Monetary and Fiscal Policy, a Balancing Act

The regional banking turmoil that started in March continued into April as First Republic Bank (FRB), the 14th largest bank in the country, was closed by the California regulators, taken into receivership by the FDIC, and sold to JP Morgan Chase during competitive bidding in a non-public auction. For most of the month, markets were on tender footing, searching for clarity on the longer-term impact of bank tensions while responding lightly to weaker economic data. First-quarter GDP growth slowed to an annualized gain of only 1.1%, below consensus expectations and well below the 2.6% pace seen in 4Q22. Business activity also remains mixed with the manufacturing sector, as measured by the Institute for Supply Management (ISM), continued to contract for five consecutive months. The ISM survey for services in March is also trending lower at 51.2 but still above the contraction level of 50. Markets will better understand how much credit conditions have tightened when the Federal Reserve releases its Senior Loan Officer Opinion Survey on May 8th. The survey started to tighten before the bank failures emerged, so even a smaller narrowing of the credit spigot would amplify the economy's downside risks.

World Markets	MTD (%)	YTD (%)	1Y (%)	10Y (%)	10Y STD (±)
DJIA	2.57	3.53	5.64	11.29	14.97
S&P 500	1.56	9.16	2.64	12.28	14.85
NASDAQ	0.07	17.13	0.05	15.31	17.51
Equity EM Mkts.	-1.12	2.85	-6.15	2.34	17.01
EM Bond Mkt.	0.39	2.55	0.06	1.94	7.32
US Aggregate Bond	0.61	3.59	-0.43	1.32	4.30
Municipal Bond	-0.23	2.54	2.87	2.26	4.63
US High Yield	0.96	4.67	1.14	3.93	7.57
Commodity	-0.75	-6.07	-16.60	-1.38	14.13
COMEX Silver	3.79	4.51	8.06	0.00	27.89
COMEX Gold	0.95	9.01	3.80	2.99	14.62
Brent Oil	-6.36	-8.13	-14.69	-6.38	39.04
Dollar Index	-0.83	-1.80	-1.26	2.20	6.52

A significant pullback in bank lending may be enough to push the economy into recession. Still, markets have been wrong before, and many believe the economy can withstand the coming credit headwinds. As of the April 6th jobs report, employment growth for March and February was revised down sharply. The jobs data is backward looking and captures only a portion of the recent stress in the banking system. In addition, the data is less reliable because of a low response rate, and the BLS birth-death model (adding 378,000 jobs) juiced the net gain in nonfarm employment in April. The recent stress in the banking sector has undoubtedly complicated the US Federal Reserves' mission of fighting inflation, making a recession much more likely. While it is not our base case, there is also ample reason to believe that if high inflation persists, the US may enter into a period of stagflation – a combination of high inflation and a severe recession. Chairman Powell stated that unemployment needs to rise to bring inflation down, but from 2015-2019, inflation did not increase despite low unemployment. We see the Fed's current thoughts on labor and inflation as a possible confirmation bias to an old model known as the Phillips curve. There is little reason to think today's 3.5% unemployment rate is inherently more inflationary than in 2019. Employment indicators can provide some information on business cycle conditions but are typically lagging indicators. As the economy shifts to a lower pace of growth, recruiting can fall without triggering layoffs. Perhaps it is time for the Fed to acknowledge that a wider set of possibilities are contributing to inflation and that the current monetary policy and rate hikes are working in the opposite direction.

Taxable Markets

On May 3rd, The Federal Reserve raised rates 25 basis points (bps) to 5.25% but also dropped from its policy statement language saying that it "anticipates" that further rate increases would be needed. After raising the federal funds rate at the fastest pace in modern times, demand growth is slowing, and inflation pressures are easing. Liquidity and insolvency concerns across the banking industry brought about another wave of volatility and a flight to quality in the last few days of April. The treasury market ended the month with the 10-year yield closing at 3.43%, 4 bps lower than a month ago. Intermediate treasuries between 3 and 10 years saw the best total returns in April, with the 10-year bellwether bond providing 71 bps of return. The curve inversion continued with the spread between 2s/10s moving wider by 2 bps to -57 bps.

U.S. Fixed Income	Price	Cpn	Total Returns (%)		Dur	Yield
	(%) Rtn	% Rtn	Mo.	YTD	+/-	+/-
Aggregate Bond	0.33	0.27	0.61	3.59	6.33	4.35
US Treasury	0.34	0.19	0.54	3.56	6.28	3.79
US Agencies	0.20	0.21	0.41	2.51	3.18	4.35
Corporate	0.42	0.34	0.77	4.29	7.23	5.10
Non-Corp	0.64	0.27	0.91	4.06	6.02	4.38
Tax-Muni	1.17	0.46	1.62	6.41	9.61	4.76
US Agency MBS	0.18	0.34	0.52	3.06	5.93	4.48
Gov/Credit	0.38	0.25	0.63	3.82	6.55	4.28
TIPs	0.05	0.06	0.11	3.45	4.79	3.98
AAA Corporate	0.47	0.30	0.77	5.84	11.20	4.22
AA Corporate	0.39	0.30	0.69	4.66	8.61	4.44
A Corporate	0.46	0.32	0.79	4.13	7.14	4.91
BBB Corporate	0.39	0.37	0.76	4.36	7.03	5.39

The Treasury bill market also saw significant swings as Treasury Secretary Yellen announced concerns that default risk might come as early as June 1st, given low tax receipts and government spending requiring a higher debt ceiling. The Government-related sector posted an 80 bp increase, with treasuries gaining 54 bps. The 3-month/10-year segments of the curve inverted to -172 in April, with the biggest change in yields being in the 3-month UST bill, 4.75% in March, to 5.15%. The Aggregate Bond Index had a total return of +0.61bps, with corporate credit providing an additional 77 bps in return. Single A-rated credits outperformed BBB and AAA by a few bps as investors continued to increase quality. The Utility sector saw the highest total returns MOM and YTD, 1.0% and 4.82%, relative to the industrial and financial sectors. Despite all the discussion regarding commercial real estate, the best-performing sectors were office REITS, oil field services, and life insurance. Investment grade (IG) supply for April of $69.38bn surprised to the downside, a 38% decline compared to last year's supply of $111.8bn. IG supply is now down (20%) YoY. We believe rates are at a near peak for the current cycle. Intermediate to long-term yields will continue to perform with volatility providing opportunities for minor backups. As the federal funds rate peaked in past cycles, intermediate-term bonds' total return tended to outperform short-term bonds during the subsequent 12 months. We continue to market weight our credit exposure in table municipals and large-cap industrials while maintaining a neutral duration relative to our benchmarks.

Tax-Exempt Markets

The Bloomberg Municipal Bond Index in April gave back - 0.23%, with year-to-date performance remaining positive at +2.54%. The 15-year maturity index, which represents final maturities between 12 and 17 years, outperformed all sectors at -0.04%. This sector has a duration of 6.92 years and a yield of 3.45% compared to the Aggregate Index 6.07% years and a yield of 3.39%, illustrating that duration extension strategies are performing well. Up until the 3rd week of April, municipals remained strong, but a renewed spout of regional bank volatility brought about a significant flight to quality in the last few days of the month, treasuries rallied, and all spread-related sectors widened despite recent weekly flow losses in tax-exempt funds. Aggregately, 2023 stands at just $4.1 billion of positive inflows. From a performance standpoint, the actual sentiment tide won't change until the pace of fund flows consistently shifts in the other direction. Like other fixed-income asset classes, municipal bonds struggled in 2022. However, yields are now higher for municipals than at any time in the past 15 years. Since 1965, a down year in the municipal market has been followed by at least one year (or several) of positive returns.

Moody's Investors Service released its annual municipal bond market snapshot, "US Municipal Bond Defaults and Recoveries, 1970-2021," with updates through 2021. In addition to noting that the muni sector continued to recover from the effects of COVID-19, the report also affirms two hallmark benefits that muni bonds offer. First, while they may have become more common over the last 15 years, municipal defaults and bankruptcies remain rare overall (there were no newly rated municipal bond defaults during significant market stress in 2021 resulting from COVID). Second, muni bonds continue, on average, to be highly rated compared to corporates. Long maturities were relatively flat and marginally outperformed short and intermediate, -0.11%, versus the 5-Year GO, - 0.58%, which was the worst performer in April. We anticipate higher issuance over the next three months; however, debt ceiling financing may delay new issuance as markets attempt to price in higher volatility.

We are adding to short positions greater than two years and long positions greater than eight years, with modest net extensions but with a significant increase in tax-free income and more yield.

Municipal Market	Price	Cpn	Total Returns (%)		Dur	Yield
	(%) Rtn	(%) Rtn	Mo.	YTD	+/-	+/-
Municipal Agg	-0.58	0.35	-0.23	2.54	6.07	3.39
1-Yr Muni (1-2)	-0.65	0.36	-0.29	0.77	1.29	3.15
3-Yr Muni GO (2-4)	-0.92	0.37	-0.55	0.85	2.40	2.82
5-Yr. Muni GO (4-6)	-0.93	0.35	-0.58	1.43	3.59	2.66
7-Yr. Muni (6-8)	-0.69	0.35	-0.34	1.95	4.51	2.84
10-Yr. Muni (8-12)	-0.57	0.34	-0.23	2.53	5.25	2.88
15-Yr. Muni (12-17)	-0.38	0.34	-0.04	3.11	6.92	3.45
30-Yr. Muni (22+)	-0.55	0.36	-0.19	4.07	10.31	4.23
AAA Muni	-0.71	0.34	-0.37	2.12	5.46	3.06
AA Muni	-0.61	0.35	-0.26	2.38	6.13	3.22
A Muni	-0.45	0.36	-0.09	2.91	6.09	3.75
BBB Muni	-0.47	0.36	-0.11	3.60	7.60	4.48
Gen. Oblig.	-0.65	0.34	-0.30	2.28	5.71	3.10
State GO	-0.75	0.36	-0.39	2.10	4.91	2.94
Local GO	-0.56	0.33	-0.23	2.44	6.42	3.24
Revenue	-0.54	0.35	-0.18	2.77	6.44	3.54
California	-0.60	0.34	-0.25	2.29	6.09	3.20
New York	-0.51	0.36	-0.15	3.06	6.46	3.40

Precious Metals

April started with gold at $1,990, then gold moved as high as $2,063.40, and April 28th, it closed at $1,999, ending the month up 0.95% and 9.01% YTD. Worsening financial conditions are expected to lead to the end of the Fed's rate hiking cycle with the market pricing in rate cuts in 2H2023, a net positive for gold prices. However, we believe the market has yet to price in the negative impact of a policy change in the fight against inflation nor the increasing likelihood of a hard landing or recession, hence higher volatility in commodities in general. The resulting banking crisis exposed the global financial system's fragility and risks while the uncertainty supports higher gold prices in the long-term. These risks include (both in the US and globally) persistent and elevated inflation, a weakening economy, debt service strains, elevated geopolitical risks, and black swan events.

Outlook

Life has few guarantees, but a nasty fight over the debt ceiling seems to pop up frequently. While the effects are starting to filter through more visibly – consumer spending is slowing, and other indicators point to weakening growth momentum – the job market is still too hot; however, the job market is usually the last shoe to drop when the broader economy is weakening. There is a growing consensus that the May rate increase will be the last. The question is, what happens next? The official stance of the Fed is that rates will be kept "higher for longer" until inflation is brought under control. For now, markets firmly disagree, pricing in a series of rate cuts beginning 4-5 months after the May increase. We remain fully invested with significant dry powder for adding yield and income while remaining highly vigilant for the possibility of more black swan events.