



Fixed Income and Credit: Never a Dull Moment at the End of a Cycle

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The next phase of the Fed's monetary policy campaign must make room for an unexpected running mate: financial stability concerns. In the background, inflation remains at large.

After a forgettable 2022, a year that accomplished the worst 12-month performance on record, U.S. Fixed Income markets were set to return to something of a more placid environment in 2023. The Federal Reserve was still clearly in hiking mode, yes, but there was light at the end of the tunnel. Entering 2023, the Federal Funds Rate stood at 4.50% and the December 'Dot Plot' indicated a peak Fed Funds rate of 5.25%, implying just 0.75% more tightening before the cycle would be complete. Treasury yields were the highest they've been in many years with the 2-year yield (4.42%) the highest since 2007 and the 10-year yield (3.88%) since 2008. Of course, the reason for the Fed's rapid tightening cycle was to rein in the uncomfortably high levels of inflation experienced across the economy. Core CPI (consumer price index) reached a 40-year high in September 2022 and the data continued to post elevated, yet moderating, inflation rates through the end of the year.

As we moved into the first quarter of 2023, the focus was on two related questions: 1) how fast would the pace of inflation decelerate, also termed *disinflation*, and 2) how high would the Fed Funds rate need to go before the Fed paused hiking? Straight forward enough, right? Faster disinflation would mean fewer hikes and/or a shorter period until pause. Slower disinflation or reacceleration – perish the thought – would mean a prolonged hiking cycle.

Turns out, it wasn't quite that simple.

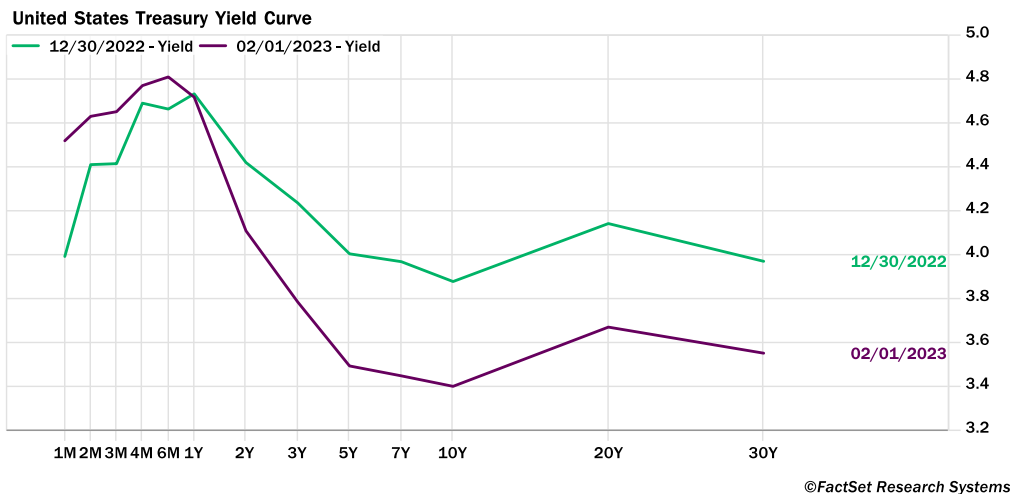
While we may in fact have reached the end of the hike cycle, as hoped for, it was not for the conventional reasons expected at the start of the year. To take a closer look we can view Q1 through the lens of two distinct periods, before and after the Silicon Valley Bank saga.

Pre-Silicon Valley Bank Failure

After three months of sequentially improving data, core PCE (personal consumption expenditures), one of the Fed's preferred inflation measures, hit 4.6% in January, the lowest in 15

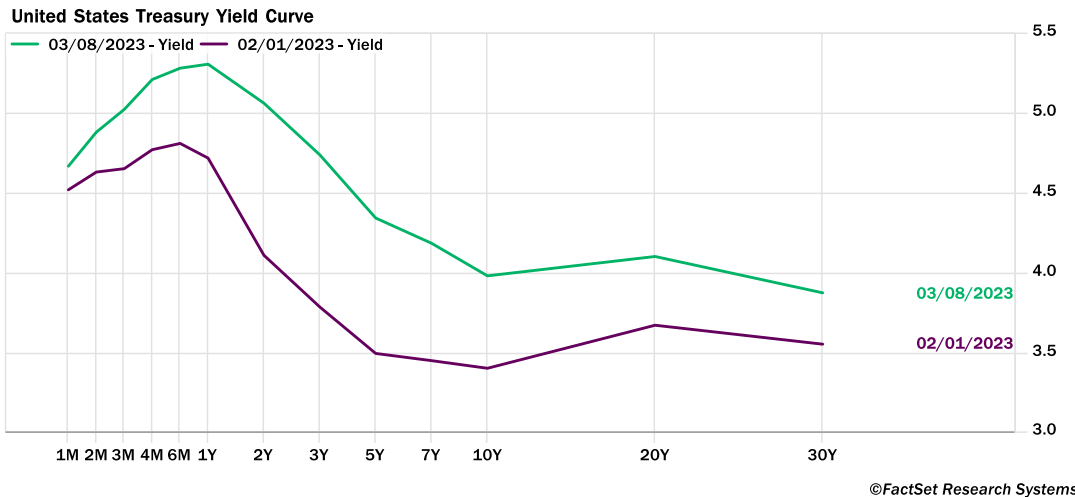
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months. Five days later the Fed hiked rates again but notably decelerated the hike to just 0.25%. It seemed as though the disinflation process was in full swing. The immediate aftermath saw equity and interest rate markets rally in unison with U.S. yields entering February lower for the year between ~0.35%-0.50% across the curve.



Then, entering February, strong economic data continued to roll in upending the simple disinflation narrative. An outstanding jobs report in early February triggered a rebound in yields. Later in the month, inflation data broke the three-month streak of lower readings, disrupting the hope for a gradual path toward the Fed's 2.0% inflation target. Rates steadily marched higher over the month of February with 2-year yields reinflating a full 1.00% (100bps!), highlighting the market's capitulation that the Fed would pause then cut rates in short order. In the first week of March, attempting to demonstrate his determination to defeat inflation, Chairman Powell even indicated the possibility of returning to 0.50% rate hikes. Other Fed Presidents reiterated their preference for a terminal rate as high as 5.75% or even 6%. The March 8th yield curve reflects accordingly.

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As it turned out, the first week of March would be the year-to-date high for rates with the 10-year Treasury peaking at ~4.10% and the 2-year just above 5%.

Enter the Silicon Valley Bank debacle.

Post-Silicon Valley Bank Failure

Skipping over the details of the first bank run of the social media era, a subject further investigated by Jason Rodnick in this Wealth Report, the impact on rates and monetary policy is considerable. In a matter of days, the banking panic sparked a flight to quality and Treasury yields plummeted in response. Yields on the 10-year fell as much as 0.70% over the course of a few weeks, with most of the rally occurring in the immediate aftermath of the collapse of SVB.

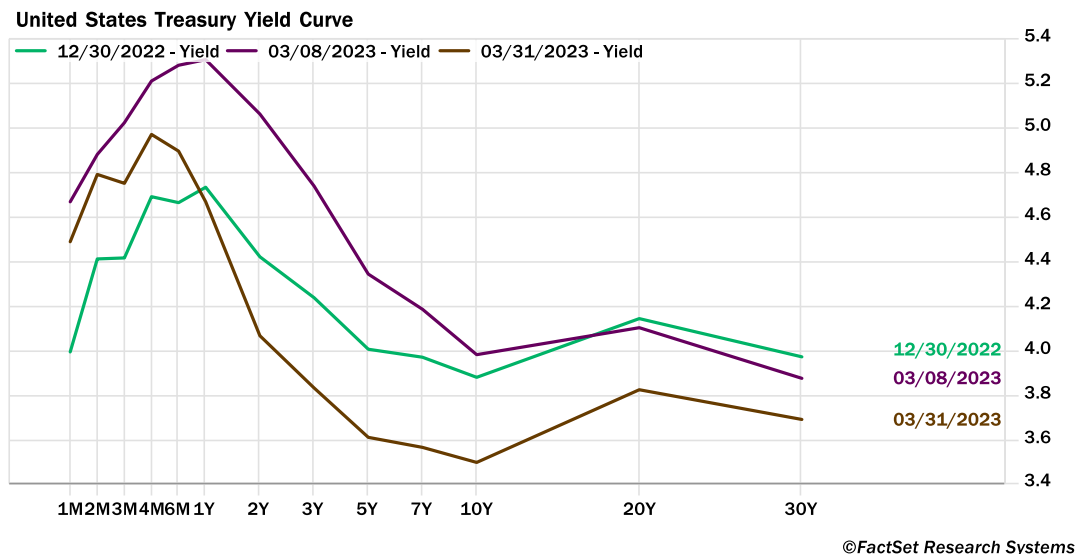
Of the many impacts of the situation, some highlights include:

- Fixed Income volatility spiked to the highest since 2009 (measured by the ICE MOVE Index).
- High Yield spreads widened over 1% in a week, from ~4% to as high as 5.2% in late March.
- The 2-year Treasury yield experienced the greatest drop, falling ~1.30% from over 5% to ~3.75% in three weeks, indicative of the market expectations for impending rate cuts.

The aftermath of the Silicon Valley Bank saga culminated with the FOMC meeting on March 28th. At that meeting, against many calls for a pause to avoid further stress to the banking system, the Fed

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chose a ‘dovish hike’ of 0.25%. Hiking the Fed Funds rate, to an upper bound of 5.00%, in the face of such a challenging environment signaled a willingness to continue the fight against inflation although softer language invited a new sense of caution, and perhaps patience, as the stresses of the rapid hike cycle come to bear. Powell and the Fed could no longer take a whatever-it-takes approach to beating inflation despite the fact that inflation remains several percentage points above target. The financial stability concerns of such a rapid rate hike campaign, although always in the ‘conversation’ in a hypothetical sense, have come to the forefront.



Looking Ahead

Moving forward, uncertainty remains ever-present – although that’s nothing new. The duration of the hike cycle is again in question with the market pricing in as many as three rate cuts by year end, despite the Dot Plot reiterating a 5.125% median Fed Funds rate. The differential is uncomfortably wide. The market is currently split ~50/50 as to the outcome of the next FOMC meeting on May 3rd. A hike would demonstrate the fight against inflation remains paramount, while a pause would usher in the end of a remarkable, albeit short, era of monetary policy.

As the world tries to figure out the exact path of monetary policy, a fool’s errand to be sure, it’s important to remember the purpose of the Fixed Income asset class for long-term investors: Income and



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Capital Preservation. While this latest banking crisis episode did result in some losses and more credit downgrades, it is important to keep perspective. High quality, non-financial investment grade bonds remained very resilient through the quarter, as overall corporate credit spreads widened only modestly and already have recaptured some of the initial change. In fact, the fall in Treasury yields caused price *appreciation* for many bond issues. The Osborne Investment Team will continue our focus on buying and holding high quality bonds in the context of a well-rounded portfolio, and seek yield without compromising on credit quality. ■

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