure in the Treasury market. In the last two weeks of February, municipal yields rose 8-53 basis points with price weakness concentrated in intermediate and long-dated tax-exempt debt as the 10-year AAA municipal yield rose 46 basis points to end the month at 1.15%. Accordingly, yield ratios cheapened toward normalized levels with the 10-year relative valuation finishing February at 81.6%, still below the approximate 94% historical average over the past five years according to Bloomberg data. With the municipal sell-off accelerating into month-end, tax-exempts underperformed Treasuries for the full month, narrowing the yield rise gap for the quarter. Year-to-date, the 10-year AAA municipal yield is higher by 44 basis points versus a 49 basis point rise in the 10-year Treasury rate. For their part, retail investors continued to deploy cash into tax-exempt debt as municipal bond mutual funds experienced positive flows in each week of February, according to Refinitiv Lipper data, although inflows notably slowed from an average of more than $2 billion in the first three weeks of February to just $38 million in the last week of the month. We continue to monitor fund flows for a negative feedback loop, as a round of retail selling could be stoked by rising rate fears due to improving prospects for economic growth. In terms of reinvestment demand, after dipping to about -$13 billion in January and February, JP Morgan projects net tax-exempt supply to flatten over the next three months before once again plummeting to negative territory over the summer months. We are also monitoring new issue supply for a potential surge if advance refunding deals are reinstated later this year as part of President Biden's tax plan. Furthermore, the recent volatility could spur a flurry of new issue deals as state and local governments pull forward deals in order to lock in borrowing costs before rates spike further. From a credit perspective, municipalities are riding the coattails of an expected stimulus package that could successfully bridge the gap until the economy fully reopens. Meanwhile, state tax revenues have declined at a lower-than-expected rate with e-commerce revenues providing a partial offset for certain states. In fact, Moody's Analytics now estimates that 31 states now have enough cash to fully absorb the economic stress of the pandemic-induced recession. For the month, the ICE BofA 1-12 Year Municipal Securities Index posted a -1.05% total return, the largest monthly loss since last March.

Maturity	AAA Muni 01/31/20	AAA Muni 02/28/21	Monthly Muni YTM Change	Treasury 01/31/20	Treasury 02/28/21	Monthly Treasury YTM Change	% of U.S. Govts. 02/28/21
2-Year	0.11%	0.20%	0.09%	0.11%	0.13%	0.02%	153.85%
5-Year	0.22%	0.46%	0.24%	0.42%	0.73%	0.31%	63.01%
7-Year	0.41%	0.81%	0.40%	0.76%	1.12%	0.36%	72.32%
10-Year	0.72%	1.15%	0.43%	1.07%	1.41%	0.34%	81.56%
15-Year	0.99%	1.40%	0.41%	1.32%	1.65%	0.33%	84.85%
20-Year	1.19%	1.60%	0.41%	1.64%	2.05%	0.41%	78.05%
30-Year	1.38%	1.80%	0.42%	1.83%	2.15%	0.32%	83.72%

Source: Bloomberg; Refinitiv