Market Update (4/21/2022)

Overview

The relentless upward shift in rates has continued unabated. This year's out-sized yield surge has exerted massive downside price pressure across the entire tax-exempt bond complex. For example, the total rate of return for one of the most conservative investments, a 3-year tax-exempt bond (Source: Bloomberg 3-Year Municipal Bond Index) was down (-4.41%) as of last night's close.

While the extreme upward yield adjustment in the municipal bond market can primarily be attributed to the rout in the U.S. Treasury bond market, tax-exempt mutual fund shareholder selling has exacerbated the price declines. As is typical, when rates are rising the net asset value of the mutual funds invested in municipal bonds decline. These price declines trigger some individuals to liquidate their holdings, causing mutual fund portfolio managers to sell bonds to meet the shareholder's redemptions. In fact, year to date through April 13th, mutual fund outflows totaled $35 billion (Source: Lipper U.S. Fund Flows).

With a broker/dealer community that is already risk-averse, the prices that they are willing to pay for a seemingly never-ending stream of municipal bond sales drops quickly. In essence, these forced sellers set the prices for the day that are used for "comps" of future transactions.

Likewise, when interest rates reverse course and head lower, the moves also occur rapidly as the broker/dealer community is loath to offer bonds at "market prices" as they seek to recoup their losses.

Themes

On the back of skyrocketing inflation and wages that are failing to keep pace with the rise in prices, individuals are dipping into savings to fund the purchase of daily necessities. In fact, the Personal Savings Rate is at levels that are in-line with those recorded during the 2001 and 2008-9 recessions (Source: St Louis Fed). In essence, the boom in spending recorded over the past many months can be viewed as having borrowed from the future pace of consumption.

As you would expect, with the many forces ganging up on households (inflation, higher rates, etc), consumer sentiment is at or near levels that in the past have coincided with economic contractions.

Against a backdrop of declining consumer health, housing prices have spiked higher, particularly over the last two years. These dynamics have caused housing affordability to crater and stand at levels similar to those witnessed during the Great Recession. We strongly believe that the demand for single family housing is poised to slow markedly.

Strategy

Thus far, the desperate rhetoric of the Federal Reserve fits the pattern of past interest rate hike campaigns. What's unique, however, is that their operation is beginning when economic activity is already faltering, and the pace of inflation is likely to be cresting.

It is important to note that rate shifts operate with a lag, and it is quite common for the effects of the higher financing costs to impact economic activity.

Our base case remains unchanged. The combination of higher rates and inflation will prove to be a potent combination for an already weakened and highly leveraged consumer.

Despite yield levels that have exceeded our upper boundaries, we have remained respectful and patient of the yield rise. We have therefore been slow to exchange short maturity/lower duration (measure of interest rate sensitivity) bonds for longer maturity/higher duration securities.

To that end, we are now seeking opportunities to extend the interest rate sensitivity of our client accounts from our current relatively neutral stance.

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