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Domestic Investment Grade Fixed Income Monthly Market Summary

March 2021

Treasury Market

Intermediate and long-term interest rates continued to rise over the month with 5+ year Treasury yields increasing 21-34 basis points, further steepening the yield curve which saw the short-end virtually unchanged once again. March marked the second consecutive monthly increase of at least 25 basis points for the 2-year and 10-year Treasury yield spread, which now stands at 158 basis points, the largest since July 2015. The rate rise narrative was much the same as a combination of additional fiscal stimulus and accelerated vaccine distribution continued to greatly improve the economic outlook. While some areas, namely Europe, saw pandemic trends worsen in March, the U.S. removed restrictions and projects to have widespread vaccine eligibility as soon as next month. Additionally, incoming data was generally positive and reflective of the economy's reopening. For example, the Institute for Supply Management (ISM) indicated that the manufacturing sector expanded faster than expected in February with the broad survey reaching the highest level in three years. New orders, production, and employment all saw faster growth compared to January. In contrast, the ISM release for the services sector declined month-over-month with the lowest reading in nine months. However, the index remained within expansion territory, and cold weather-related disruptions in certain areas accounted for at least a portion of the slower service sector growth. Meanwhile, the Bureau of Labor Statistics reported that 379,000 nonfarm payrolls were added in February, sharply higher than the 200,000 expected, with the unemployment rate ticking lower to 6.2%. The leisure and hospitality sector led the way with 355,000 jobs created during the month. Not surprisingly, given the removal of restrictions in some states, most of the sector's gains came from restaurants and bars. Furthermore, initial jobless claims that had increased in December and January trended lower in March. The heavily anticipated coronavirus relief package became a reality in March via the $1.9 trillion American Rescue Plan which will send direct payments of up to $1,400 to individuals and extend supplemental unemployment benefits. These positive developments provided further support to the market's optimistic tone, leading to a continued increase in intermediate and long-term rates and a steeper yield curve, as inflation expectations reached an eight-year high during the month according to Treasury Inflation Protected Securities pricing. Around the mid-month point, 5+ year Treasury yields had increased 10-25 basis points with the 10-year at 1.63%. Despite the Fed's steadfast communication that accommodative policy would remain intact, investors also began speculating that monetary tightening could be warranted ahead of the central bank's projected timeline. As such, the 3-year Treasury rate also crept higher, increasing six basis points to 0.34%. As the Fed convened for its March meeting, market participants eagerly awaited the Fed's reaction to the significant move in Treasury yields. While acknowledging in the Federal Open Market Committee (FOMC) meeting statement that economic activity and employment "have turned up recently," the central bank made no policy changes, including no alterations to the ongoing bond purchasing program despite speculation that the Fed could initiate an Operation Twist plan to focus support on intermediate and longer-term yields. Within its updated projections, the median central bank member now forecasts 6.5% real GDP growth this year compared to 4.2% expansion projected in December. Similarly, the 2021 inflation forecast also moved higher from 1.8% in December to 2.4%, above the central bank's 2% long-term target. However, the pricing pressures are expected to be temporary with the median projection falling back down to 2% for 2022. While most FOMC members continued to anticipate no change in the funds rate through 2023, there are now four members projecting at least one rate hike next year compared to only one member in December. Importantly, Chairman Powell stressed the desire to see actual inflation rather than simply projected price pressures before starting to remove accommodative policy. This is consistent with messaging throughout the month, including comments during a Wall Street Journal webinar in which Chairman Powell mentioned that disorderly market conditions would concern him, implying possible action to avoid tighter financial conditions impeding the recovery. After a brief period in which both moved lower, Treasury rates and stock prices continued to move higher through month-end. As vaccine distribution continued to expand, federal guidance shifted to a recommendation for the broad adult population to be eligible for inoculation by mid-April, earlier than previous expectations. Evident of the rising optimism, consumer confidence surveys from the University of Michigan and The Conference Board hit their highest respective levels since the pandemic with expectations for an associated increase in spending that should drive impressive near-term economic growth. For the month, 5+ year Treasury yields increased 21-34 basis points with the largest change to the 10-year which ended March at 1.74%, the highest level since January 2020 and an 83 basis point year-to-date increase. With credit spreads largely unchanged, broad returns largely tracked the move in Treasuries, and the Bloomberg Barclays Intermediate Government Credit Index earned -0.78% in March, pulling the first quarter return down to -1.86%.

Taxable Credit

Optimism over the recovery has allowed credit to outperform Treasuries in 11 of the last 12 months, including March. With risk premiums generally below historical average and pre-pandemic levels, excess returns moving forward may be limited. For example, corporate bonds outperformed government debt by only 14 basis points in March, and issuers rated A or better essentially matched Treasury performance. Within taxable municipals, previously referenced supply headwinds in 2020 led to attractive relative valuations to start the year. After strong outperformance of 190 and 147 basis points, respectively, in the first two months, taxable municipals also had less room for further excess return and provided just 10 basis points of alpha in March. Thus far, the volatility in benchmark Treasury rates has not seeped into credit spreads but could widen if the market perceives that higher intermediate and long-term rates threaten to slow the recovery without Fed intervention.

Municipal Market

While Treasury yields continue to climb higher in March, as risk-on investors brimmed with optimism over a post-pandemic economic surge, tax-exempt rates gyrated but were generally supported by strong demand due in part to muni-friendly fiscal stimulus developments. For the month, tax-exempt yields fell 3-6 basis points, outperforming Treasuries in all maturities and sending municipal-to-Treasury yield ratios tumbling lower. The tax-exempt curve moderately bull steepened with the front-end rallying 6 basis points, while the back-end dipped by only 3 basis points. As such, the 2-year and 10-year AAA municipal yield spread ended the first quarter at 98 basis points. After tax-exempts succumbed to the selling pressure in the Treasury market in February, strong investor demand resurfaced in March buoyed by the $1.9 trillion fiscal stimulus package winding its way through Congress, the passage of which included $350 billion in direct aid to municipalities. For local governments, the American Rescue Plan is a credit positive in terms of limiting deep state funding cuts and providing direct aid totaling over $130 billion. Meanwhile, Moody's Analytics revised lower their pandemic induced fiscal shock estimates for states given the accelerated vaccine rollout and more resilient than expected personal income levels across the country during the COVID-19 downturn. On a federal aid adjusted basis, the net shortfall at the state level is a much smaller than originally forecasted $56 billion or about 6% of fiscal 2019 general fund revenues. 31 states are projected to have sufficient reserves and federal aid to fully absorb the forecasted pandemic fiscal shock, and another 7 states have adequate reserves to weather most of the COVID-19 economic stress (<3% net shortfall). Importantly, while the projections broadly accounted for a stronger economy resulting from the American Rescue Plan, the direct aid to states was not incorporated as the bill was not enacted at the time. The positive credit news was a green light for investors who are also keeping an eye on potential tax hikes that may increase the value of the municipal exemption. For instance, President Biden's American Jobs Plan is expected to fund infrastructure spending and R&D investments in part by increasing the federal corporate tax rate from 21% to 28%, which would increase demand for tax-exempts from institutions like banks and insurance companies. According to Refintiv Lipper weekly fund data, after experiencing net outflows totaling $605 million during the first week of March, municipal funds added $3.1 billion thereafter to month-end. As such, although the 10-year Treasury yield rose by 33 basis points to 1.74% in March, the comparable maturity AAA municipal rate actually declined by 3 basis points to 1.12%, pushing the relative value metric lower to an expensive 64.4%. The relative strength for municipal debt in March was a departure from the norm, as the month traditionally represents a period of modest reinvestment activity while secondary selling pressure rises to fund tax liabilities, potentially delayed this year due to the tax filing deadline extension. In fact, the ICE BofA 1-12 Year Municipal Securities Index had previously posted a negative return in 12 of the last 19 months of March. Over the next several months, yield ratios are likely to remain at painfully rich levels due to the summer reinvestment season as well as the tailwind of strong investor sentiment – stronger credit coupled with the prospects of higher income taxes. At current yield ratio levels, benchmark municipals will likely be more highly correlated to the Treasury market in a rising rate environment but could underperform their taxable counterparts if yields decline. However, idiosyncratic risks such as a tax reform induced supply surge could help reflate municipal-to-Treasury yield ratios to more attractive levels. For example, reinstating advance refunding as a tax-exempt refinancing tool could lead to a meaningful uptick in tax-exempt supply (downtick in taxable municipal supply). A strong technical environment relative to the taxable bond market resulted in the ICE BofA 1-12 Year Municipal Securities Index producing a 0.33% total return in March and a modest -0.29% loss for the first quarter.

Maturity	AAA Muni 02/28/21	AAA Muni 03/31/21	Monthly Muni YTM Change	Treasury 02/28/21	Treasury 03/31/21	Monthly Treasury YTM Change	% of U.S. Govts. 03/31/21
2-Year	0.20%	0.14%	-0.06%	0.13%	0.16%	0.03%	87.50%
5-Year	0.55%	0.51%	-0.04%	0.73%	0.94%	0.21%	54.26%
7-Year	0.81%	0.77%	-0.04%	1.12%	1.42%	0.30%	54.23%
10-Year	1.15%	1.12%	-0.03%	1.41%	1.74%	0.33%	64.37%
15-Year	1.40%	1.35%	-0.05%	1.65%	1.98%	0.33%	68.18%
20-Year	1.60%	1.55%	-0.05%	2.05%	2.31%	0.26%	67.10%
30-Year	1.80%	1.75%	-0.05%	2.15%	2.41%	0.26%	72.61%

Source: Bloomberg; Refinitiv

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