Review

Interest rates climbed in the first quarter as markets weighed a strengthening economy, potential inflation, and continued large scale monetary and fiscal support. Long treasuries, agencies, and corporate bonds were the hardest hit while municipals and high yield corporates proved more resilient. The table on the right summarizes the returns of a few major fixed income indices:

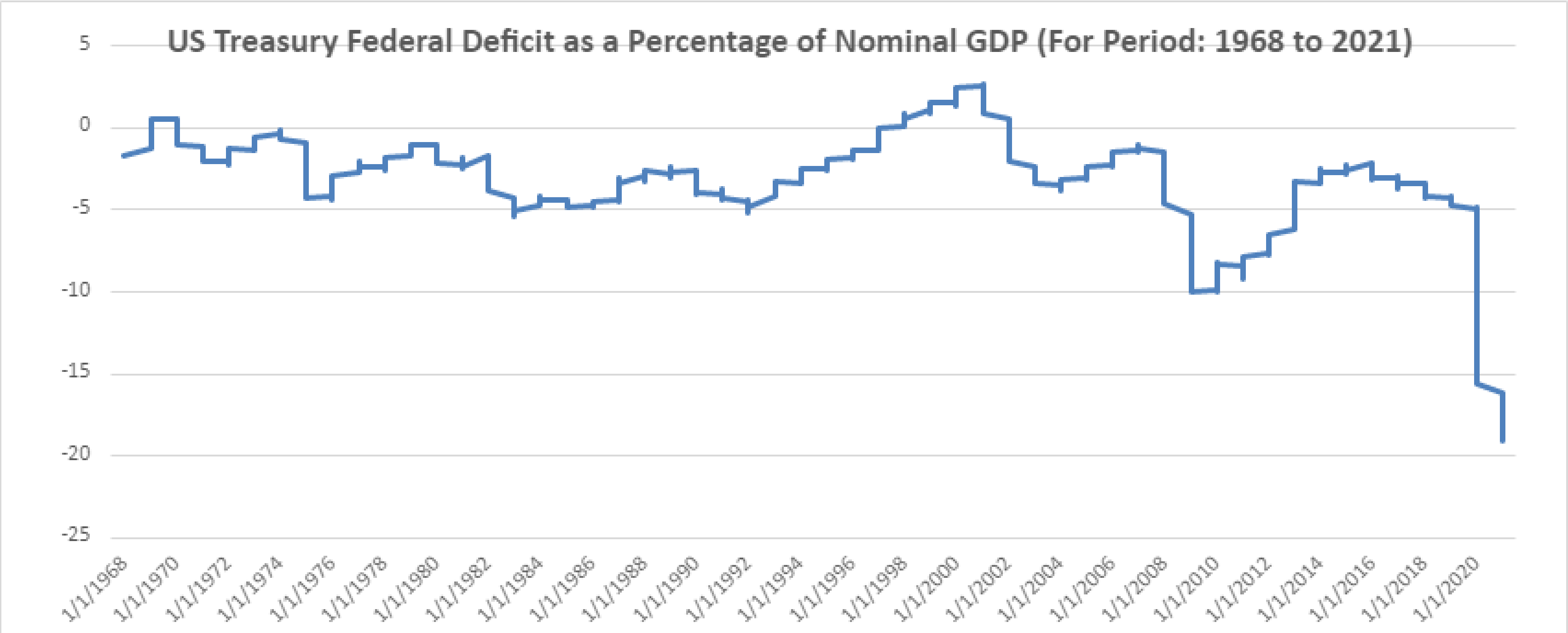
Municipal Index	Effective Duration	1Q 2021 Return	YTD Return
ML Municipal 3-7 Year Index	3.85	-0.304%	-0.304%
ML Municipal 12-22 Year Index	7.53	-0.454%	-0.454%
Taxable Index	**Effective Duration**	**1Q 2021 Return**	**YTD Return**
ML US Corp & Gov 5-7 Year A Rated & Above	5.70	-3.306%	-3.306%
ML US Treasury/Agency 7-10 Year	7.96	-5.751%	-5.751%
ML US High Yield BB Rated	4.80	-0.214%	-0.214%

Inflation and the Public Policy Response

Our studies have shown interest rates are primarily a function of the growth rate of the economy and inflationary expectations. Current fiscal and monetary policies should be examined in this context. First, the fiscal response to the COVID crisis has been extraordinary. The table below shows the fiscal policy response to the pandemic over the last year. The total response has been almost $6.5 trillion.

COVID Legislation	Enacted	Act	Purpose	Amount ($ Billions)
Trump Admin	3/6/2020	COVID Approp Act	R&D	8.30
Trump Admin	3/18/2020	Families First Act	Testing, paid leave, food stamp	192.00
Trump Admin	3/27/2020	CARES Act	Unemployment,PPP,Stimulus Checks,Misc	2,700.00
Trump Admin	4/24/2020	PPP, Hlthcare Enhancement Act	PPP,Hospital, Testing	733.00
Trump Admin	12/27/2020	Consolidated Approp Act	Unemployment,PPP,Education, Hlthcare,Vaccine Distribution	910.00
Biden Admin	3/11/2021	American Rescue Plan Act	Stimulus Paymts,Misc	1,900.00
Total COVID Fiscal Policy Response				**$6,443.30**
Source: Hilltop Securities				

This dwarfs the response to the fiscal crisis a little more than a decade ago. This has led to massive deficit spending by the Federal government. The chart below shows the extent of this deficit spending compared to Nominal GDP for the last 50 years. Last year it was almost 20 % of GDP.

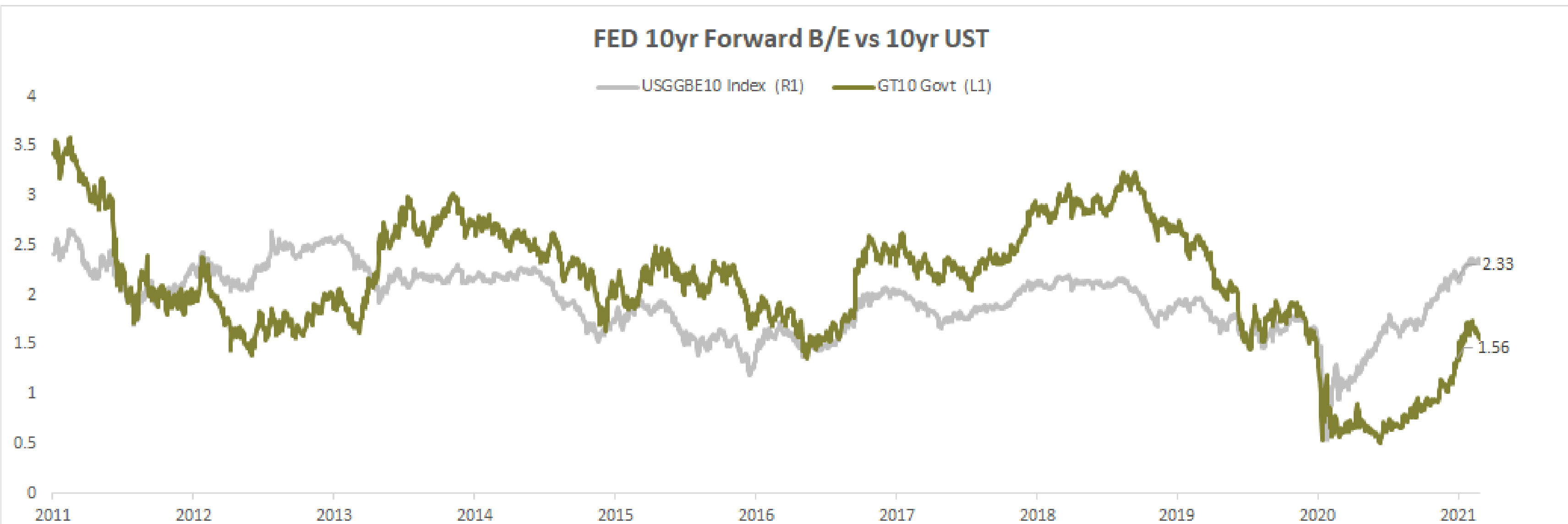


The recent $1.9 trillion spent by the Biden Administration is not included in this chart. This chart shows a government determined to do whatever it takes to keep our economy going. It is certainly not afraid to spend money it doesn't have and accumulate massive amounts of debt. The economy has been showing some signs of recovering during the last few months. It seems possible this policy response may be excessive and lead to an overheated economy. There are already several signs of supply chain problems which may contribute to higher inflation in the future.

Next, Monetary Policy has been extremely accommodative. The money supply as measured by M-2 has been growing at a rate of over 27.0% annually year over year. This is an unheard of level of monetary accommodation. During the Financial Crisis, M-2 only grew at a 10.0% rate for a short period of time before settling into a rate of about 6.0%-7.0%. The Fed is also expanding its balance sheet by buying a combination of $120 billion of UST and Mortgage securities every month. Their balance sheet is almost $8.0 trillion or 36% of GDP. This is twice as much as it was 18 months ago.

This combination of Fiscal and Monetary policy is a powerful tool to fuel economic growth. We have not witnessed anything like this in our lifetimes.

The bond market has already taken notice. The chart below is the 10 year breakeven rate of inflation compared to the UST 10 YR yield. The current breakeven rate of inflation is 2.33%. This is about .80% or 80 bp's above the current yield of the 10 Yr UST. This will put pressure on rates to rise since rates tend to track the breakeven rates.



Managing Interest Rate Risk

There are several ways to help mitigate interest rate risk of a fixed income portfolio in a rising rate environment. Perhaps the most obvious way is to go to cash. With short-term interest rates at or near zero this is not a great option. With rates at low levels it is already a challenge to have an income producing component in the portfolio. Going to cash aggravates this problem. It is also possible rates won't rise very much from these levels or possibly fall which would also increase the reinvestment risk of the portfolio. This is equivalent to making a bet on the direction of rates. We have been using 4 different strategies to help mitigate the risk of rising rates.

First, a primary advantage of an intermediate-term fixed income strategy is it is already a conservative strategy. A typical portfolio in this strategy has a duration of 4.5-5.5. Duration is a measure of how much interest rate risk is in a portfolio. We have allowed our portfolios to shorten by not actively reinvesting in longer securities. During the course of a year this reduces the duration from a target of 4.5-5.5 to 3.5-4.5. This is a significant reduction in the riskiness of the portfolio to interest rate risk.

Second, we have been investing in bonds which have shorter calls (2-4 years) and longer maturities of up to 15 years. The bonds we are purchasing are likely to be called on the call date, but provide more income than cash. If these bonds due go to maturity, which is unlikely, we will pick up a significant amount of yield.

Thirdly, we have bought some floating rate securities. These bonds are difficult to find. Most of them were issued in 2007 and are only available in the secondary market. These bonds have coupons which usually change quarterly and the coupon is pegged at a certain spread to a short-term index such as Libor. These bonds will perform well in an inflationary market.

Finally, we have purchased some higher yielding low investment grade Corporate bonds for companies which will benefit from an improving economy or investment in infrastructure. Most of these are epicenter companies which were affected by COVID. Airlines are an example of this. Security selection is crucial in this strategy. We like shorter maturities and the least leveraged companies within an industry. This strategy has allowed us to enhance returns by picking up extra yield while simultaneously protecting the principal in our portfolios.

Conclusion

Fiscal and Monetary policy is currently extremely aggressive. This should lead to further economic recovery and higher interest rates. The breakeven rate on UST suggest this is the case. However, there are still forces which will temper this rise in rates. Negative demographic trends, high levels of debt, and technological change will all help mitigate inflation. While we expect rates to be higher at the end of the year, we do not expect the 10 yr UST to be higher than 2.50-3.0%. We are taking steps in our portfolios to help mitigate the risk of higher rates in the future.

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