Fixed Income Quarterly

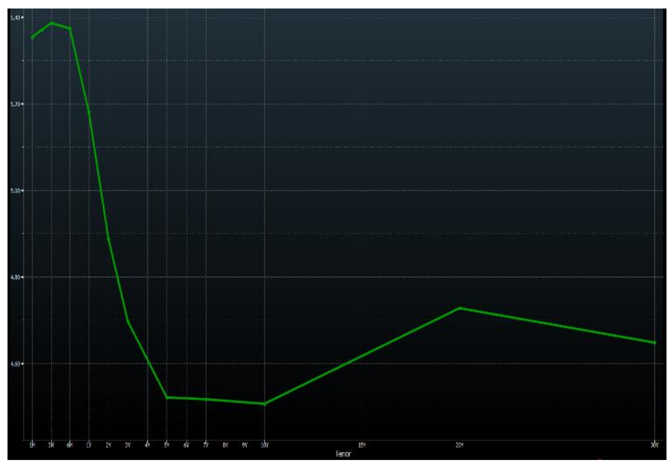
June 2024

Yield Curve Normalization

- The inverted yield curve remains in place, even as expectations for a recession subside.
- With an economic soft landing, we expect the curve to normalize through a combination of easier Fed policy and rising long-term yields.
- Inflation continues to create bond market risks by eroding most of the yield in short maturities and potentially driving down long-term bond prices.
- Focusing on intermediate-maturity bonds can help address the rising risks in short- and long-term bonds.
- We suggest a slightly shorter duration posture, with overweight exposures in Treasuries and MBS and an underweight exposure to corporates.

The yield curve, which is a graphical depiction of Treasury yields across a spectrum of maturities, has been a primary topic in the bond market for the past couple years. Of particular interest has been its inverted shape, where shorter-maturity yields are higher than those of longer maturities.

Treasury Yield Curve – 5/31/2024



(Source: Bloomberg)

Usually, longer-maturity yields are higher than shorter ones, creating a curve that slopes upward in what is known as a "normal shape." Inverted curves are unusual and garner a lot of attention because they have predated all recessions in the modern era. For this reason, when the curve inverted in 2022, many investors (including ourselves) began to anticipate a recession.

One of the more common ways to consider yield curves is to create a spread, subtracting the two-year Treasury yield from the 10-year yield. When the line in this next graph is positive (above the red line), the yield curve has a normal shape, while areas below the red line (shaded in yellow) reflect periods with inverted curves. [Technically, the Mexican peso crisis didn't quite create an inversion in the yield curve, but monetary policy followed a cadence similar to what has happened in other periods of inversion.] It's also apparent that inverted curves are often precipitated by crises and the expectations of a recession, and recessions are usually caused by or become part of the crises.

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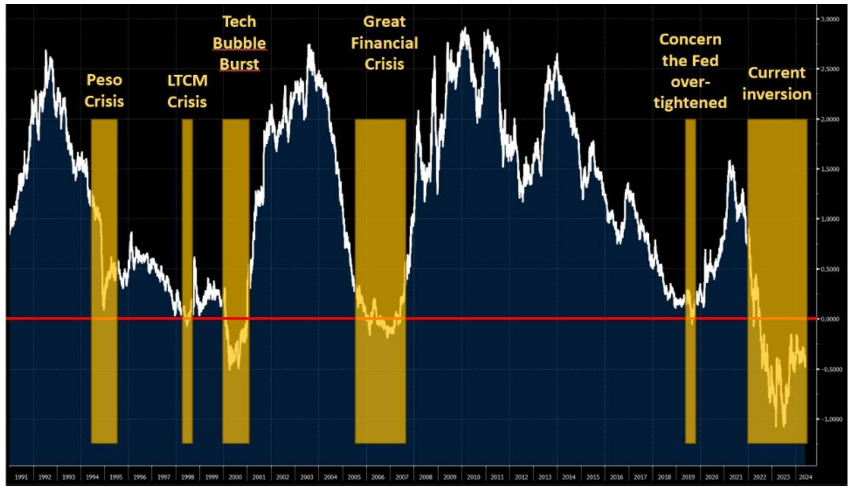
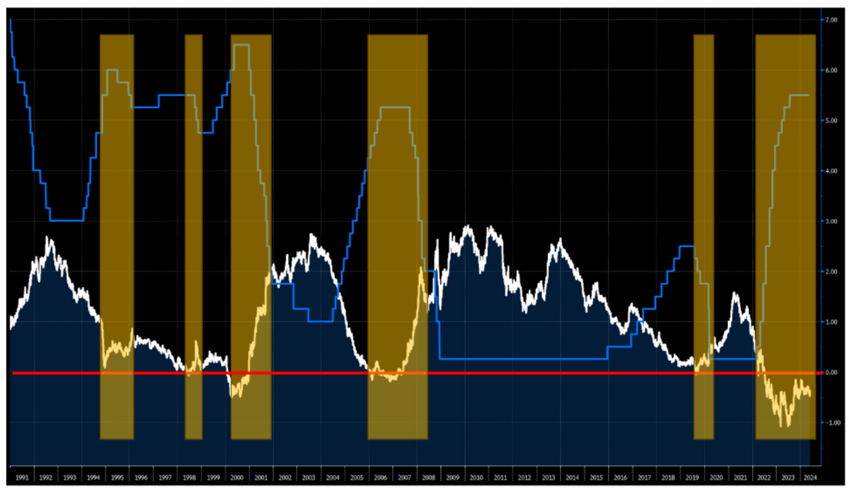
Yield Curve of Two/10-Year Treasury Notes
(January 1991 - May 2024)



(Sources: Bloomberg, Confluence)

The four time frames highlighted on the left side of this chart illustrate crisis-inspired inversions, while the two more recent inversions reflect a view that the Fed tightened too much and the resulting recessions caused the Fed to ease. Importantly, we can observe a consistent pattern in recent decades that after a crisis or recession has abated, the yield curve returns to a normal shape.

Yield Curve of Two/10-Year Treasury Notes & Fed Overnight Interest Rate
(January 1991 - May 2024)



(Sources: Bloomberg, Confluence)

The change from an inverted to a normally shaped curve involves lower short-term yields, higher long-term yields, or some combination of the two. In modern history, yield curve normalization has consistently involved easier policy from the Fed. We can illustrate this point by modifying the previous graph to include the Fed's short-term interest rate with the blue line. Here we can see that in each previous cycle, after the curve reached its greatest degree of inversion, the Fed began lowering rates within a year. In other words, bond investors have properly anticipated the Fed's easing policy as it responded to crises and recessions.

The current inversion is deeper and has lasted longer than other modern cycles. Furthermore, its greatest degree of inversion took place early in July 2023, meaning the expectation for the Fed to ease this September is generally in line with what happened in previous cycles. However, each cycle is unique, and if the economy avoids a recession (which is our expectation), it would represent the only time in modern history that an inverted curve hasn't predated a recession.

Against this backdrop, our view is that short-term yields are likely to decline as the Fed eases. But without a recession, and with inflation generally still above the Fed's 2% preferred level, we expect Fed easing to be more limited relative to previous cycles. If this proves to be the case, normalization of the yield curve will need to involve higher long-term yields.

Treasury Sector

Inflation has long been the bane of bond investors because it erodes the present value of coupons and principal. As mentioned above, we expect inflation to decline cyclically, at times perhaps even reaching the Fed's preferred 2% level. But over the longer-term, we expect inflation to run higher than the pre-pandemic era, probably in the 3-4% range, given the ongoing societal preference to deglobalize trade.

This higher inflation would form a headwind across maturities, but the risk would manifest in different forms. The Fed could still ease but probably would do so more slowly and the magnitude would be tempered. Investors in cash and short-term bonds might cheer the resulting "higher-for-longer" yields, but we expect inflation will consume most, if not all, of their returns. At the same time, we believe higher inflation will pressure long-term bond yields higher, meaning part of the yield curve normalization occurs from price declines among long-maturity bonds.

Fortunately, we believe there is a rather straightforward solution in this environment: focus on intermediate-maturity bonds. This posture limits high levels of reinvestment risk from shorter maturities, while avoiding significant price risk from longer maturities. Furthermore, we believe intermediate bond yields are likely to deliver positive real income, even as we expect higher inflation. Our guidance is to position the average duration of bond allocations slightly shorter than traditional intermediate bond exposures, preferably through laddering. We suggest an overweight exposure to Treasurys to help accommodate underweight exposure in corporates.

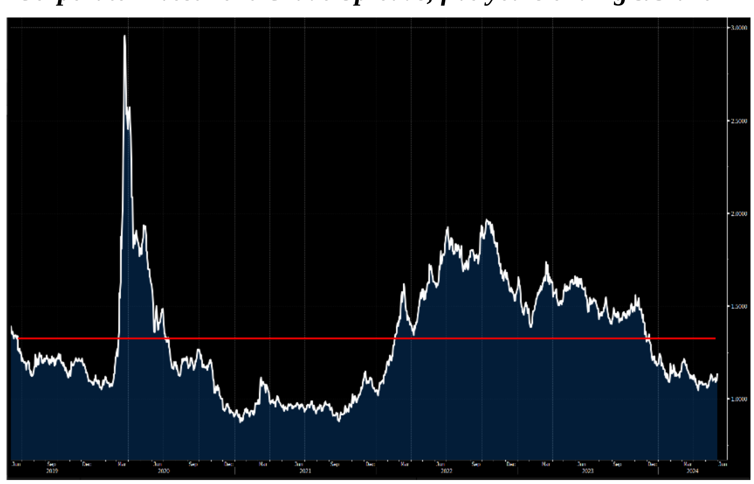
Corporate Sector

Last year, as the bond market began to anticipate the end of the Fed's tightening, expectations broadened for an economic soft-landing. In response, corporate bond spreads tightened in the fourth quarter, setting the stage for corporates to outperform other investment-grade sectors. Thus far in 2024, corporate spreads have generally maintained their tighter posture.

Although corporate defaults remain relatively low, we are beginning to see evidence of operating fatigue among investment-grade borrowers. Revenue growth rates, while still positive on the whole, continue to trend lower, while profit growth has turned negative for some industries, particularly those involved in commodities. Debt levels are rising modestly, and, by extension, so too are interest expense burdens.

Overall, investment-grade operating fundamentals appear to be relatively stable, though the mixed picture has stalled incremental spread tightening. Nonetheless, corporate spreads are much tighter than the five-year average (red line), creating a return/risk profile that is less attractive. Accordingly, we prefer to underweight the corporate sector.

Corporate Investment-Grade Spreads, five years ending 5/31/2024



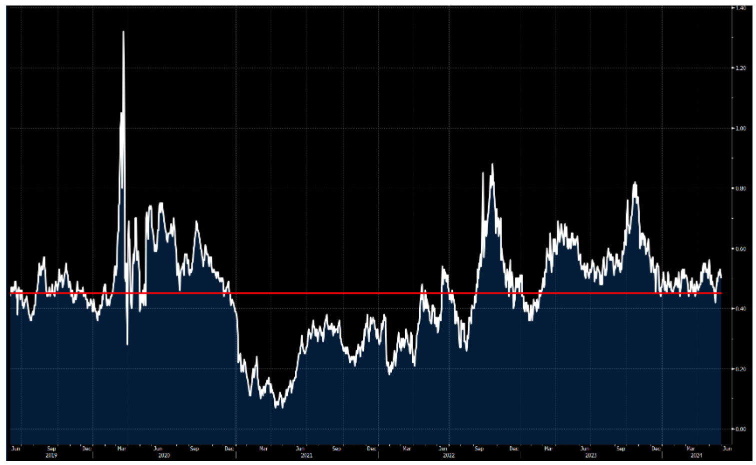
(Source: Bloomberg)

Mortgage-Backed Securities (MBS) Sector

The MBS sector continues to move through a period of relative calm, which is welcome news for investors in what has been a sometimes choppy arena of the bond market. After tight monetary policy was unleashed in 2022, rising Treasury yields caused mortgage rates to rise and MBS prices to fall. But with Treasury yields recently trading in a relatively narrow band, conditions for MBS have settled down quite a bit. Most fixed-rate MBS prices are now well below par, which helps to address prepayment risk; at the same time, refinancing trends are low enough to limit incremental extension risk. In addition, the Fed's decision to limit its MBS runoff should help limit spread widening.

We illustrate MBS option-adjusted spreads for fixed-rate MBS, and the absence of big market drama is reflected in relatively stable spreads. But despite the relatively calm environment, spreads remain wider than the five-year average (red line). For this reason, we prefer an overweight posture for the MBS sector.

30-Year Fixed-Rate MBS Spread, five years ending 5/31/2024



(Source: Bloomberg)

Municipal Bond Sector

As the economy has remained strong and recession likelihood has declined, municipalities have resumed issuing bonds at an accelerated rate. Year-to-date, municipal bond issuance increased 35% compared to the prior year. This increased supply combined with seasonal technical factors affected the muni market, with net supply overwhelming the primary demand. On average, June represents the highest net issuance of municipal bonds out of any month of the year. Nevertheless, the following three months usually see a net negative supply of muni bonds due to low issuance. This seasonality can create a supportive environment for municipal bonds over the summer. However, the shape of the yield curve, future path of monetary policy, and underlying fundamentals are stronger long-term factors affecting market performance.

Similar to the Treasury yield curve, the muni yield curve is also inverted. The muni curve has a technical uniqueness to it – owing to the 10-year call provision, it is extremely unlikely that the longer end of the yield curve would invert. Thus, the inversion affects the front end of the curve. Prior to the end of 2023, the muni yield curve had never spent any meaningful time being inverted. We favor the intermediate segment of the curve to avoid the shorter-duration reinvestment risk and longer-duration price action risk when the curve normalizes.

The underlying health of state and local governments remains healthy as real estate values remain near historic highs and consumer spending (and thus sales tax revenues) has remained strong on the back of a robust labor market and steady income tax receipts. Additionally, municipal budget cash reserves are near all-time highs. States have a long history of building up reserves, especially when economies are strong. This has allowed them to successfully navigate challenging times.

Municipal bond yields remain attractive, with the Bloomberg Municipal Bond Index yield to worst at 3.93% as of May 31, 2024. Given our assessment of the health of municipal finances, we suggest a slight overweight to general obligation bonds (GOs) relative to municipal revenue bonds. The prospect of continued volatility in the rate of inflation encourages our recommendation of an intermediate duration and our preference for a laddered structure with an emphasis on intermediate maturities.

Confluence Fixed Income Strategy Committee

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Confluence Investment Management LLC

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