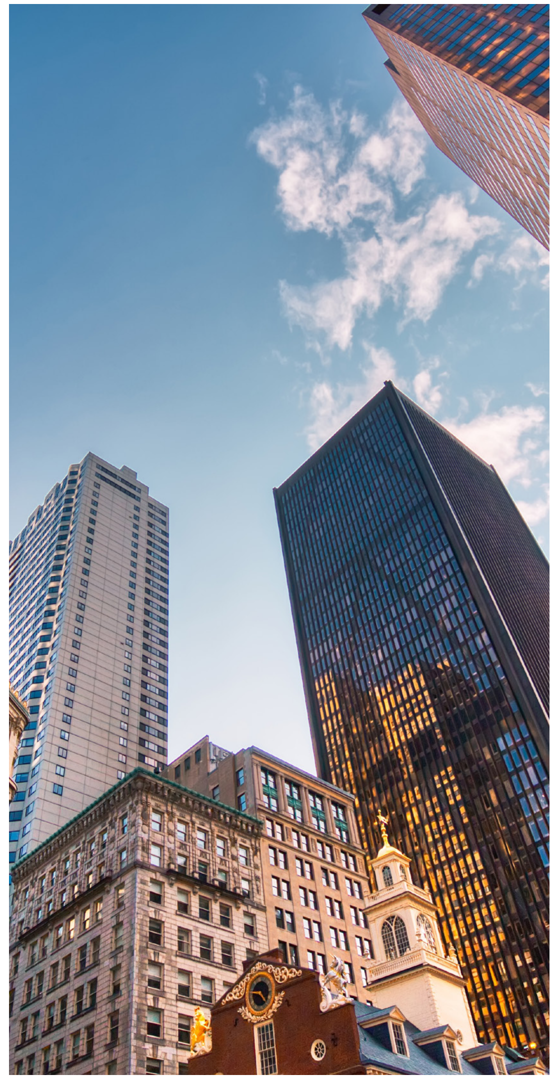
Breckinridge
CAPITAL ADVISORS

August 2021 Market Commentary



Strategy and Outlook

- **U.S. Treasury Curve:** Treasury yields bounced off July lows but remained relatively range-bound, with the 5-year and 10-year increasing by 8 basis points (bps).
- **Municipal Market Technicals:** According to *The Bond Buyer*, August issuance was $39.7 billion, marking a 11 percent increase from July. Strong fund flows persisted.
- **Corporate Market Technicals:** Investment grade (IG) fixed-rate bond supply for August was $88 billion, per Bloomberg. IG fund flows were about $20 billion, a decrease from July levels.
- **Securitized Trends:** Mortgage-backed securities (MBS) underperformed as spreads widened, due to additional taper talk. Asset-backed securities (ABS) and agency commercial mortgage-backed securities (ACMBS) both moderately outperformed, with spreads relatively unchanged.

Market Review

During August, attention turned to Federal Reserve (Fed) Chairman Jerome Powell's speech at a virtual Fed symposium. While he reaffirmed regional Feb bank leaders' earlier statements on stimulus tapering, Mr. Powell's comments about maximum employment and inflation were more dovish than that of the other Fed bank presidents.[1]

Mr. Powell was careful to separate tapering from the start of rate hikes. He also reiterated his confidence that inflation could prove temporary. The Fed's next meeting is scheduled for September 21 and 22. Market observers will look for details on timing and pace of tapering after that meeting.

The Bureau of Labor Statistics reported that the consumer price index (CPI) increased 0.5 percent month-over-month (M/M) and 5.4 percent year-over-year (Y/Y) in July. Core CPI, which excludes food and energy, rose only 0.3 percent M/M and 4.3 percent Y/Y. The increases were lower than many market observers expected.[2]

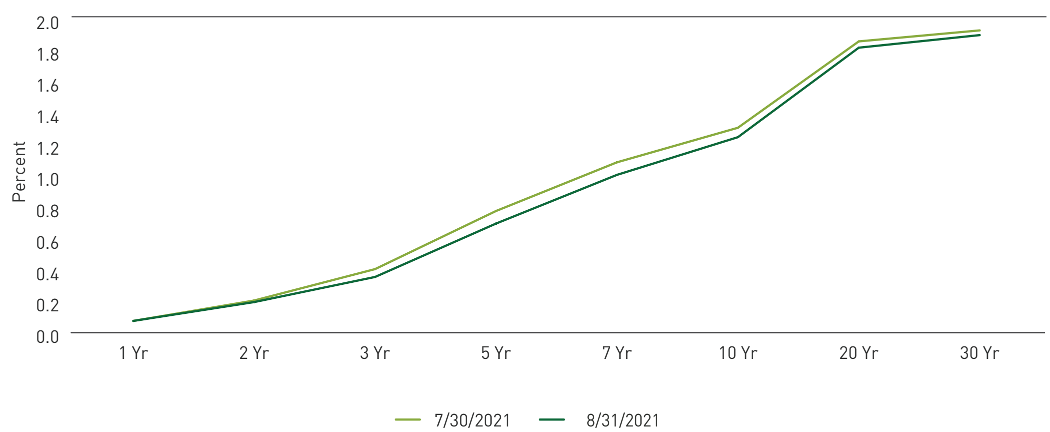
The Fed favors the personal consumption expenditures (PCE) price index as an inflation indicator.[3] The Bureau of Economic Analysis (BEA) reported that PCE increased 0.3 percent M/M and 4.2 Y/Y in July. The July core PCE price index increase was a more modest 3.6 percent Y/Y.[4]

The Labor Department reported that initial claims for state unemployment benefits rose 4,000 to a seasonally adjusted 353,000 for the week ended August 21.[5] Because seasonal factors as the summer closes can influence employment reporting, most observers had little reaction to the increase in claims, Reuters reported.

The BEA's second quarter gross domestic product (GDP) estimate was revised higher to 6.6 percent on a seasonally adjusted annual rate during August.[6]

Treasury yields reversed course during August, increasing by 3bps at the 2-year spot while adding 9, 9, and 4bps in the 5-, 10-, and 30-year tenors (See Figure 1). They ended August at lower levels than they had touched earlier in the month.

FIGURE 1: LONGER TREASURY YIELDS INCREASED, PARTICULARLY IN THE BELLY OF THE CURVE



Source: Bloomberg, August 31, 2021.

In our view, yields may trend higher over the next 6 to 12 months, as the Fed inches closer to a taper announcement. Over the short-term, rates may remain low due to strong demand from both domestic and foreign buyers.

Despite some volatility in August, U.S. government, corporate, municipal, and securitized bonds continue to enjoy yield and market advantages over foreign bonds.

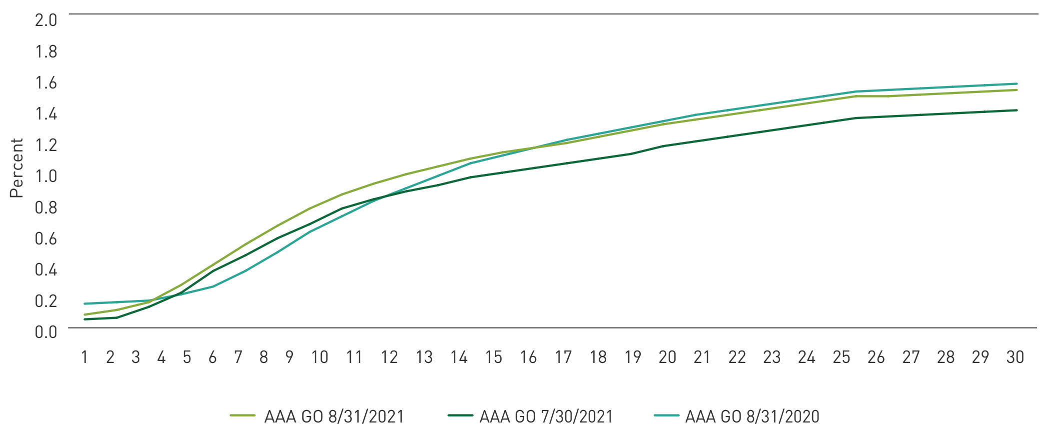
Circumstances in the U.S.—above trend economic growth, Fed policy moving past COVID-related stimulus, and stabilizing employment and personal income—lend strength to U.S. bonds relative to foreign bonds, supporting buyer demand.

Municipal Market Review

According to Bloomberg data, municipal bond yields followed Treasuries higher in August. Yet, AAA-rated bond yields remained below 1 percent until 12 years. One-year yields added 3bps by the end of the month. Two-year yields remained at 6bps.

The municipal yield curve modestly steepened during August, although somewhat unevenly, since July 2021. The 2s10s and 2s30s curves were 6 and 11 bps steeper, respectively (See Figure 2).

FIGURE 2: AUGUST MUNICIPAL YIELDS WERE HIGHER THAN IN JULY, HIGHER THAN AUGUST 2020 IN SHORT TO INTERMEDIATE RANGES, LOWER THAN AUGUST 2020 BEYOND 15 YEARS



Source: Bloomberg, August 31, 2021.

Municipal/Treasury (M/T) ratios recovered a bit from, but remained close to, July's historic lows (See Figure 3). They also remained well below August 2019 levels. Ratios improved more in the 10-year spot than they did in the 2- to 5-year ranges.

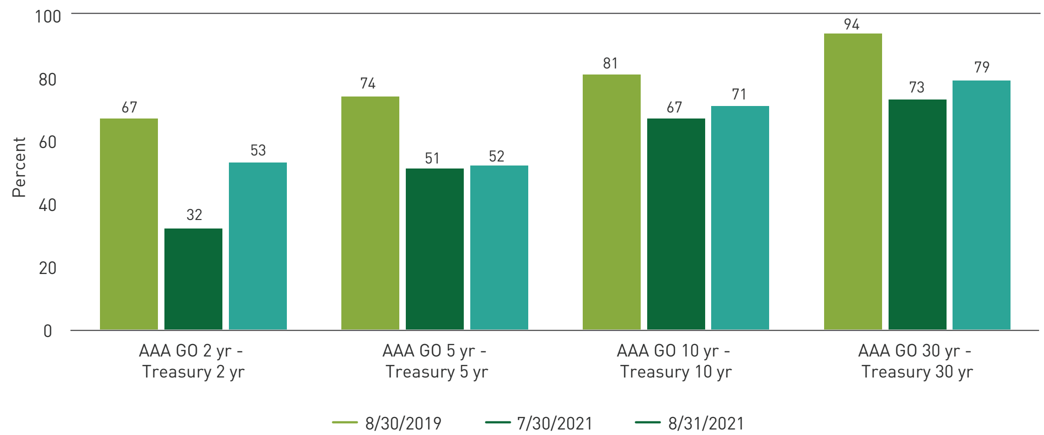
According to *The Bond Buyer*, August municipal bond issuance was $39.7 billion. August issuance was 11 percent higher than that of the prior month and 8.4 percent lower than that of the same month in 2020. *The Bond Buyer* said the Y/Y decline was due to factors such as rising interest rates, uncertainty over federal monetary policy, and unprecedented federal aid for state and local governments.

Municipal bond supply and demand remained strong, based on data from *The Bond Buyer*. Year-to-date total issuance in 2021 was $306.8 billion through August 31, versus $301.5 billion in the same period in 2020. Notably, taxable municipal bond issuance was lower in August by 7.6 percent from the prior month and 39 percent lower than the same month of the prior year, when pent-up issuance following pandemic-related restrictions influenced issuer decisions.

High municipal bond fund flows continued in August. For the month through August 25, ICI reported inflows of approximately $9 billion, bringing year-to-date flows to more than $69 billion.

The Bloomberg Managed Money Short/Intermediate (1-10) Index declined 0.17 percent while the 1-10 Year Blend Index fell 0.13 percent. As has been the case for most of the last 12 months, BBB-rated municipal bonds outperformed higher-rated bonds, but the margin of outperformance in August narrowed on prospects for reduced federal stimulus and spreads on many lower-rated issuers through their pre-pandemic levels, causing buyers to pause. Shorter maturities tended to outperform longer maturity bonds.

FIGURE 3: M/T RATIOS IMPROVED IN ALL SPOTS, MOST IN SHORT END, STILL TRAILED 2019 LEVELS



Source: Bloomberg, August 31, 2021.

High demand continued to shape the market, driving valuations higher and keeping absolute yields low. We continued to be selective. M/T ratios for 10- to 30-year maturities became somewhat more attractive during August. Still, 2- to 5-year maturities remained expensive, which continued to offer us opportunities to exercise our experience and familiarity in the taxable municipal bond market, where yields in that segment of the curve were somewhat higher.

We expect market technicals to shift to increased supply and lower demand in the tax-exempt market in the months ahead, with the potential to offer more opportunities to capture better relative values as the fall season advances.

Corporate Market Review

Investment grade (IG) corporate bond spreads widened for the second consecutive month, per Bloomberg data, albeit only by 1bp to 87bps, and were 9bps tighter year-to-date by the end of the month of August. The Bloomberg IG Corporate Index (the "Index") declined 0.30 percent for August on a total return basis and had a negative 5bps excess return compared with duration-matched Treasuries.

Bloomberg's investment grade corporate indices showed that lower-rated IG bonds modestly outperformed higher-rated bonds on a total return basis. Shorter-maturity bonds generally earned higher total returns than did longer-maturity bonds, and, on an excess return basis, intermediate maturity corporate bonds (5- to 7-year maturities) had the strongest performance.

According to Bloomberg, the best-performing corporate sectors in August were Sovereigns, Packaging, Supermarkets, Airlines, and Metals and Mining. The worst-performing sectors were Oil Field Services, Utilities, Railroads, and Pharmaceuticals.

Index-eligible IG bond issuance in August, per Bloomberg, was $88 billion, down about 13 percent from July. Net issuance, after redemptions, was a modest $18 billion, down from $31 billion in July. Demand for bonds remained strong. According to Emerging Portfolio Fund Research (EPFR), monthly IG fund inflows were about $20 billion in August.

During August, FactSet reported that corporate earnings reports remained positive. With 91 percent of the companies in the S&P 500 having reported actual Q2 results, 87 percent reported actual earnings per share above estimates, well above the 5-year average, per FactSet.[7]

Corporate earnings reports for Q2 continued to support our view that improving credit fundamentals may be a modest strength for the IG market moving into the fall. Rating agency actions year-to-date reflected improved credit fundamentals. IG downgrade and fallen angel activity have slowed relative to the prior year. Growth in earnings may reduce gross leverage, and buoy key credit metrics across most IG corporate sectors. Healthy balance sheets provide large firms additional financial flexibility, which could include capex, share buybacks, dividends, and mergers and acquisitions. In a global context and relative to IG corporate bonds in the euro, UK, and Japanese markets, U.S. IG bonds offered continued higher relative value for investors through August.

Securitized Market Review

Agency MBS modestly underperformed Treasuries during the month of August, per Bloomberg indices. Spreads on MBS backed by pools of mortgages with lower coupons widened the most, as the 10-year Treasury ended the month higher. MBS spreads widened due to a faster prepayment backdrop, record supply, and more talk of tapering. Spreads ended the month trading at the high-end of the year-to-date range. ACMBS modestly outperformed Treasuries, as spreads marginally tightened M/M. The ABS sector modestly outperformed Treasuries in August, based on Bloomberg data, with spreads mostly rangebound. Strong demand for high quality, short duration bonds continued to support ABS spreads.

Per Bloomberg, primary market ABS issuance slowed in August, with $16 billion of new issuance compared to $25 billion in July. Year-to-date issuance remained healthy at $187 billion, up 15 percent compared to 2019 and 58 percent compared to 2020.

#267926 (9/8/2021)

FOOTNOTES:

1. *https://www.wsj.com/articles/powell-says-fed-could-start-scaling-back-stimulus-this-year-11630072789?mod=hp_lead_pos1*
2. *https://www.reuters.com/business/us-consumer-price-increases-slowed-july-inflation-still-high-2021-08-11/*
3. *https://www.federalreserve.gov/faqs/economy_14419.htm*
4. *https://www.bea.gov/news/2021/personal-income-and-outlays-july-2021*
5. *https://www.reuters.com/business/us-second-quarter-economic-growth-revised-slightly-higher-weekly-jobless-claims-2021-08-26/*
6. IBID
7. *https://www.factset.com/hubfs/Website/Resources Section/Research Desk/Earnings Insight/EarningsInsight_081321A.pdf*