Review

The 1st quarter saw positive returns across all portions of the muni market. Duration was rewarded instead of being punished in the prior year. With weakness beginning to show in the economy, yields began to fall as we saw a flight to quality.

Municipal Index	Effective Duration	1Q 2023 Return	YTD Return
ML Municipal 3-7 Year Index	3.61	1.951%	1.951%
ML Municipal 12-22 Year Index	8.15	3.257%	3.257%
Taxable Index	**Effective Duration**	**1Q 2023 Return**	**YTD Return**
ML US Corp & Gov 5-7 Year A Rated & Above	5.31	2.952%	2.952%
ML US Treasury/Agency 7-10 Year	7.51	3.504%	3.504%
ML US High Yield BB Rated	3.90	3.563%	3.563%

The Fed's Dual (Single for now?) Mandate

The Federal Reserve has a dual mandate of maximum employment and stable prices. As of this writing, unemployment sits at a historic low of 3.4%. With unemployment at these levels, it has allowed the Fed to focus solely on their fight against inflation.

The Fed began raising rates in March 2022. Since then, the target Federal Funds Rate has jumped 500 basis points. This has put substantial stress on the banking system with SVB, Signature Bank, and First Republic Bank all going under in the past 60 days - and others may follow suit. Losses from long duration holdings and concentrated deposit risks have brought about an end for these banks. There may be other surprises ahead as this is already leading to credit tightening in the economy.

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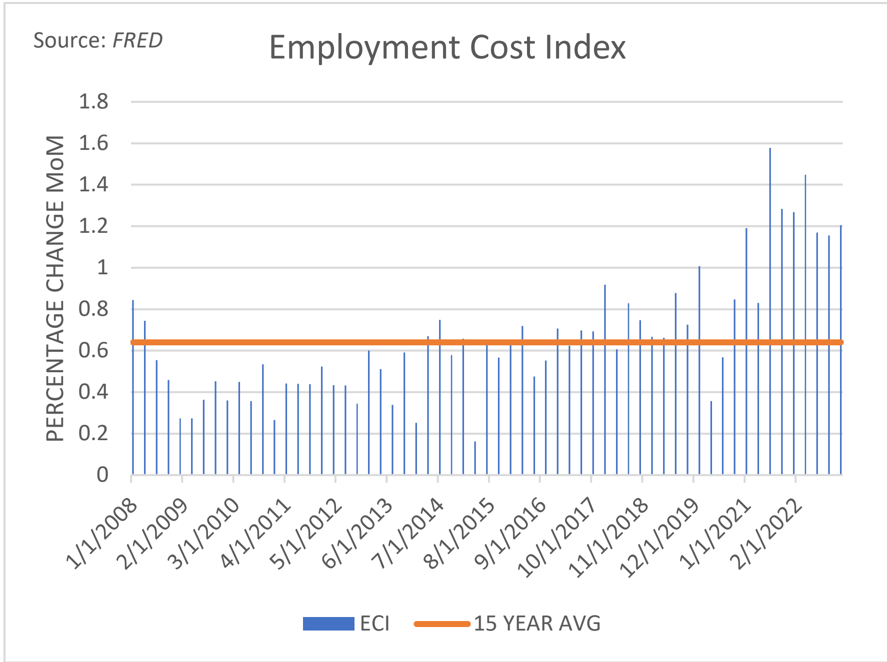
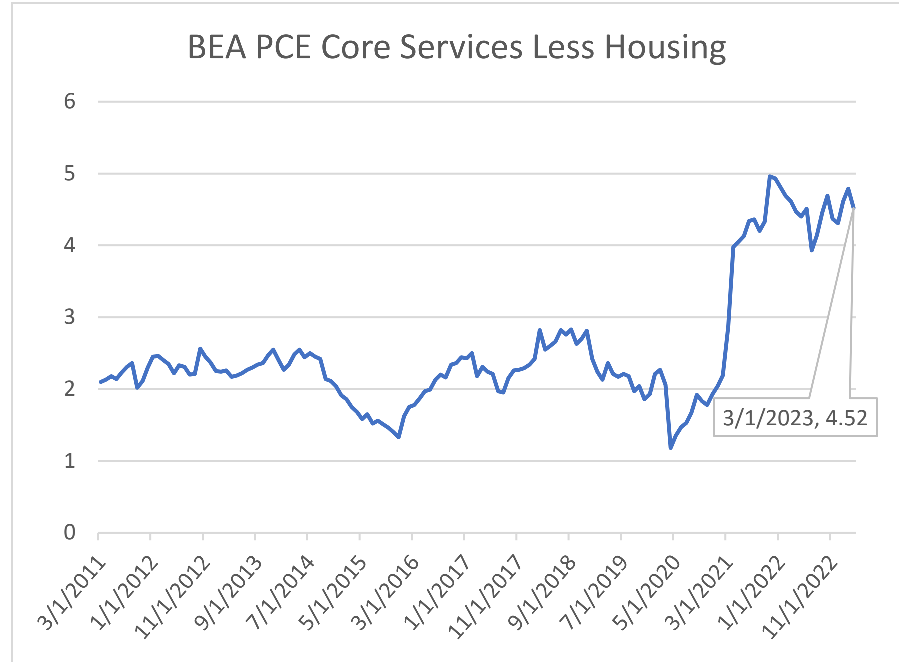
The Inflation Picture





Source: *Bloomberg*

The Fed is attempting to assist the banking system with one hand and fight inflation with the other. While low unemployment is allowing them to continue to focus on price stability, there are continued areas where inflation is proving to be stickier than hoped. One gauge is the Employment Cost Index (upper left). This index is a measure of how much it costs businesses to hire the workers they need and considers wages, bonuses, medical benefits, and more. The 15-year average of the ECI is .64, while the read has been over 1 for the past 7 quarters and 8 out of the past 9. With the latest read remaining at 1.2, we are at twice the levels of the average since 2008.

Another gauge of inflation that Jerome Powell specifically alluded to this week is the PCE Core Services Less Housing YoY (upper right). While in the 1-3 range for the prior 10 years, it has not proven to be transitory and remained in the 4-5 range for 2 years. These are 2 of many indicators for why the Fed had a unanimous vote for another 25-basis point hike and why they continue to forecast rates to stay higher for longer.

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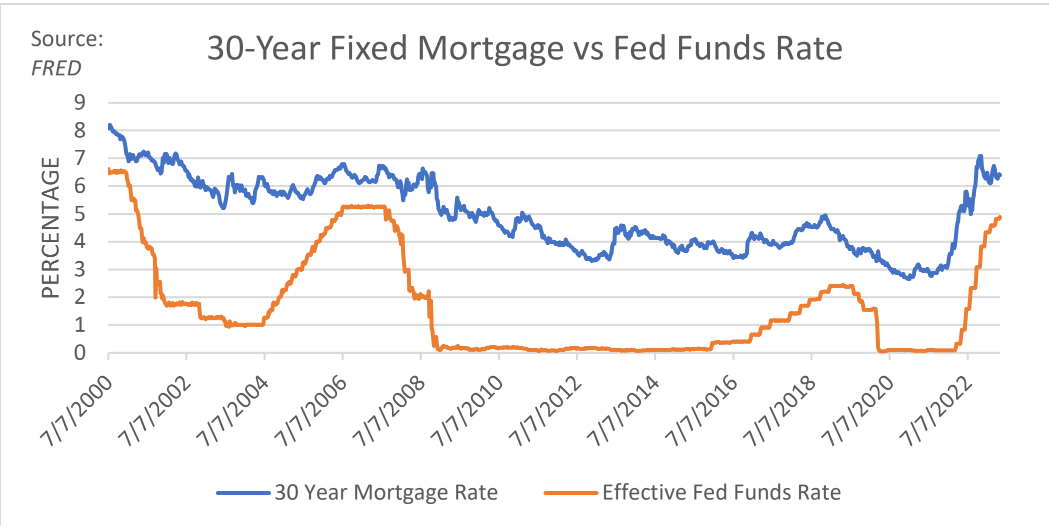
Housing Affordability

The housing market has shifted dramatically in the past 2 years. With rates being so low, many moved into new homes or re-financed their homes at all-time low rates just above 2.5%. Many times, homes on the market were getting over 20 offers and offers coming in were substantially over asking price.

Since the Fed began the tightening cycle, 30-year mortgage rates have jumped from 2.5% all the way up to 6-7% range beginning in the fall of 2022. We are currently around 6.4%. Those who locked in rates at 2.5% are now far less likely to move unless home prices fall dramatically.

This rapid shift higher in rates has pushed monthly payments for new homes up substantially. The median national home price in Q1 was $437,000. For a house of that value, the monthly payment goes up over $1,000 per month for the buyer when rates go from 2.5% to 6.5%. This is a blow to the common consumer and affects affordability. Even though the Case-Shiller Index (right) shows home prices coming down slightly, there is still a wide discrepancy between wages and what kind of home people can afford. Nationally, we are still in need of more affordable housing.



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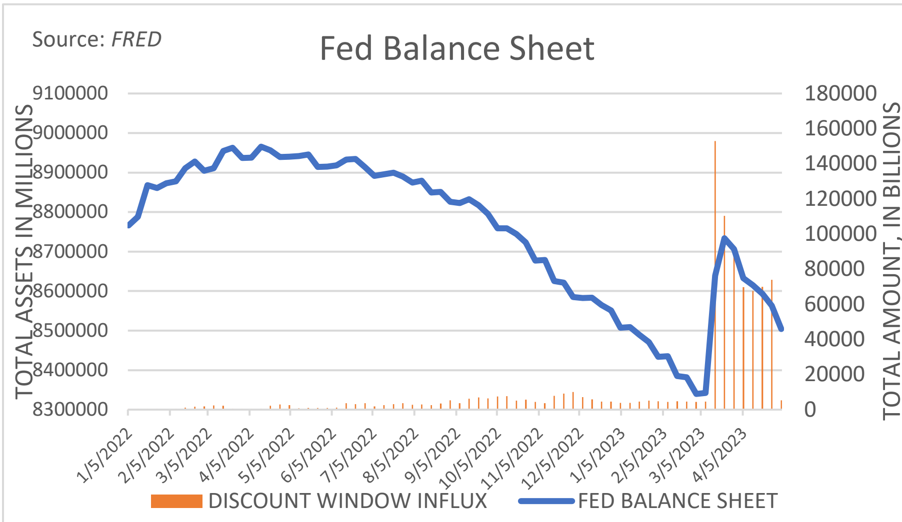
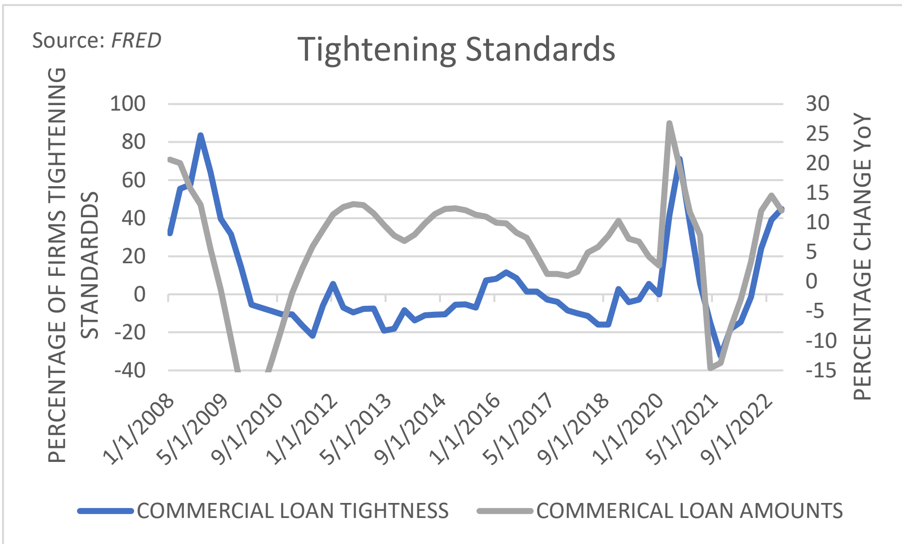
Credit Tightening





Regional banks came into the spotlight during Q1 2023. On March 10th, Silicon Valley Bank failed, and Signature Bank followed shortly on March 12th. SVB fell victim to their own investment decisions as they stretched their clients money out too far in regards to duration. Searching for yield was difficult during 2020-2021 and they did not maintain proper investment discipline. When investors caught wind of this, investors pulled their deposits and a bank run began sinking the bank quickly.

As stress has increased in the banking system, the Fed and the FDIC provided liquidity to the banking system through the discount window providing depositors confidence once again. This re-inflated the Fed's balance sheet as shown on the left. The Fed continues to unwind the balance sheet and have now come down from $8.96 trillion to $8.5 trillion.

Credit conditions continue to tighten as well (left). Regional banks play a large role in the lending of money to smaller businesses and start-ups. With so many of these banks struggling, it is a headwind for growth as lending options are evaporating. Banks are losing the ability to lend as clients put more money into money market funds and deposits have the potential to flee. Confidence in certain banks seems to rise and fall daily. As long as rates remain high, this will continue to be the case.

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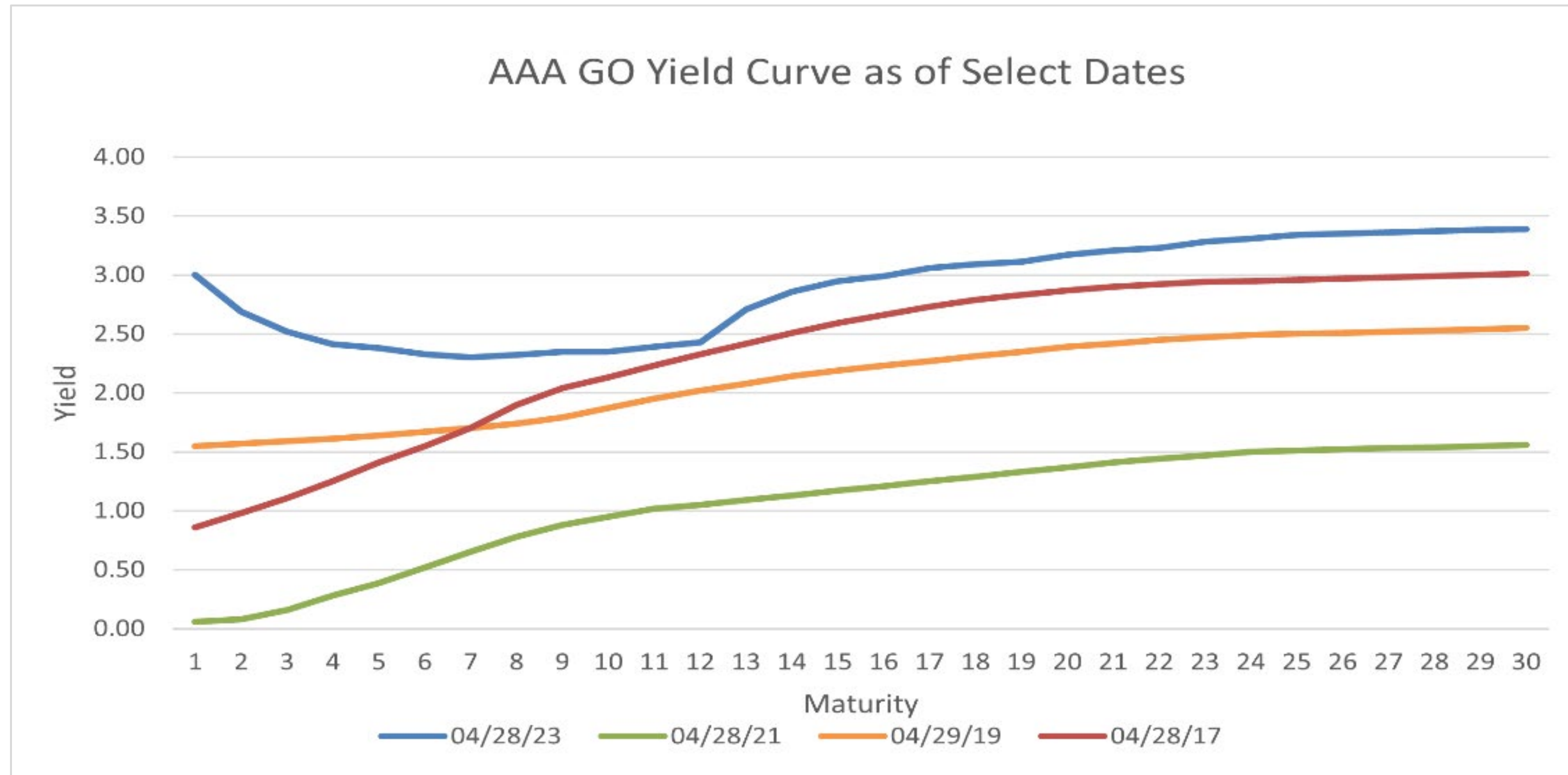
Current State of the Municipal Market



The picture above illustrates how rates slowly moved down from 2017 to 2021 and that we are now above all these levels on the curve. The yield curve remains inverted and has been since mid-December, pointing to a slowdown in the economy in the future. We continue to believe we are in a great buy zone for munis and are buying bonds at yields that are very attractive. We continue to extend duration and are positioning portfolios longer in preparation for a slowdown and lower yields in the next year or 2. We are extending duration to generate better performance in the future and to protect income streams for clients that depend on this steady, predictable income.

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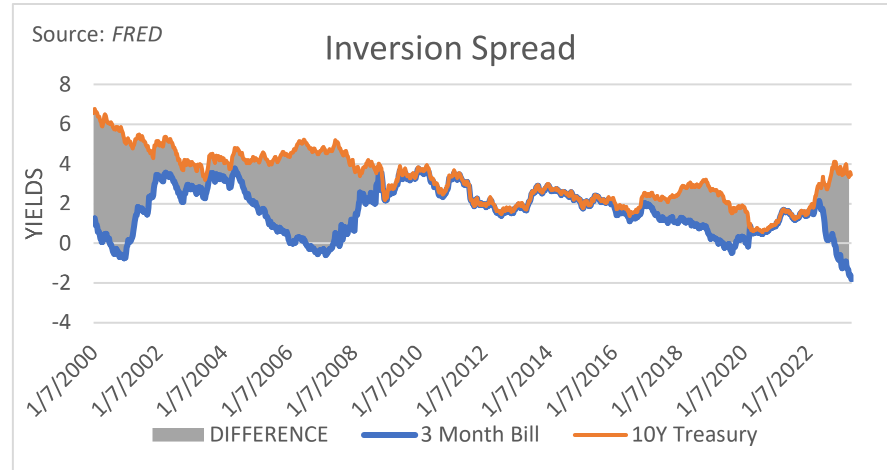
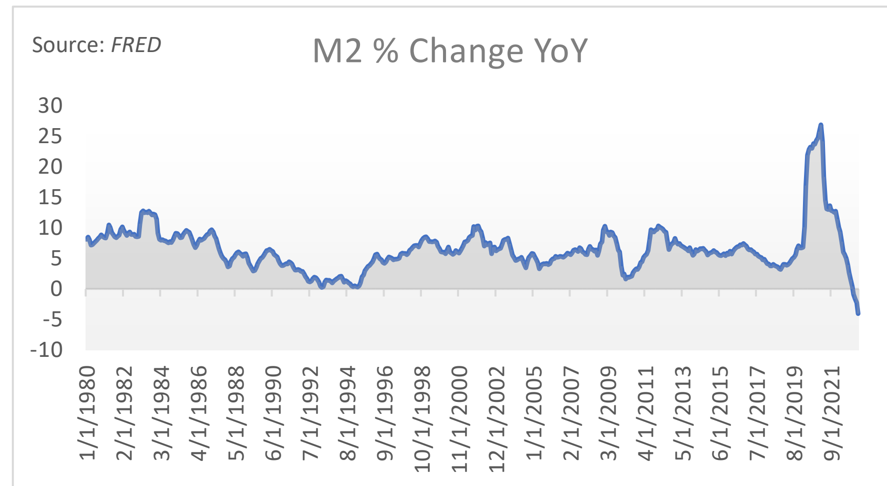
Conclusion: Lower Rates and Economic Weakness Ahead

Powell continues to say that the banking system is sound and resilient. Many Federal Reserve Presidents continue to say that going into a recession is not their 'base case.' The economy and the consumer continue to stay strong. Unemployment continues to stay low and after this quarter's earnings reports, many companies continue to look strong. There are some positive undercurrents in the economy, but we continue to see headwinds as well.



With 500 basis points of tightening, reduced lending moving forward, and quantitative tightening ongoing, we have a hard time seeing increased growth. The 10-Year 3-Month inversion/spread (right) is at an all-time high at 189 basis points – screaming that we are headed for a slowdown. M2 YoY has declined by -5%. This is the fastest pace (right) in well over 50 years. This can be positive news for inflation but negative for growth. Flooding the economy with $8 trillion during Covid made M2 spike and now the unknown answer is, 'How long does it take for that money to circulate through the system?'



While we do not know if it will be a major recession like the Great Financial Crisis, we do believe we are headed for a slowdown and most likely a recession in late 2023 or in 2024. We hope inflation will continue trending down and the pain will be minimal. This should be a positive environment for fixed income investors.

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