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Investment Review

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It's Tough to Make Predictions, Especially About the Future

As the curtain rises on the year's second half, the economy's growth engine is still running on most cylinders. That said, the central bank's upgraded forecast didn't stop it from skipping a rate hike at the June 14-15 meeting after ten consecutive increases dating back to March 2022 aimed at taming inflation. It's unclear if the Fed paused because it believed another rate hike would have triggered a bad reaction in the financial markets. After all, the Fed had telegraphed that it would skip a rate hike well in advance, and traditionally it does not like to upend market expectations. But it also does not want to convey a different message – that it is abandoning the inflation fight. Hence, policymakers warned that a pause does not mean a stop, predicting two more quarter-point rate increases by year-end. The question is whether they follow through with continued tightening, which economists believe would almost surely cause a recession.

World Markets	MTD (%)	YTD (%)	1Y (%)	10Y (%)	10Y STD (±)
DJIA	4.68	4.94	14.23	11.24	15.04
S&P 500	6.61	16.88	19.56	12.83	14.93
NASDAQ	6.66	32.32	26.17	16.26	17.69
Equity EM Mkts.	3.83	5.02	2.12	3.31	16.92
EM Bond Mkt.	1.49	3.30	5.64	2.72	7.11
US Aggregate Bond	-0.36	2.09	-0.94	1.51	4.31
Municipal Bond	1.00	2.67	3.19	2.68	4.56
US High Yield	1.62	5.34	8.88	4.33	7.52
Commodity	4.04	-7.79	-9.61	-0.99	14.18
COMEX Silver	-3.01	-4.91	11.70	1.19	27.59
COMEX Gold	-2.29	5.08	5.91	4.52	13.92
Brent Oil	8.91	-3.57	-7.48	-5.35	37.93
Dollar Index	2.62	0.78	2.53	2.27	6.58

So far, conditions seem to be holding up better than expected, raising the hope that the Fed can tame inflation without causing a recession – the so-called soft landing it set out to achieve at the start of the rate-hiking cycle. The rate increases seen over the past year are just beginning to stimulate the disinflationary forces as rate increases come with long and variable lags. However, high interest rates can also have an inflationary effect on the economy, given the high debt-to-GDP ratios in the US and most developed countries. Structurally high public debts, high fiscal deficits, and tight resource supplies are where stagflationary conditions will persist in the short run. Bloated government spending at 37% of GDP compared to the private sector at 20.2% will mask the private sector recession that is building. We are beginning to see a decline in real-disposable income, real-wages, and across profit margins of small and medium-size businesses. Research by the economist Daniel Lacalle, PhD, in a recent article for the Mises Institute, pointed out when an agent like the state, which weighs 40% to 60% of GDP, continues to consume wealth (taxation) and spend, GDP does not show a recession even though consumption and private investment in real terms are declining. A recent Bloomberg report showed a year-to-date, large bankruptcy count for companies filing Chapter 7s or 11s and carrying $50 million or more in liabilities, posted a second month of filings at 22 in June, on par with May. Pandemic aside, the YTD total of 117 bankruptcy filings has one comparison period – the Great Recession.

An accurate leading indicator of the economy, the Institute for Supply Management (ISM) is a good case in point of a stealthy recession brewing. The recent July 5th report showed the 10th straight month that ISM New Orders have been below the 50-line, delineating expansion or contraction. Manufacturing backlogs seen in June are a sign that future demand is nonexistent. Not one industry reported increasing backlogs for a second consecutive month. Slowing demand eventually reduces the need for laborers.

The two powerful forces of disinflation and recession in the private sector will continue to push against the inflationary forces of the public sector, exacerbating deficit-driven inflation and pouring more money into the economy. These stagflationary conditions will persist, creating more volatility across capital markets, until something breaks. Equities in June were priced in a goldilocks scenario as risk assets continued their YTD rally along with a broadening of market participants as inflation continued to show signs of cooling. All major stock indices, the DOW, S&P 500, and NASDAQ, were up 4%-6% for the month, with precious metals and government bonds giving back some of their YTD returns. Municipal and Corporate bonds outperformed, particularly across high-quality sectors, as concerns in the US banking sector appeared to be constrained.

Taxable Markets

Following repeated indications from the Federal Reserve officials that more rate hikes are possible due to sticky inflation, the implied volatility of one more hike by July is roughly 88%, according to the fed funds futures market. The market focus now shifts to the timing and level of the terminal rate, along with the timing and magnitude of rate cuts expected early next year. Market pricing is closer to the Fed's rate projections compared with the two months following March's bank tensions, though investors are not showing complete confidence that fed funds will reach the upper bound of 5.75% suggested by the June dot plot. Treasury securities fell 0.25% in June, the third consecutive monthly decline. The yield curve inverted further last month, almost entirely from higher yields at the shorter end of the curve. Rising fed funds expectations, reinforced by data consistently stronger than expected in June, helped move 2-year UST yields to their highest since the first week of March. 10s and 20s were steadier through the month, reaching as high as 3.84% and 4.12%, respectively.

Investment-grade corporates returned 41 basis points (bps) in June. The strength was focused on longer-maturity securities, with industrials outperforming 0.58% on average with longer maturities +1.75%. Financials followed a similar path, only less robust on average at .20%, with longer maturity financials at 1.45%. Agency Mortgages underperformed treasuries for the month at -.41% but are now outperforming treasuries on a YTD basis. High coupon 6% MBS performed the best but only contributed 1% to the overall MBS index.

Consistent with the inverted yield curve, intermediate (1Y-10Y) treasuries, and corporate bonds underperformed the Aggregate and long-maturity indexes. Intermediate bonds tend to outperform when the tightening cycle peaks; until then, we remain underweight in this segment of the yield curve.

U.S. Fixed Income	Price	Cpn	Total Returns (%)		Dur	Yield
	(%) Rtn	% Rtn	Mo.	YTD	+/-	+/-
Aggregate Bond	-0.64	0.28	-0.36	2.09	6.31	4.81
US Treasury	-0.95	0.20	-0.75	1.59	6.20	4.37
US Agencies	-0.70	0.22	-0.48	1.64	3.20	4.93
Corporate	0.06	0.35	0.41	3.21	7.14	5.48
Non-Corp	-0.60	0.28	-0.33	2.63	5.90	4.91
Tax-Muni	-0.23	0.46	0.23	4.46	9.46	5.09
US Agency MBS	-0.78	0.35	-0.43	1.87	6.07	4.78
Gov/Credit	-0.58	0.26	-0.32	2.21	6.46	4.80
TIPs	-0.40	0.06	-0.34	1.87	4.53	4.60
AAA Corporate	-0.05	0.30	0.25	3.99	10.90	4.57
AA Corporate	-0.06	0.31	0.25	3.22	8.49	4.82
A Corporate	-0.09	0.33	0.25	2.90	7.06	5.30
BBB Corporate	0.22	0.38	0.60	3.47	6.93	5.76

In an increasingly volatile fixed-income market, we continue to underweight the "belly" of the curve, overweighting short maturities while remaining neutral on duration relative to benchmarks. We will continue to extend durations with longer maturity high-quality corporates and treasuries when portfolios are substantially rewarded in yield and income. Our tactical positioning has provided positive excess returns across all strategies for the month and YTD.

Tax-Exempt Markets

The Municipal Aggregate bond index was up, +1.00% in June and +2.67% YTD. The first two months of 2Q23 saw some pullback of 1.1%, but June's rebound reversed the downtrend, with municipal bonds outperforming the taxable bond market for the month and YTD. Municipals have benefitted from the short supply as issuance is off 20% from 2022's pace, with tax-exempt volume down 13% and taxable muni supply down 43%. Reinvestment of interest payments in July will exceed $35 billion- a figure that may struggle to be met by new issue supply. Similar to the treasury curve, the inversion out to 15 years is making longer-duration yield ratios much more attractive as allocations in this range are predicted to drop in yields in the next 6-12 months. Five percent coupon 10Yr callable bonds with 15 years of maturity offer 60-70 bps in additional yield, 3.43%, versus non-call 10-year bonds with a yield of 2.76%. Ratios in shorter maturities also continue to hold their levels as plenty of defensive positioning exists while the Fed cycle plays out.

Revenue bonds continue to see an outperformance to GOs of about 82 bps YTD, +3.00% vs. +2.18%, respectively. We prefer the pledge of revenues, particularly during recession periods, as these services tend to be less sensitive to economic downturns. Muni market performance tends to be positive over the summer months, with Bloomberg's Muni Bond Index producing a positive total return every year since 2015, except in 2022, with the average since 2015 a +1.09%.

On June 27th, the California governor signed an FY24 budget deal of $310bn that keeps core programs in place without depleting the $37bn reserves, in contrast to the last two years of surpluses. The budget includes $6-$16bn in climate bonds that will help California supply, down 20% year-to-date. In addition, the budget consists of $5bn over four years for public transit agencies to use for operations and capital projects subject to state oversight. S&P revised its outlook on 5/18/23 to negative for the State, reflecting a weakened and uncertain revenue environment due to the tax revenue receipt delay until October.

Municipal Market	Price	Cpn	Total Returns (%)		Dur	Yield
	(%) Rtn	(%) Rtn	Mo.	YTD	+/-	+/-
Municipal Agg	0.64	0.36	1.00	2.67	6.06	3.52
1-Yr Muni (1-2)	0.11	0.37	0.48	1.14	1.31	3.27
3-Yr Muni GO (2-4)	0.20	0.37	0.58	0.86	2.39	3.00
5-Yr. Muni GO (4-6)	0.32	0.36	0.68	1.16	3.59	2.85
7-Yr. Muni (6-8)	0.35	0.36	0.71	1.50	4.54	3.06
10-Yr. Muni (8-12)	0.40	0.35	0.75	2.16	5.28	3.07
15-Yr. Muni (12-17)	0.67	0.35	1.02	3.13	6.92	3.59
30-Yr. Muni (22+)	1.32	0.37	1.68	4.96	10.18	4.22
AAA Muni	0.49	0.35	0.85	2.08	5.46	3.21
AA Muni	0.61	0.36	0.97	2.41	6.11	3.37
A Muni	0.72	0.36	1.08	3.24	6.10	3.87
BBB Muni	1.15	0.36	1.51	4.45	7.47	4.48
Gen. Oblig.	0.52	0.35	0.87	2.18	5.71	3.25
State GO	0.36	0.36	0.73	1.98	4.91	3.10
Local GO	0.65	0.34	0.99	2.34	6.40	3.39
Revenue	0.72	0.36	1.08	3.00	6.41	3.65
California	0.64	0.35	0.99	2.44	6.00	3.32
New York	0.85	0.36	1.22	3.39	6.38	3.50

Despite positive performance YTD, we remain cautious given a hawkish Fed and the possibility of overshooting, a possible recession, and financial dislocations, as evidenced by the recent bank failures and deposit runs. With Municipal accounts having rolled down the curve and significant amounts maturing in under one year, some extension is prudent to offset growing reinvestment risk as we approach terminal tightening. We especially favor 5%+ premium issues pricing to a 10-year call which is beginning to appear again in more extensive, new issue offerings.

Outlook

If the Fed continues to raise rates in response to backward-looking inflation and economic data – which it seems poised to do – the risk that it turns a prospective soft landing into a hard downturn is greatly enhanced. One more rate hike probably won't make much difference, but two might be the straw that breaks the economy's back. Policymakers are prepared to accept a mild recession, including a rise in the unemployment rate to 4.5 percent. That would still be historically low, but once employers are convinced the Fed will induce a recession, they will probably abandon the hoarding instinct and send more workers onto the unemployment lines than policymakers anticipate.

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