

October 28, 2022



A rapid rise in yields is changing the fixed income conversation

Key Takeaways:

Investors are dealing with changing prospects for the economy and investment markets entering the last quarter of 2022. During an October 20, 2022, webinar, Breckinridge Chief Investment Officer Oggie Sosa discussed key issues with Christopher Day and Christina Lynch, co-heads of Consultant Relations. The views of the participants contained in this transcript were current as of the broadcast date while market data was as of September 30 or dates indicated. The key topics included:

- *Initiating and Increasing Fixed Income Allocations Now*
- *Macroeconomics and the Fed*
- *Portfolio Positioning*
- *Investing Opportunities*
- *Securitized Bond Performance*
- *Bond Market Technicals*
- *Corporate and Municipal Bond Fundamentals*
- *The UK Gilts Market*
- *Geopolitical Issues*
- *Mid-Term Election*
- *Inflation Reduction Act*





Speakers



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Initiating and Increasing Fixed Income Allocations Now

Christina Lynch: At this point in the rate hiking cycle, the question top of mind for folks is whether or not they should be increasing bond allocations or extending duration or doing both.

Yields today are approaching levels not seen since 2008 and 2009. Over the last 20 years, the 5-Year AAA GO yield has only been higher than the 3Q close 14% of the time.

Chris Day: Christina, that's the question I am hearing most often, too.

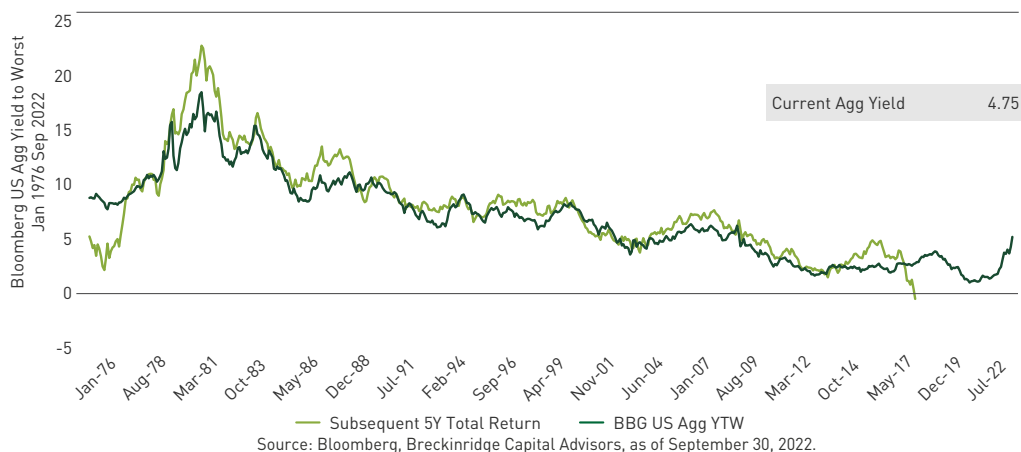
I think many clients think back to what happened two years ago. As the pandemic emerged in 2020, yields spiked quickly, and there was lots of talk about locking in what looked to be very attractive rates. Unfortunately, the window more or less closed very quickly. Clients are wary of a repeat.

What's your take, Oggie?

Oggie: As you both know, from an asset allocator's perspective, I often talk about the three primary roles that bonds play in investors' portfolios: income, diversification, and capital preservation.

The income story has taken a back seat in that discussion for quite some time. That has changed. In the current environment, the income story is much stronger, and yields are likely to stay elevated.

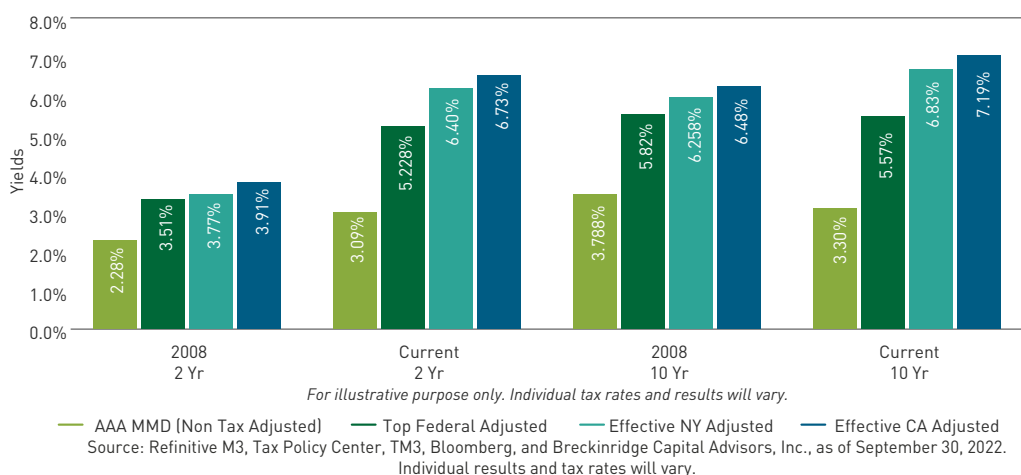
US AGGREGATE YIELD AND 5 YR FORWARD RETURNS



The Summary of Economic Projections released after the Fed's September meeting pointed to a terminal rate of around 4.6%. According to industry analysts, market expects a terminal rate are closer to 5%.



HIGHER TAXES AND YIELDS MAKE MUNIS MORE COMPELLING THAN IN 2008



Think about this. Two, two and a half years ago, the 10-year Treasury yield was 50 basis points. Investors buying bonds back then were expecting to earn half a percent a year for 10 years.

As this week began, that 10-year Treasury was yielding around 4%. On September 30, Corporate bonds yields were at their highest level since 2009. If you're buying municipal bonds at 10 years, your tax-equivalent yield, based on the highest marginal tax rate, is close to 5.5% and, in some states, more than 6%.

Is this a good time to put cash to work in bonds or extend duration to capture higher yields? Our answer is yes.

Christina: And, before folks start to think we are just talking our book, let's acknowledge that the last 12 months were volatile—sometimes historically volatile—so concerns on timing absolutely are legitimate.

Oggie: We feel that bonds right now are reflecting fair value pretty much across the curve. There is very little question that the curve may continue to gyrate but, again, a 4 handle is a reasonable yield level when the Fed's fed funds rate target is 4 to 5%.

When we build portfolios, we take a long-term view. That is why we consider curve positioning, sector allocations, credit quality, and duration and convexity factors as we identify bonds to add for clients.

Chris: In 2020, the market, investor sentiment, technicals, all turned very quickly, and yields fell quickly. When that happens, it can be harder to put money to work.

Christina: Risk-reward dynamics in a 0 to 2% yield environment are very different than in a 4 to 5% market.

Chris: It is always difficult to time the tops. And in many cases a dollar-cost-averaging into a position can be a sensible approach. But, I'm hearing the current environment is a favorable one for making those allocation decisions or putting cash to work to extend bond duration.

Ultimately, though, building a collection of bonds can be done quickly, but building a balanced, well-positioned portfolio using a thoughtful approach may take some time. In that time, yields can go up and they can go down.



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Macroeconomics and the Fed

That is something that should be considered when thinking about the timing of establishing an allocation or extending from a shorter duration to longer.

Christina: Clients want to know our view of the markets on a macroeconomic level.

Oggie: The Fed's plan remains to increase the fed funds rate until inflation is closer to its 2% target. With the Consumer Price Index above 8% year-over-year as of September, we have a long way to go for inflation to get to 2%.

Chris: I thought the Investment Committee's report at the end of the quarter captured the current environment pretty well when it mentioned, "All markets continue to adjust to a world where QE is being replaced by QT."

Christina: So, what is our house view?

Oggie: We believe that Fed is committed to bringing inflation under control and is very unlikely to pivot.

The Summary of Economic Projections released after the Fed's September meeting, provided all of the justification needed to continue to raise rates further. We expect the rate hikes to continue for the remainder of 2022 and into 2023 and a U.S. recession increasingly likely over the next 6 to 12 months, as consumer sentiment sours, and higher rates slow the economy.

CHANGES TO THE FED'S SUMMARY OF ECONOMIC PROJECTIONS

	2022	2023	2024	LONGER RUN
Change in Real GDP	0.2%	1.2%	1.7%	1.8%
June Projection	1.7%	1.7%	1.9%	1.8%
Unemployment Rate	3.8%	4.4%	4.4%	4.0%
June Projection	3.7%	3.9%	4.1%	4.0%
PCE Inflation	5.4%	2.8%	2.3%	2.0%
June Projection	5.2%	2.6%	2.2%	2.0%
Core PCE Inflation	4.5%	3.1%	2.3%	
June Projection	4.3%	2.7%	2.3%	
Federal Funds Rate	4.4%	4.6%	3.9%	2.5%
June Projection	3.4%	3.8%	3.4%	2.5%

Source: Federal Reserve, as of September 30, 2022.

Portfolio Positioning

Chris: How are our portfolios positioned entering the fourth quarter?

Oggie: Our multi-sector portfolios are neutral from duration and curve positioning standpoints with respect to their strategy benchmarks. While we maintain a structural overweight to spread product versus Treasuries, we are at the lower end of the range relative to history due to recession concerns. It is also the reason we are underweight lower-quality BBB credits.

Christina: What about looking ahead as we approach year end?

Oggie: Looking forward, while we manage duration in a relatively tight range versus benchmarks, we expect that our next move will be to extend within those bounds before year end.



Chris: How about our tax-efficient strategies?

Oggie: The municipal market is likely to continue to be pressured by selling in the secondary market and Fed rate increases. The duration targets for these strategies remain slightly short of their benchmarks. This positioning acknowledges a seasonally weaker period and hawkish Fed.

We are being selective in some sectors, including hospitals. Wage pressures and labor shortages in the sector are challenging. In addition, utilities are wrestling with rising natural gas prices.

Investing Opportunities

Christina: Where did the team direct investments in the third quarter?

Oggie: The fundamentals story in tax-exempt municipals has remained favorable broadly. Increases in Federal and State taxes make municipals more compelling on a tax-adjusted basis. Higher absolute yields also make in-state exposure more compelling, so we have been seeing more capital being deployed in-state for state-biased portfolios. The team also has been finding some opportunities in callable bonds. Finally, sustained elevated yields also are offering continued opportunities for tax-loss harvesting through the third quarter.

The municipal team extended duration slightly during the latter part of the quarter, as a steeper curve from 10 to 15 years offered a more compelling entry point.

Christina: How about our corporate outlook.

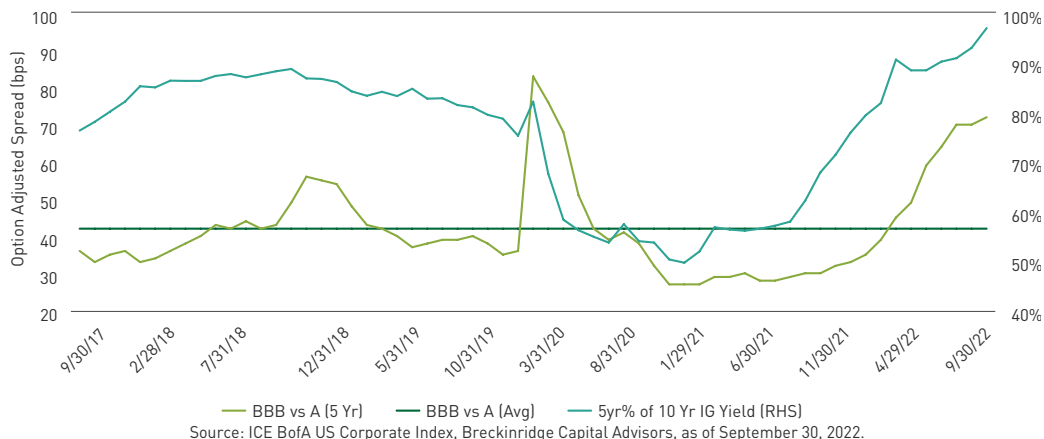
Oggie: These are very different market conditions for bond investors than we have seen in more than a decade. For some perspective, the credit spread as a percent of the IG corporate yield peaked at 80% in both 2008 and 2020. Both of those periods were times of acute credit distress.

This year, the IG Corporate Bond Index yield is akin to 2009 but the rate component is well above the spread, suggesting stable credit fundamentals. The multi-sector team maintained an overweight to taxable municipals, as the sector historically performs well in risk-off environments. In fact, in Q3, Intermediate taxable municipal bond spreads widened very modestly, outperforming other spread sectors.

A complication in that market segment has been a substantial reduction in supply.

Chris: At the end of the third quarter the IG Index OAS was 159 basis points (bps), 10bps wide to its mean since 1993. Then last week, it widened again and closed at an OAS of 164. Outside of the March 2020 pandemic time period, that's the widest levels since April 2016.

RELATIVE VALUE BY MATURITY FAVORS 5-YEAR IG ISSUERS





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Securitized Bond Performance

Oggie: At current valuations, BBB spreads are over two-standard deviations wide to Single-As in 5-years. But, they are in-line with their long-term average in the 30-year bucket.

Pockets of value have emerged particularly in select IG issuers, where intermediate 5-Year yields are very close to 10-Year yields

Christina: Fed action has an outweighed influence in the mortgage-backed securities market. Through QT, it is letting the bonds on its balance sheet—including MBS—mature without reinvesting the proceeds. That removes a significant buyer from that market. What is our take on the securitized markets in the third quarter and going forward?

Oggie: Securitized really was a mixed bag. There wasn't much good news in mortgage-backed securities—largely due to QT.

Lower coupons underperformed higher coupons and Ginnies underperformed conventionals, as there was speculation that the Bank of Japan sold MBS to support the yen.

With valuations looking attractive, we shifted our MBS positioning to neutral during the quarter. We added higher coupons: 6 percents and we barbelled it with some lower coupon bonds.

MBS POSITIONING UPDATE

	YTD EXCESS RETURNS (BPS)	BCA POSITIONING
Conventional 2	-363	Underweight
Conventional 2.5	-324	Underweight
Conventional 3	-320	Overweight
Conventional 3.5	-296	Overweight
Conventional 4	-188	Overweight
Conventional 4.5	-73	Overweight
Conventional 5	-90	Overweight
Conventional 5.5	-7	Overweight
Conventional 6	+76	Overweight

Source: Bloomberg, Breckinridge Capital Advisors, as of September 30, 2022.
Excess returns are measured against similar duration Treasuries.

At 80 cents on the dollar and positively convex, lower coupons are starting to look attractive. We may look to leg back into these coupons depending on where rates go through year end.

Christina: ABS turned out to be a bright spot in the market, right?

Oggie: Yes. Which was welcomed. The sector is high quality with shorter duration and wider spreads year-to-date. Auto loan ABS spreads widened and outperformed credit cards, where spreads narrowed. Year-to-date volume is down relative to the comparable period in 2021, which has supported prices.

Bond Market Technicals

Chris: New issuance is lower year-over year in the corporate and municipal markets. What are your thoughts?

Oggie: In the tax-exempt market, new issuance as of September 30 was down about 29% year-over-year and refundings were down 70%, not too surprising in a higher rate environment. We have been active in the secondary market for a few reasons. First, lower new issue supply obviously reduces the opportunities on that front. Second, outflows from municipal mutual bonds are elevated. Third, increased tax-loss harvesting.



Corporate and Municipal Bond Fundamentals

On the corporate side, index-eligible investment grade new issuance year-to-date through September was down 13% on a gross basis and about 10% net after redemptions.

Chris: What about potential shifts in financial fundamentals in the municipal market? Is there concern about corporate IG issuers with a potential of recession looming?

Oggie: Municipal bond upgrades continue to outpace downgrades at Moody's and S&P. The state-local sector exhibits strong liquidity. Unspent federal aid, still-rising sales taxes, delayed capital expenditures all are positive. On top of that, we are tracking a slower pace of rehiring that tends to support reserves.

There are signs to watch. The first decline since March 2012 in the Case-Shiller home price index quarter-over-quarter occurred in the second quarter. Rising interest rates and a shortage of construction labor may crimp capex and increase costs. Wage pressure may eventually result in larger pension liabilities if expiring collective bargaining agreements are renewed with higher-than-expected wage scales. Finally, California is forecasting a small fiscal year 2023 deficit and, New York state income tax growth is negative on a year-over-year basis.

But, most states still report tax gains through August, and school districts have not spent down Covid aid. Bottom line: It will take time to drain reserves.

Christina: On the corporate side, issuers are coming off a couple of years of balance sheet repair: reducing leverage and increasing cash while managing M&A and share buybacks pretty carefully.

All of that, however, has to be considered in the context of what looks to be—as some have called—the most anticipated recession in history.

Oggie: IG corporate debt leverage has risen in past economic recessions, as EBITDA tends to drop faster than issuer debt obligations. We looked at the past four U.S. recessions and observed that median IG gross leverage moved up 0.4 times, peak-to-trough. With median gross leverage of 2.4 times for the IG cohort at 2Q22, history suggests leverage could peak at 2.8 times in 2023. As an offset, IG issuers have added cash to their balance sheets this year and they tend to build up cash during recessions, so the increase in net leverage may be lower.

At this point, we view credit fundamentals as stable but with a weakening bias. The drop in M&A in 2022 is a credit-positive that is partially offset by higher share buybacks. Still, IG issuers are resilient and have big market shares and lots of levers to pull in a slower economic environment.

The UK Gilts Market

Chris: I got a question after the gilts market in the UK was thrown into turmoil and we certainly learned more about that this morning with the Prime Minister's decision to resign. Ultimately, the government stepped into backstop pensions with liability driven investment strategies implemented with derivatives, but one of our clients wondered if we had a view on the situation.

Oggie: The UK's bond buying was driven by circumstances unique to the UK market. Huge debt-funded announced tax cuts caused a plunge in the pound and a sell-off in the gilts market. That forced margin calls for many pension portfolios that used cheaper, synthetic derivative positions. That specific liability driven investment mandate implementation you mentioned is unique to the that market,



As always, we monitor global markets with an eye to implications for U.S. monetary policy and any potential effects on our portfolios.

Geopolitical Issues

Christina: I have gotten question over the last eight months or so that explore how geopolitical issues might impact conditions in the U.S. economy and the investment markets. You can choose the specific situation: from Russia's war in Ukraine to North Korea to ongoing tension between China and Taiwan, clients ask about implications for Breckinridge and investors.

Oggie: Those are always a challenge because it isn't necessarily the primary concerns that affect our approach to the markets, but the secondary or tertiary issues that can have a meaningful impact. We have seen the impact of Russia's actions—and more recently, its actions with the OPEC Plus nations—on European security, eurozone economies, and global prices for oil, for example.

We need to factor that calculus into our actions as an asset manager. In several of these instances, we are specifically monitoring influences on foreign exchange markets or the actions of other central banks.

Mid-Term Election

Chris: An issue that has direct and immediate implications for our market is the mid-term elections.

Specifically on the municipal side, a likely outcome is that the Democrats and Republicans each emerge from the midterms in control of one chamber of the legislature. If that is the case, gridlock is likely. We could see a return of advance refundings, but no return of Build America Bonds, Private Activity Bonds, or higher marginal tax rates. Also, no action of the State and Local Tax Deduction caps.

Inflation Reduction Act

Oggie: Clients want to know if there is anything in the Inflation Reduction Act that could have a material impact on bond markets. We don't see anything revolutionary, certainly, but a couple of provisions are noteworthy from a climate, municipal, or corporate, perspective.

The Act provides that public agencies can take advantage of tax credits and get up to 30 percent of their project costs covered. They can issue tax-exempt bonds to finance projects, but the tax credits will be reduced.

The Act also provides tax credits for nuclear power and carbon capture technology, and imposes a new fee on excess methane emissions from oil and gas drilling, while giving fossil fuel companies access to more leases on federal lands and waters.

Finally, the Act creates a 1 percent excise tax on stock buybacks. Stock buybacks can be considered counter to bondholder interests. The likelihood that the new excise tax will discourage buybacks is debatable because some consider the penalty to be modest.



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