Investment Review

A Pause, a Skip, and a Slump

May 2023

The first half of May was heavily influenced by banking conditions and the Federal Reserve's decision to raise interest rates again by 25 basis points (bps). Budget negotiations, better known as the Fiscal Responsibility Act, overwhelmed the second half of May. After countless predictions of Economic Armageddon to raise the debt ceiling, the Biden White House and Congressional Republicans agreed on a new budget deal that does nothing to change the status quo, allowing for a 1% increase in spending each year while abolishing the debt ceiling altogether until 2025. Muted by the debt ceiling worries, economic data showed signs of modest strength in May as inflation showed signs of decelerating, and the May employment report showed much stronger-than-expected hiring. Simultaneously, the unemployment rate ticked higher. While it appears consumers are still spending, they are also getting less bang for the buck, as inflation is taking more of the dollars spent. With the cost of borrowing surging from the Fed's aggressive rate hikes, new purchases are showing signs of slowing as monthly payments on variable-rate loans, such as on credit card balances, are becoming overly burdensome on a growing swath of the population. Credit card delinquencies are rising, particularly among young adults, the fastest-growing group of borrowers. Investors widely believe the Fed's hiking campaign will end with a pause or a "skip" at the June 14th meeting; however, Chair Powell and his colleagues spent most of the month trying to convince markets that they intend to keep rates elevated longer than traders in the financial markets expect to assess the impact that past increases are having. Monetary policy affects the economy with long and variable lags. Still, the lags are getting shorter, showing up in real-time transactions, such as recent supply increases in auto sales and surging mortgage rates.

World Markets	MTD (%)	YTD (%)	1Y (%)	10Y (%)	10Y STD (±)
DJIA	-3.17	0.25	1.96	10.60	14.97
S&P 500	0.43	9.64	2.89	11.97	14.85
NASDAQ	5.93	24.07	8.06	15.36	17.51
Equity EM Mkts.	-1.66	1.15	-8.12	2.26	17.01
EM Bond Mkt.	-0.75	1.78	-0.68	2.11	7.32
US Aggregate Bond	-1.09	2.46	-2.14	1.39	4.30
Municipal Bond	-0.87	1.65	0.49	2.28	4.63
US High Yield	-0.96	3.66	-0.13	3.88	7.57
Commodity	-5.64	-11.37	-22.48	-1.86	14.13
COMEX Silver	-6.16	-1.95	7.82	0.16	27.89
COMEX Gold	-1.34	7.55	6.13	3.42	14.62
Brent Oil	-9.55	-18.78	-14.08	3.42	39.04
Dollar Index	2.62	0.78	1.33	2.47	6.52

With the higher-for-longer narrative gaining traction in May, bond markets shifted while the yield curve inversion continued. The tech-heavy NASDAQ moved significantly higher across a very narrow breadth of the market driven by AI exuberance (+5.93%). The S&P was relatively flat (0.43%), the industrial-heavy DOW index was down (-3.17%), and most global markets and commodities fell into negative territory. The Consumer Price Index (CPI) report before the June FOMC rate decision will be the essential data point shaping June expectations.

Taxable Markets

The bond market ended the month with the 10-year yield closing 22 bps higher at 3.64% and the 2-year yield up 40 bps at 4.41%. The curve, measured from 2-year to 10-year, inverted 18 bps to -75 bps during May; however, 10-year to 30-years remained positive since mid-March +22 bps with a modest flattening of 3 bps in May. Market expectations shifted in the last few weeks with expectations for rate cuts sometime this year, but additional tightening is now a real possibility, according to markets. Market expectations show a 63% probability for a 25 bp hike at the June FOMC meeting and a 77% chance of a 25 bp tightening through the July meeting.

U.S. Fixed Income	Price	Cpn	Total Returns (%)		Dur	Yield
	(%) Rtn	% Rtn	Mo.	YTD	+/-	+/-
Aggregate Bond	-1.36	0.28	-1.09	2.46	6.34	4.59
US Treasury	-1.36	0.20	-1.16	2.35	6.23	4.07
US Agencies	-0.59	0.22	-0.37	2.13	3.14	4.62
Corporate	-1.79	0.34	-1.45	2.78	7.14	5.37
Non-Corp	-1.32	0.27	-1.05	2.97	5.92	4.65
Tax-Muni	-2.51	0.45	-2.06	4.23	9.49	5.03
US Agency MBS	-1.06	0.33	-0.73	2.30	6.15	4.61
Gov/Credit	-1.50	0.25	-1.24	2.53	6.48	4.56
TIPs	-1.26	0.06	-1.20	2.21	3.93	4.25
AAA Corporate	-2.28	0.30	-1.99	3.74	10.95	4.45
AA Corporate	-1.91	0.30	-1.61	2.97	8.55	4.68
A Corporate	-1.75	0.32	-1.42	2.65	7.07	5.18
BBB Corporate	-1.81	0.37	-1.44	2.86	6.91	5.68

The Corporate sector gave up 145 bps in return. Corporate spreads widened with the Financial Institutions sector decreasing by 93 bps, while the Industrial sector declined by 163 bps and Utilities by 222 bps in return. Much of the backup was due to the longer duration of Industrials (7.86) versus Financials (5.40). Without a doubt, the experience in the banking system this year caused significant dispersion in spreads within the financial sector alone, as idiosyncratic credit concerns ahead of debt maturity and refinancing risks are a concern. In the aggregate, we believe that the credit sector has the strength to weather a potential recession that could come in the second half of the year, but volatility and risk will remain high; therefore, deep fundamental analysis and credit selection will be key. Across taxable accounts, we continue to improve quality in non-cyclical sectors such as healthcare while reducing our exposure during market rallies in financials, increasing income and yields with modest duration extensions. Higher yields in the short end of the curve have lowered the opportunity cost of short-term investments; building our allocation to such holdings maintains our return profile and provides the necessary dry powder to deploy capital at the appropriate time.

Tax-Exempt Markets

Uncharacteristic of May, municipals had another down month of performance. The asset class had to contend with many headwinds, including the debt ceiling impasse, May 3rd rate hike, sticky inflation, renewed regional bank concerns, and recession worries that led to higher volatility. The Muni Aggregate returned - 0.87% for the month, +1.65% YTD due to a combination of rising yields and above-average supply. The belly of the curve, the 7 Yr Muni bond index (6-8Yrs), underperformed the most (-1.14%) versus the 3 Yr Muni index (2-4Yrs) (-0.56%) as the best performer in May.

Municipal Market	Price	Cpn	Total Returns (%)		Dur	Yield
	(%) Rtn	(%) Rtn	Mo.	YTD	+/-	+/-
Municipal Agg	-1.22	0.35	-0.87	1.65	6.08	3.64
1-Yr Muni (1-2)	-0.47	0.37	-0.11	0.66	1.28	3.44
3-Yr Muni GO (2-4)	-0.93	0.37	-0.56	0.29	2.37	3.15
5-Yr. Muni GO (4-6)	-1.29	0.35	-0.94	0.47	3.58	2.99
7-Yr. Muni (6-8)	-1.49	0.35	-1.14	0.79	4.52	3.17
10-Yr. Muni (8-12)	-1.45	0.34	-1.10	1.39	5.29	3.17
15-Yr. Muni (12-17)	-1.32	0.34	-0.98	2.10	6.95	3.69
30-Yr. Muni (22+)	-1.18	0.36	-0.81	3.22	10.31	4.35
AAA Muni	-1.23	0.35	-0.88	1.22	5.42	3.33
AA Muni	-1.29	0.35	-0.93	1.42	6.14	3.48
A Muni	-1.12	0.36	-0.76	2.13	6.12	3.99
BBB Muni	-1.03	0.36	-0.67	2.90	7.57	4.64
Gen. Oblig.	-1.31	0.34	-0.96	1.30	5.72	3.37
State GO	-1.20	0.36	-0.84	1.25	4.92	3.21
Local GO	-1.40	0.33	-1.07	1.34	6.40	3.50
Revenue	-1.21	0.36	-0.85	1.90	6.45	3.78
California	-1.18	0.35	-0.84	1.44	6.07	3.45
New York	-1.25	0.36	-0.89	2.14	6.44	3.64

Yields may have limited upside from here as the Fed nears its peak rate, which should prevent their prices from falling much further. While the odds of a recession are growing, credit risk in the muni market will likely hold up even if the economy slows. Credit spreads are rising with broad market volatility; however, the wider spreads make higher-rated munis more attractive. With the recent rise in spreads, investors no longer need to target the lowest rungs of investment grade for more yield.

The correlation between the S&P 500 and the Municipal Aggregate index is near zero, meaning that total returns for munis tend not to move much with equities, particularly should a selloff in risk assets occur later in the year. We believe municipals can be a complement to a fully diversified portfolio. We are looking for opportunities to extend the duration to offset extension risk as maturities under 1-year mature. We favor tactical positioning with 5% coupon bonds pricing to a 10-year call as a perfect complement in a short/intermediate strategy, often considered a “barbell” strategy.

Precious Metals

The shift to gold by World Central Banks is about creating a more neutral portfolio in response to geopolitics as they become more distrustful of dollars. It is important to remember that the US continues to value its gold at $42 oz. Younger generations, however, are not into gold, especially in Europe, and are more into crypto despite fraud, losses, and manipulation. In this context, as an offset, according to the 2020 census, it is essential to remember that the over-65 US population is now 16.5%, or one in six people in the US getting older. However, we are still younger than Japan, many European countries, Canada, and Hong Kong. Given the decline in global growth and elevated geopolitical risks, we believe gold can add value in a portfolio. Timing is key, as is allocating to more stable large-cap miners, streamers, and commodity ETFs.

Outlook

There are too many variables at this point to predict accurately which way the economy is going in the short term. However, with today's heightened uncertainty, now is the time to prioritize quality. The good news is that a defensive posture does not mean sacrificing returns; there is enough excess spread to compensate for the potential costs of rising credit risk. Similar to 2018, fears of overtightening caused the Fed to pause its rate-hiking cycle, but yields were significantly lower then. Like 2018, the Fed vowed to continue with quantitative tightening. However, the fundamental picture is better today with lower net leverage and higher interest coverage across most rating categories relative to prior downturns, with balance sheet liquidity, while not evenly distributed, remaining stable.