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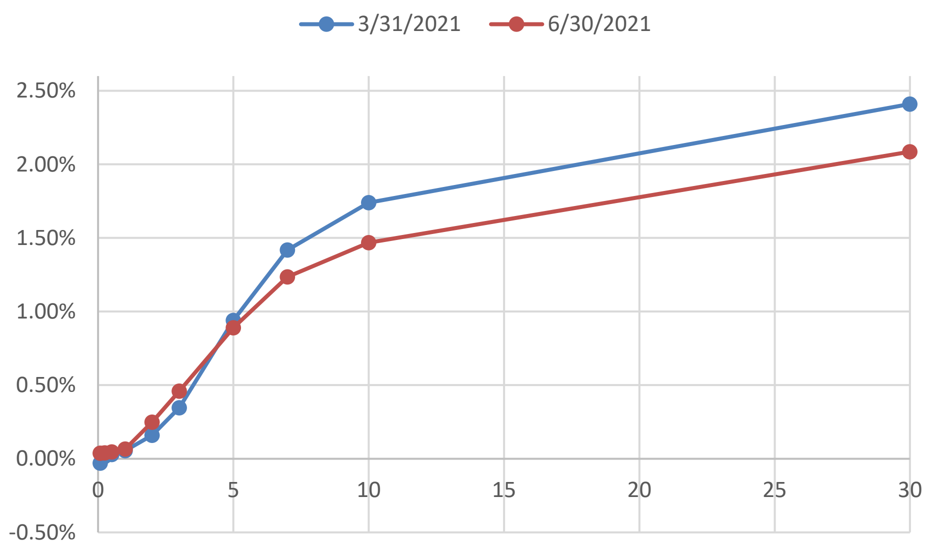
MARKET Commentary

Summer 2021

Macro View

Risk assets pushed to new highs as economic growth accelerated and earnings expectations rose. Most pandemic restrictions have been lifted leading to a broad, fast-paced reopening straining portions of the economy. The Federal Reserve (Fed) signaled the start of policy tapering as inflation metrics surged. All of the positive momentum contributed to new highs in equity prices and, counterintuitively, a decline in longer term treasury yields (see Figure 1). A variety of reasons have been floated to justify the flattening yield curve – monetary policy discipline (hiking sooner, but shallower), short-covering, less-than-expected fiscal stimulus.

Figure 1: Yield Curve Flattens



Source: Bloomberg

The Fed continued its course of zero interest rate policy as well as asset purchases, $80B of Treasury and $40B of agency mortgage-backed securities a month. Official Fed communication has been slightly less dovish, with hints of higher rates in the distant future (think 2023) and a nod to an asset purchase taper.

The broad market recovery and accommodative monetary policy stance continues to support historically low spread levels across fixed income sectors. Front-end and intermediate treasury yields will remain near zero, tethered by 0.00-0.25% fed funds for the near-term future. However, markets should gain more clarity on the Fed's exit plan over the coming quarter.

Federal Funds Target

0.00-0.25%

U.S. Treasuries

As of 30-June

Benchmark	Yield
3 Month	0.04%
6 Month	0.05%
1 Year	0.07%
2 Year	0.25%
5 Year	0.89%
10 Year	1.47%
30 Year	2.09%

ICE BofAML Index Returns

YTD 2021 Return

Index	Return
0-3 Month UST	0.02%
1-3 Yr Gov/Corp ≥ A	-0.03%
1-3 Yr Municipals	0.36%
1-3 Yr Agencies	-0.02%
1-5 Yr Gov/Corp ≥ A	-0.33%
S&P 500	15.2%

Source: US Treasury, Bloomberg, ICE/BofAML, and S&P

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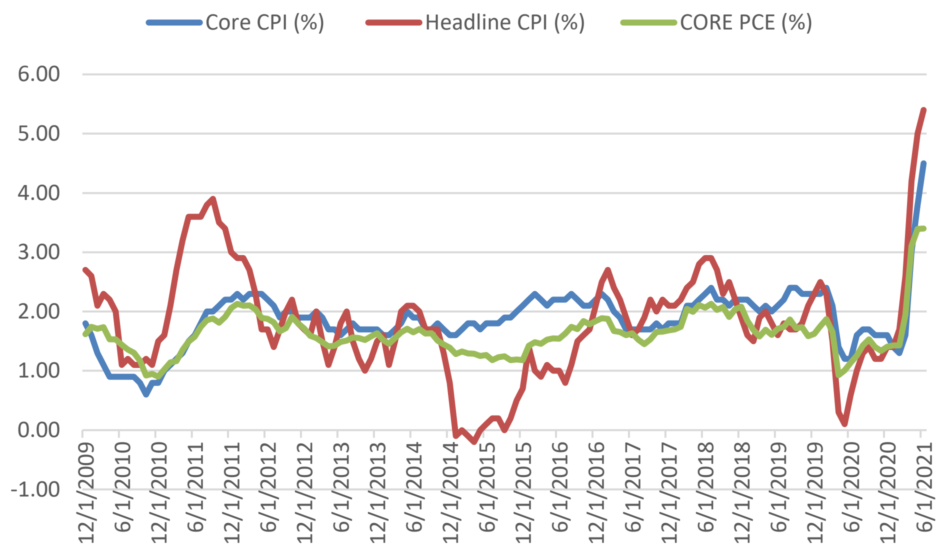
Monetary Policy

The Federal Reserve grappled with the strength of the reopening and transitory nature of inflation. Fed forecasts for inflation increased materially between their March and June meetings as data prints came in well above consensus (see Figure 2) and most FOMC participants expect to hike rates by the end of 2023. Taper talk picked up and markets expect specifics in the coming months.

Figure 2: Transitory Inflation?



Source: Bloomberg

The Fed left its benchmark interest rate unchanged and continued to signal that rates will stay low as it expects the recent surge in inflation will wane. Further, Chairman Powell continues to provide fairly dovish statements at the news conferences following the FOMC meetings. However, amid the swath of hot inflation reports, Fed members began discussing the need to taper bond purchases and seemed to have advanced their timeline for eventual rate hikes. Markets will be looking for further clues on taper timing and pace starting with the annual Jackson Hole Economic Symposium in late August.

Markets

Long duration, lower quality credit exposure was rewarded over the quarter. Credit spreads narrowed through earlier cycle tights while credit curves flattened. Cyclical sectors led corporate performance as economic activity surged. Year-to-date, primary market activity is running 30% behind 2020, but is up 38% versus the same period in 2019 and demand has been very strong.

The next phases of President Biden's massive fiscal programs have become mired in a Congressional quagmire. The domestic economy doesn't appear to need further stimulus and the political appetite is waning. As Congress wrestles with a stripped down version of an infrastructure bill, the debt ceiling will need to be addressed fairly quickly. Treasury Secretary Yellen has asked Congress to increase the limit as soon as possible as the emergency measures taken to stave off the debt limit could be exhausted soon after Congress returns from recess in September. At present, markets aren't too concerned but it's easy seeing this issue becoming a political football.

The rise in COVID cases spurred by the Delta variant and corresponding changes in pandemic policies along with expectations that the torrid pace of growth will slow into year-end casts uncertainty on the path for markets over the coming quarters. Volatility has increased but spreads have not widened as there is little expectation that the pandemic will materially impact economic activity – a sentiment echoed by Chairman Powell. With the shortest recession on record (two months according to the National Bureau of Economic Research) spurring fiscal and monetary stimulus to a historically high level, it's little wonder markets aren't too concerned.

However, the Fed's stance will start to shift less dovish over the coming months which could jolt markets accustomed to massive monetary support. Further, should the political situation deteriorate further, a messy debt ceiling battle could further exacerbate markets. In either case, we would opportunistically add to credit, asset-backed and possibly agency mortgage-backed sector exposure.

Looking Forward

The domestic economy has "made progress" towards the Fed's price stability and employment goals. Yet, the path to higher fed funds is still expected to be a couple of years away. Money market investors should continue to seek spread product exposure as Treasury and agency securities offer single digit yields out to eighteen months to maturity. This very low yield environment should subside as the Fed provides details on tapering asset purchases, the Delta variant surge peaks and economic data distortions normalize. But, a move materially higher is still over a year away.

Money market reform is working its way through the various regulatory bodies. Given this is the third go around since 2010, markets may have a good sense of which reforms regulators will favor by the end of this year. Most of the changes will again be directed towards prime funds which saw institutional investors draw down 30% of prime fund assets during March 2020 contributing to money market turmoil. With average prime fund yields in low-to-mid single digits and further regulation coming, it's worth revisiting a separately managed account tailored to a specific risk profile.

Please contact the desk with questions or to discuss investment opportunities.

Form ADV Part 2

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