Short Maturity Muni and Low Duration Taxable

Commentary – Third Quarter 2021

Macro Overview

Eighteen months into the rapid economic recovery off pandemic-related lows, the US economy continued to improve over the quarter, although at a moderating pace. The spread of the Delta variant prompted a slowdown in hiring and consumer spending, while some inflationary pressures persisted for longer than anticipated. At its September meeting, the Fed reiterated its intent to begin tapering asset purchases in Q4 '21, and conclude by mid '22. Fed median forecasts now imply one rate hike in '22, however eight governors still forecast no increases in '22, suggesting uncertainty on the appropriate path for monetary policy. Although there was a quick uptick late in the period, UST yields were largely unchanged for the quarter, while the S&P ended effectively flat driven by a ~5% selloff during September.

- GDP estimates for full year '21 have softened recently, now forecasted around 5.9%. Growth is then expected to steadily decline from there to 4% in '22 and 2.5% in '23.
- Inflation pressures have intensified as the Fed-preferred Core PCE reached 3.6% in August. However, these elevated readings are being disproportionately driven by several sectors still experiencing covid-related supply bottlenecks.
- Meaningfully higher front-end yields are still unlikely in the near-term as the Fed remains committed to employment recovery, is comfortable with higher short-term inflation readings, and has well-telegraphed the upcoming tapering.
- The administration continues to have trouble gathering support for a large infrastructure spending and tax package. It appears a smaller plan will be a more likely outcome, however, a larger social spending agenda could still be passed through the budget reconciliation process.

Market Dynamics

The September meeting of the Federal Reserve provided market participants with a bit more clarity in how and when the committee will likely begin tapering pandemic related asset purchases. We now expect that they will reduce UST and MBS purchases by approximately $15Bln at each of their meetings starting in December and lasting through the middle of next year. Additionally, Fed governors also modestly raised their forecast for future Federal Funds rates, now approximately 1% by the end of '23. We continue to view a future tapering, and a possible Fed hike in late '22 or early '23 as positive steps in returning to a more normalized monetary policy. However, we also see many market cross-currents that could make this difficult for the Fed to fully accomplish.

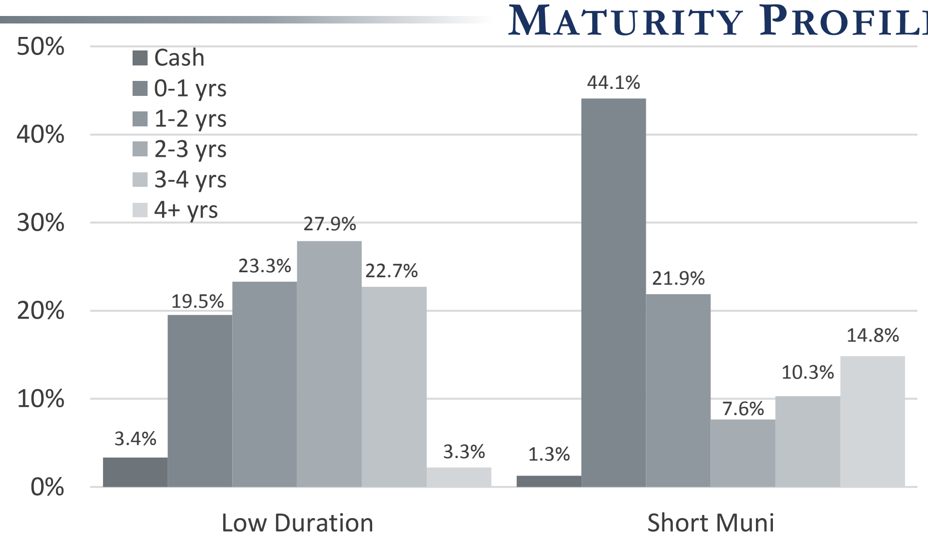
Low Duration

Duration: 1.97 yrs
Yield-to-Worst: 0.51%
Yield-to-Maturity: 0.58%
Maturity: 2.09 yrs

Short Muni

Duration: 1.54 yrs
Yield-to-Worst: 0.49%
Yield-to-Maturity: 0.52%
Maturity: 1.65 yrs

Maturity Profile



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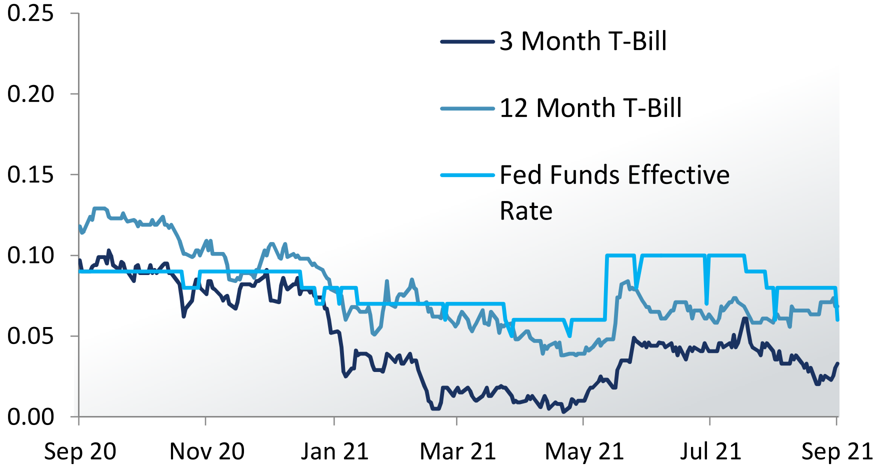
Performance Notes

Shorter-term bonds saw yields move steadily higher during the second-half of the quarter as expectations of Fed tapering grew. The 5YR UST yield climbed nearly 30bps from its August low, to end the period at nearly 1%, a level not seen since March '20. Despite the move higher in yields, the Low Duration Taxable strategy posted positive total returns as the overweight to corporate credit produced incremental income return. Corporate spreads continue to benefit from a rapid reduction of balance sheet debt, a slowing pace of issuance, and strong demand. We view shorter-term yields, particularly from 4-6 years as now offering more reasonable value for reinvestment to help gradually improve overall portfolio yield and income levels.

3M / 12M T-Bill Rates (%)

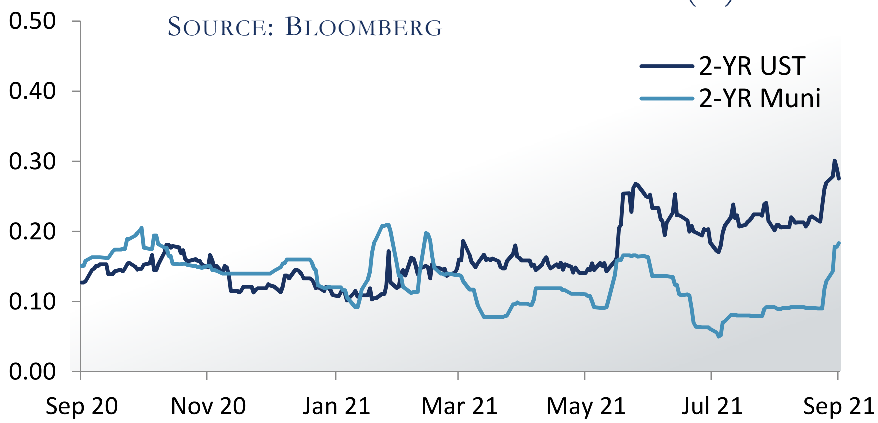
Source: Bloomberg



"We view potential asset purchase tapering by the Fed as a positive step in returning to a more normalized monetary policy, and do not anticipate a disorderly move higher for short-term rates."

2 YR UST vs 2 YR MUNI Yields (%)

Source: Bloomberg



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