An Update on the Fixed Income Market

APRIL 15, 2022

WWW.NEWEDGEWEALTH.COM

Yields are low, but rising (aka why do I own bonds?)

Let's reflect… one year ago, the yield on U.S. 2-year notes was at 0.15%; today (4/15/22), they are marked at 2.45%. One year ago, the FOMC expected the Fed Funds rate to be 0% at the end of 2023; today, the dot plot suggests they expect it to be at 2.75% by the end of 2023. Consensus vacillates as to the timing and magnitude of the Fed's next move, but it is noteworthy that the last time the Fed raised rates by 50 bps at a single time was in 1994.

Notwithstanding the recent rise in interest rates, 10-year Treasury bond yields (2.83% as of 4/15/22) remain well below their historic average of 4.5%. This comes despite a 63% rise in 10-year Treasury bond yields in 2021 and an 86% rise in yields thus far in 2022. Rates have remained well below this historic average since 2007, which seems like a very long time, but pales in comparison to the 1922-1965 period when rates were also below the 4.5% historic average.

But what about Municipal bonds?

Municipal bonds, the mainstay fixed income security for retail and ultra high net worth investors, started 2022 as "expensive" when measured as a percentage of Treasuries. That changed in a seeming blink of an eye.

AAA Muni/US Treasury After-Tax Spreads (Basis Points)

	January 5, 2022	April 14, 2022	5-Yr. Average
Two-Year	-19	56	17
Five-Year	-22	57	23
10-Year	9	81	53
15-Year	11	91	75
20-Year	10	83	85
30-Year	29	107	92

*As of April 14, 2022

Source: Muncipal Market Data and AB; AllianceBernstein, The Week in Muniland (4/18/22)

Why did Munis get cheap on a relative basis?

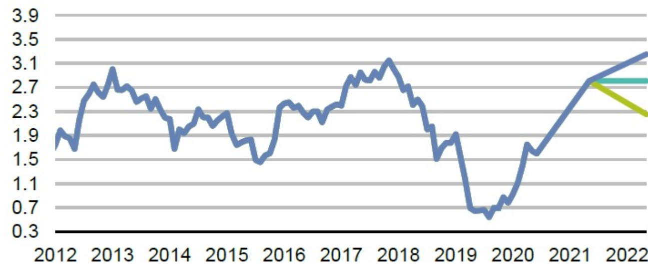
For the first quarter, the Bloomberg Municipal Index returned -6.23%, which is the worst quarterly return since Q3 1981, when the index returned -9.69%. In addition to the impact of rising rates, last week Municipal mutual fund outflows totaled $7.9 billion, which is the 14th consecutive week of outflows. Year-to-date outflows total $35 billion. This has exacerbated the decline in returns into the early weeks for Q2 2022.

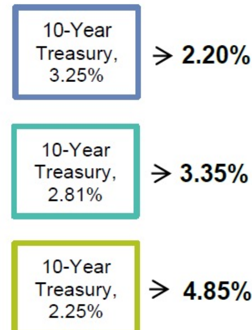
Digging in a bit deeper, to begin the year, two-, 10- and 30-year AAA Muni yields were 0.24%, 1.03% and 1.49%, respectively. Today those yields are 1.76%, 2.18% and 2.53%. The 10-year yield has more than doubled, **but** we consider another doubling over the next three months unlikely. The Fed Fund futures market anticipates a 2.5% short rate by February 2023. The two-year Treasury at a 2.43% is largely pricing in that move. Even the 10-year forward rate one-year out is 2.42%. The market is in effect pulling yields forward.

WWW.NEWEDGEWEALTH.COM

To provide further perspective, for the total return of a five-year duration A+ average rated Muni portfolio to break even during the next 12 months, the 10-year Treasury yield would need to reach approximately 3.5%. In an environment where economic growth and inflation may begin to abate, we do not believe that the current pace of rising rates will continue.

Expected 12-Month Municipal Returns Scenario Analysis
10-Year US Treasury Yield (Percent)





Past performance and historical analysis do not guarantee future results.
Display reflects expected returns of a five-year duration intermediate municipal portfolio under three scenarios: 10-year US Treasury yields rise to 3.25%, remain the same or decline to 2.25% over the next 12 months.
Through April 14, 2022
Source: Bloomberg and AB

Source: AllianceBernstein, The Week in Muniland (4/18/22)

Is now a good time?

The Muni market is known for its inefficiencies, but during times like these, those inefficiencies can be exaggerated. Today, BBB Muni credit spreads are 81-bps ("basis points"). However, investors can purchase AAA-rated New York City Transitional Finance Authority bonds at a 100-bps spread. Known as a "belly button" bond in New York (because everyone has one), these bonds generally come with wider spreads relative to their rating, say 35-45 bps, and today these bonds are clearly on sale.

From a sector perspective, A+/AA-rated hospitals and airport bonds are trading with spreads between 100 and 120 bps. Investors will need to go out 20-30 years from a maturity perspective, but there is no question these bonds are cheap. Coupons do matter as 4% coupons are about 25 bps cheaper than 5% coupons to compensate for additional extension risk. That said, we are maintaining duration targets by increasing our exposure to 5% coupon bonds, with a continued emphasis on "kicker*" bonds.

Over the past few years, low interest rates and Federal Tax Legislation have created structural shifts in the Municipal Marketplace. Notably, taxable issuance will likely exceed $100 billion for the third year in a row, 5% plus coupon structures have declined from 63.2% issuance in 2017 to 34.6% today, and the non-Rated percentage of the Bloomberg High Yield Municipal Index now exceeds 61% – up from 40.9% in 2017.

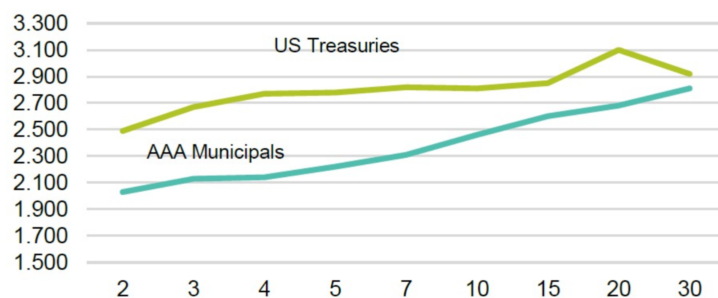
Source: Bloomberg 12/2021; Factset

Should I fear the grim reaper (aka an inverted yield curve)?

The market has become acutely aware and concerned about an inverted yield curve and what it portends. Fun fact: the municipal yield curve is not currently inverted, nor has it ever been. The fact that central banks around the world have manipulated yield curves should not be taken lightly. The yield-curve shape is generally a poor predictor of near-term returns as the time between inversion to recession could be as little as six months to more than two years. Given much higher yields and wider spreads, today's Muni bond valuations look attractive.

WWW.NEWEDGEWEALTH.COM

Fixed-Income Yield Curves



Neither the 2-10 year US Treasury yield curve nor the AAA-rated municipal curve are inverted.

Through April 14, 2022
Source: Municipal Market Data, US Treasury and AB

Source: AllianceBernstein, The Week in Muniland (4/18/22)

With all that is going on in the economy and the world, this raises the inevitable question… why own any bonds at all?

There are five principal reasons why fixed income should remain a key component of client portfolios.

1. Diversification – The only asset that consistently demonstrates a low to negative correlation to risk assets is fixed income. Over the past five years, the range of correlations for traditional fixed income ranges from -0.40 to 0.00. This range suggests that fixed income is either not correlated (0.00) or negatively correlated (-0.40) relative to traditional risk assets. This underscores the importance of using fixed income as a diversification tool.

2. Efficiency – While the potential returns for fixed income may appear to be limited in the current market environment, investors should still consider designating some capital to fixed income. The following exhibit illustrates the return/risk ratio for various asset classes for the trailing five years (all returns annualized). The return/risk ratio for the Bloomberg Barclays (BB) US Aggregate Bond Index is 1.20 — this equals the S&P 500 as the most efficient allocation across the major asset classes.

Asset Class	Return	Std Dev	Return/Risk
S&P 500 Index	18.5	15.4	1.2
MSCI EAFE Index	10.1	14.8	0.7
MSCI EM NR USD	9.9	16.6	0.6
HFRX Global Hedge Fund Index	3.5	4.9	0.7
Invesco Global Listed Private Equity ETF	15.4	21.8	0.7
BBgBarc US Aggregate Bond Index	3.6	3.1	1.2
BBgBarc US Treasury Index	3.1	3.8	0.8

Return & Std Dev data represent 5 year annualized figures
Source: Zephyr Portfolio Analytics [Informa] (as of 12/31/21)

3. Underlying return potential – It is important to bear in mind that uncertain markets can translate into volatility that, in turn, can produce returns well above what a security may be yielding at the time. This was true in 2020 when, despite historically low interest rates, the BB Aggregate Index returned 7.51%.

4. Drawdown risk mitigation – There are few asset classes that can mitigate drawdown risk while providing income/return potential and liquidity. Fixed income offers a wide variety of investment options including U.S. Treasuries, corporate bonds and tax-exempt bonds.

5. Income generation – Over the last 10 years, 80% of the return on fixed income (in this example, the BB US Aggregate Bond Index) has been from income generation.

Some key observations for the Muni market in 2022

Whether inflation is transitory or not, municipal investments can be an inflation hedge

Credit-sensitive municipal bonds provide a larger cushion against inflation relative to other fixed income investments of similar quality because municipal bond credit tends to improve with inflation. Many taxes supporting municipal credits increase as asset prices rise. For example, general obligation issuers collect higher ad valorem taxes as real estate values grow. Dedicated tax bonds increase coverage ratios as the prices of taxed items rise. An array of municipal credits, including toll road financings and tobacco bonds, incorporate annual inflation adjustments in their covenants that increase revenues available to debt service. Adjusting fixed income exposures in favor of municipal bonds can help mitigate potential higher inflation.

Maintain overweight in high yield, but…

An overweight position in high yield municipals could drive outperformance through at least the first half of 2022 as rates rise. Select – certainly not all – high yield municipal issuers emerged from lockdowns in strong financial condition as the ratio of ratings upgrades to downgrades in 2021 hit its highest level since 2013. Increasing demand from high liquidity levels could tighten spreads and contributes to strong relative returns compared to rate sensitive high grades.

Shift focus to structure as fiscal policy (spending) gives way to monetary policy

Municipal investors must contend with the longer durations of lower coupon bonds. Since 2017, 2% and 3% coupons have risen from 16.1% to 29.8% of tax-exempt issuance as defensive coupon structures (higher coupons) were refunded. Low-coupon par bonds are more interest-rate sensitive as they have longer durations, which makes them highly susceptible to rising rates. They also have little cushion to the de minimis rate, which is how the IRS defines a market discount bond. Once that threshold is reached, a bonds value will fall further.

As an example, looking at two New York City Transitional Finance Authority bonds, both due in 2042, although one has a 3% coupon and the other 5%, the 3% bond was down as much as 17% in the first quarter, while the 5% was down 11%. Stick with premium bonds. Although premium bonds can cause sticker shock, they will reduce volatility and provide a higher stream of income to reinvest in a rising rate environment.

Swapping can be a good thing

A municipal bond swap is accomplished by selling certain bonds in a portfolio with the sale proceeds reinvested in other similar, but not identical municipal securities, in an effort to take advantage of present market conditions and/or tax considerations.

Consider short-kicker bonds and/or pre-refunded Munis for cash holdings

Short pre-refunded Munis (less than one-year) are yielding almost 2% tax-free and short kicker bonds (less than two-years) are yielding over 2% tax-free, and in some states as much as 3% tax-free.

Taxable municipals outperform… again

In 2022, we believe taxable municipal bonds will extend ten years of inflation-adjusted outperformance versus most of the investment grade U.S. market. Issuers' ability to raise taxes and fees on their essential services maintains adequate debt service coverage, stabilizes credit ratings, and reduces bond price sensitivity to rising rates and higher inflation. As a result, the price correlation between taxable municipal bonds and other taxable market segments can decline.

The investment grade taxable market, as measured by the Bloomberg Aggregate Bond Index, is approximately 44% U.S. Treasury and Government related securities. Investors traditionally tracking this benchmark are facing significant exposure to both interest rate and inflation risk. In 2022, expected higher taxable municipal supply and trading volumes will likely attract new, non-traditional investors looking for low-correlation, high quality assets.

**A kicker bond is a callable, premium bond that is priced assuming it will be redeemed at an upcoming call date in advance of its final maturity. However, should the call feature not be exercised by the issuer at the call date, the yield the investor will receive increases, or "kicks up," based on holding the high coupon bond to the later maturity date. Buyers receive higher yields because they must be compensated for the uncertainty of the call.*

WWW.NEWEDGEWEALTH.COM

Definitions

Federal Funds Rate – The term federal funds rate refers to the target interest rate set by the Federal Open Market Committee (FOMC). This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

Federal Open Market Committee (FOMC) – The Federal Open Market Committee (FOMC) is the branch of the Federal Reserve System that determines the direction of monetary policy specifically by directing open market operations. The committee is made up of 12 members: the seven members of the Board of Governors; the president of the Federal Reserve Bank of New York; and four of the remaining 11 Reserve Bank presidents on a rotating basis.

AAA Municipal Bonds – AAA is the highest possible rating that may be assigned to an issuer's bonds by any of the major credit rating agencies. AAA-rated bonds have a high degree of creditworthiness because their issuers are easily able to meet financial commitments and have the lowest risk of default. Rating agencies Standard & Poor's (S&P) and Fitch Ratings use the letters "AAA" to identify bonds with the highest credit quality, while Moody's uses the similar "Aaa" to signify a bond's top-tier credit rating.

Credit Spread – A credit spread is the difference in yield between a U.S. Treasury bond and another debt security of the same maturity but different credit quality. Credit spreads between U.S. Treasuries and other bond issuances are measured in basis points, with a 1% difference in yield equal to a spread of 100 basis points.

After Tax Yield (used in determining AAA Muni/US Treasury After-Tax Spreads) – The after-tax yield or after-tax return is the profitability of an investment after all applicable taxes have been paid.

S&P 500 Index – The S&P 500 Index, or the Standard & Poor's 500 Index, is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the U.S. re-positioning

MSCI EAFE Index – The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the U.S. and Canada. With 825 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI Emerging Markets (EM) Index – The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries. With 1,399 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

HFRX Global Hedge Fund Index – The HFRX Global Hedge Fund Index is comprised of funds representing all main hedge fund strategies. The underlying strategies are asset weighted based on the distribution of assets in the hedge fund industry.

Invesco Global Listed Private Equity ETF – The Invesco Global Listed Private Equity ETF (Fund) is based on the Red Rocks Global Listed Private Equity Index (Index)

Bloomberg US Aggregate Bond Index – The Bloomberg US Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. This includes Treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities and collateralized mortgage-backed securities

Bloomberg US Treasury Bond Index – The Bloomberg US Treasury Bond Index includes public obligations of the US Treasury, i.e. US government bonds. Certain Treasury bills are excluded by a maturity constraint. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as US Treasury TIPS, are excluded

Important Disclosures

The information contained herein has been prepared solely for educational purposes and is not intended as an offer or solicitation of an offer with respect to the purchase or sale of any security and should not be relied upon by you in evaluating the merits of investing in any securities or investment strategy. Please remember that different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment or investment strategy (including those undertaken or recommended by NewEdge) will be profitable or equal any historical performance level(s). Investors should carefully consider their own investment objectives and never rely on any single chart, graph or marketing piece in making investment decisions. NewEdge is neither a law firm, nor a certified public accounting firm, and no portion of its services should be construed as legal or accounting advice.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties, which in certain cases has not been updated through the date of the distribution of these materials. While such sources are believed to be reliable for the purposes used herein, NewEdge does not assume any responsibility for the accuracy or completeness of such information. Further, no third party has assumed responsibility for independently verifying the information contained herein and accordingly no such persons make any representations with respect to the accuracy, completeness or reasonableness of the information provided herein. Unless otherwise indicated, market analysis and conclusions are based upon opinions or assumptions that NewEdge considers to be reasonable.

Forward Looking Statements:

Certain information contained herein may constitute "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "project," "estimate," "intend," "continue," or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events, results or the actual performance of an adviser's investments [or portfolio companies] may differ materially from those reflected or contemplated in such forward-looking statements. Nothing contained in this piece may be relied upon as a guarantee, promise, assurance or a representation as to the future.

Index and Performance Disclosures:

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results.

Historical performance results for investment indices, benchmarks, and/or categories have been provided for general informational/comparison purposes only, and generally do not reflect the deduction of transaction and/or custodial charges, the deduction of an investment management fee, nor the impact of taxes, the incurrence of which would have the effect of decreasing historical performance results. It should not be assumed that your account holdings correspond directly to any comparative indices or categories. **Please Also Note:** (1) performance results do not reflect the impact of taxes; (2) comparative benchmarks/indices may be more or less volatile than your accounts; and (3) a description of each comparative benchmark/index is available upon request.

Investment Disclosures:

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio. Interest on **municipal bonds** is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence.

NewEdge Wealth is a division of NewEdge Capital Group, LLC. Investment advisory services offered through NewEdge Wealth, LLC an investment adviser registered with the US Securities and Exchange Commission. Securities offered through NewEdge Securities, Inc. Member FINRA/SIPC.

WWW.NEWEDGEWEALTH.COM