OSBORNE PARTNERS
Capital Management, LLC

Fixed Income and Credit: The Fed Goes Marching On

By: Jack Fagan, CFA

July 2023

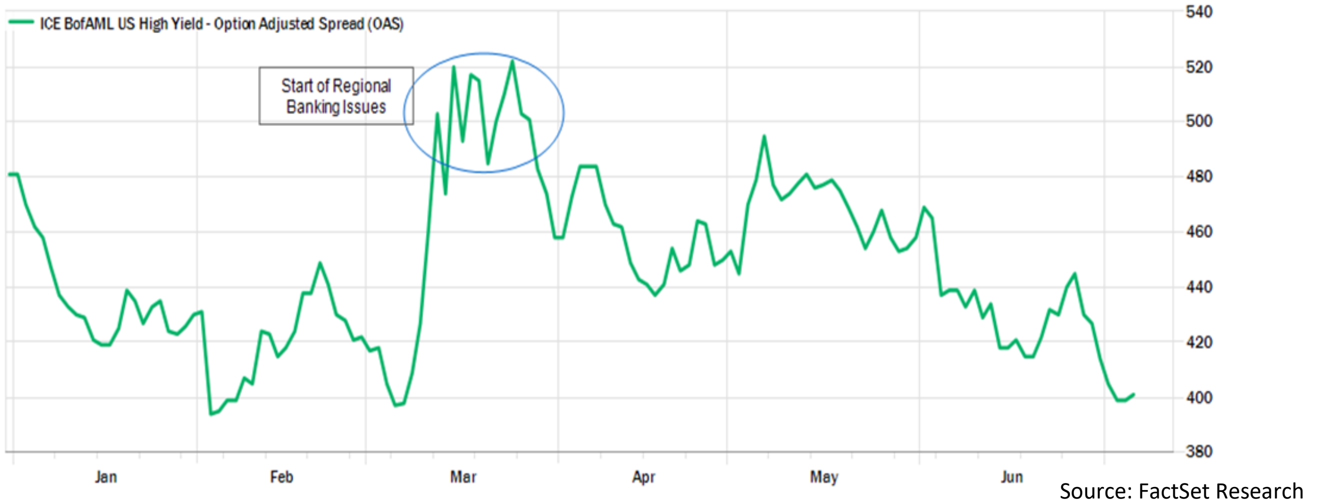
The bond market settled down even as the Fed continues its fight against inflation.

After a rather unpleasant five quarters of frenzy in the fixed income market, a vague sense of 'normalcy' started to emerge in the second quarter of 2023. The quarter began with investors and regulators alike sorting through the wreckage of a regional banking crisis that saw three significant bank failures occur within weeks. Through that experience, markets were forced to quickly adjust to elevated credit risk in the financial sector amidst an already difficult environment including tightening financial conditions and the prospect of an impending recession. Fortunately, any contagion risk within regional banks appears to have been quelled nearly as fast as the crisis started. Since the local peak on March 16th, volatility in near-term Treasury bonds returned to pre-Silicon Valley Bank failure levels by mid-April (ICE MOVE Index). Following a similar pattern, credit spreads initially widened by over 1.20% but gradually tightened back to pre-crisis levels by mid-June (U.S. High Yield - Option Adjusted Spread). Overall, the second quarter ended approximately where March began.

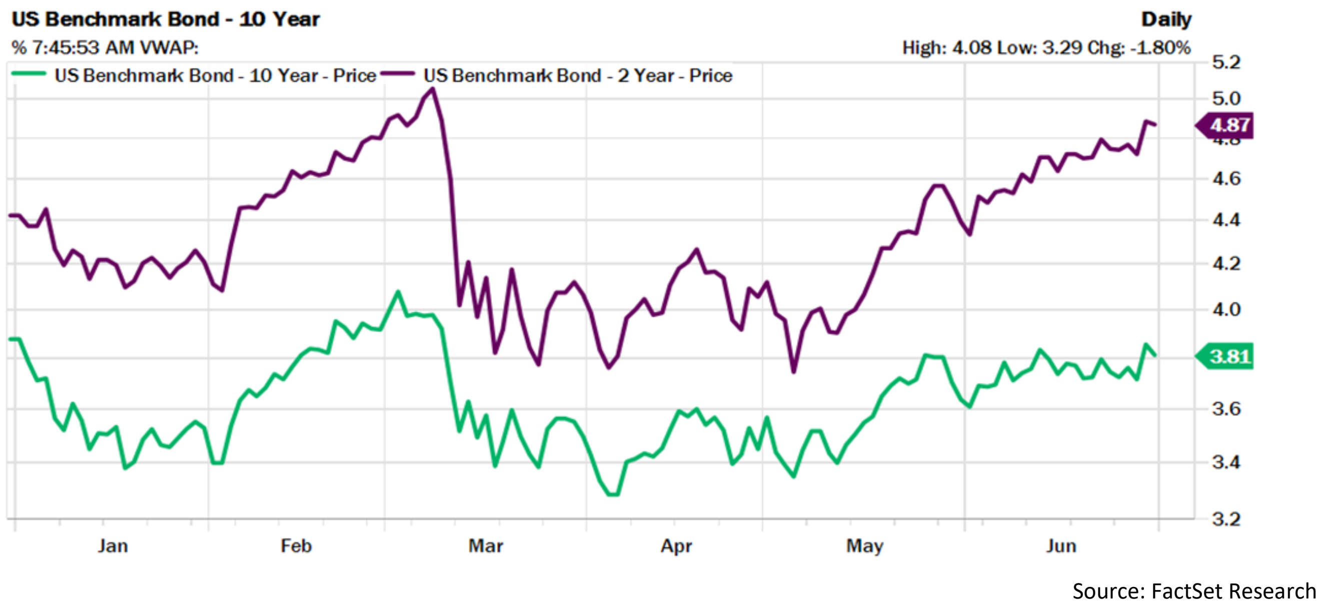
Source: FactSet Research

OSBORNE PARTNERS
Capital Management, LLC

Fixed Income and Credit: The Fed Goes Marching On



Source: FactSet Research



Source: FactSet Research

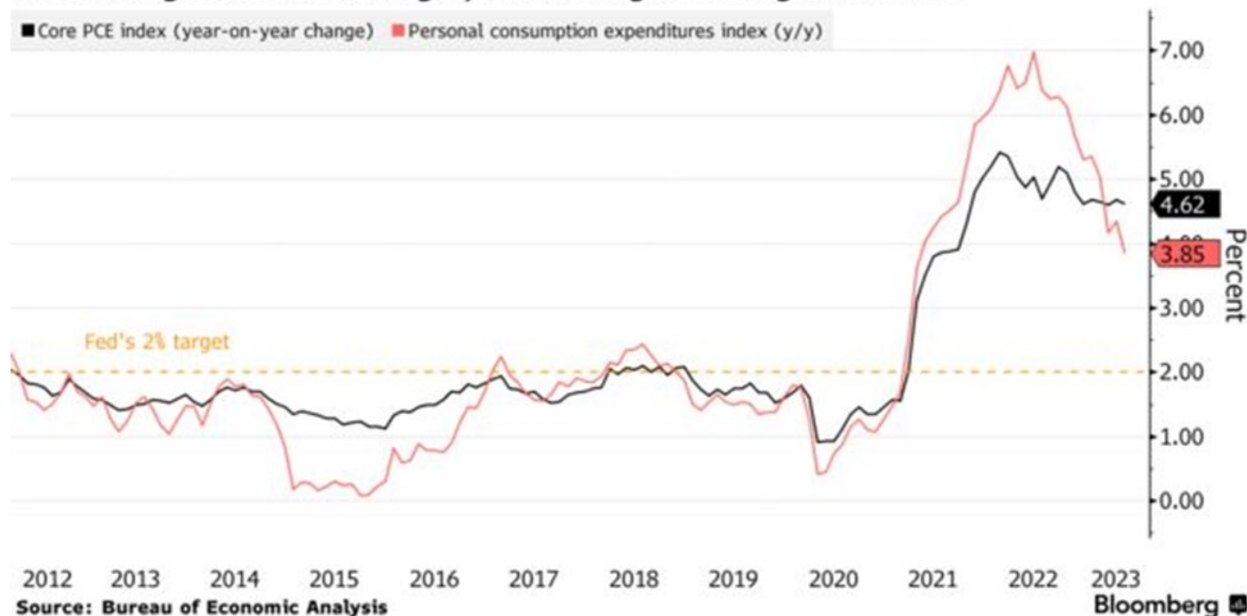
What Changed Fundamentally?

Despite various claims of cracks in the labor market, a dearth of credit availability, tighter lending standards, and calls for an impending recession, the economy kept rolling along. Sequential and year-over-year (YoY) data generally held up well or even improved in the second quarter:

- ***Non-Farm Payrolls:*** Both April (+294k) and May (+339k) posted very strong job growth despite the Unemployment Rate remaining in the mid-3%'s. The May data sparked a bond selloff as the labor market continues to tighten, creating worry that overly strong wages will aid inflation.

Fixed Income and Credit: The Fed Goes Marching On

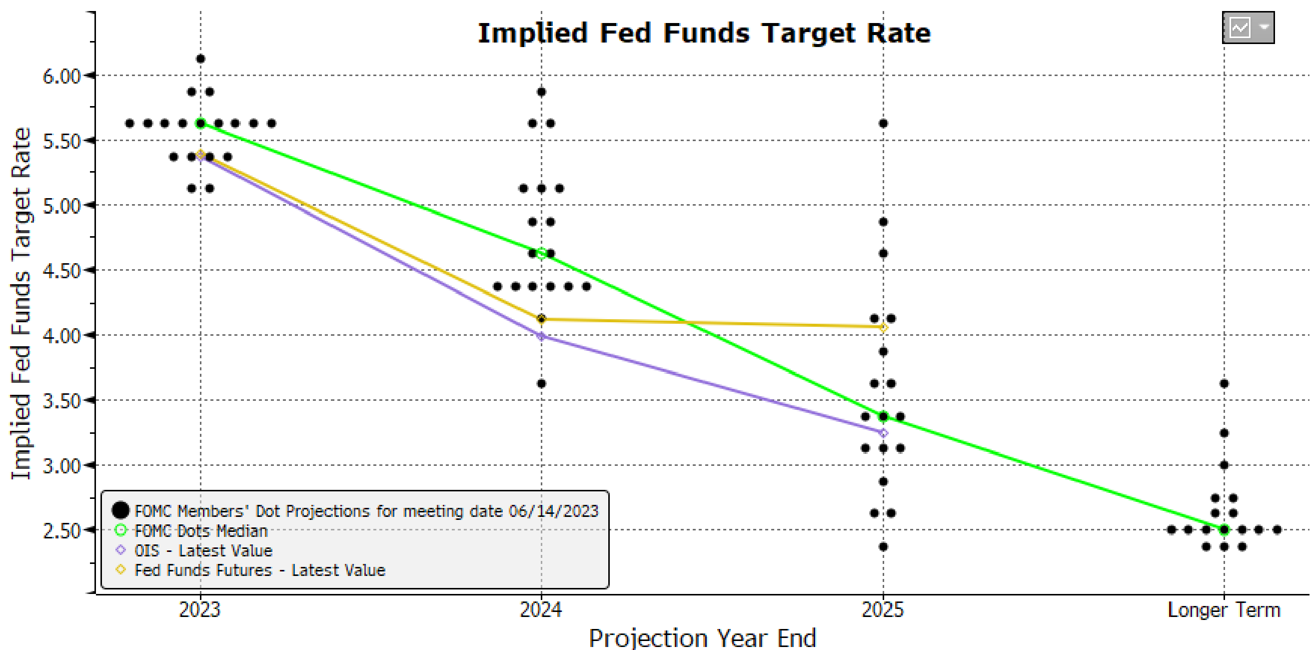
- ***Wage Growth:*** April (+4.4%) and May (+4.3%) YoY wage growth remained elevated but in-line with expectations and continued the gradual slowdown toward levels consistent with the Fed's 2% inflation target. 2022 averaged over 5.1% YoY wage growth.
- ***Jobless Claims:*** The last June data print broke a five-week stretch of rising initial claims and was the biggest week-over-week decline since October 2021.
- ***PCE Inflation:*** The Core Personal Consumption Expenditures Index (Core PCE) remained stubbornly high in 2Q'23, but didn't worsen either. The Index rose 4.7% YoY in April and 4.6% in May, both levels effectively unchanged since the start of the year.



The Fed Goes Marching On, but Took a Quick Breather

As solid economic data continued to surface, the Fed kept on their path toward higher rates. The Fed's 0.25% hike in May was completely overshadowed by the more consequential 'pause' at the June meeting. In the wake of banking issues, which were inextricably tied to the rapid pace of rate hikes, the Fed decided to hold the Federal Funds rate steady in June. This allowed for more time to pass so prior

hikes could work their way through the economy and banks could regain their footing. Many expected the pause to mark the beginning of the end of the hike cycle with Fed Funds futures going as far as to price in several interest rate cuts by year end. The Fed, however, signaled they'll march on. The latest June "Dot Plot," a summary of where Fed Presidents expect the Federal Funds rate at different points in time, indicated a peak Fed Funds rate of 5.75% by year-end (up 0.50% from March) and a terminal rate of 2.50% (unchanged from March). The divergence between market expectations for near-term rate cuts and the Fed's suggestion of higher rates for longer forced a significant repricing of yields off the April lows. The 2-year Treasury yield rose 1.11%, from 3.76% to 4.87%, by June 30th. Solidifying Fed Chairman Jerome Powell's comments at the June Meeting, the FOMC Minutes confirmed that some officials "could have supported" a 0.25% hike in June and "almost all" participants judged that additional increases would be needed before the fight against inflation is complete.



Source: Federal Reserve

Impact to Portfolios

Although no major changes were made to fixed income allocations during the quarter, recent events in the financial sector and the generally late-rate-cycle period are good reasons to reevaluate

positioning. Within financials, the Investment Team is skewing new purchases toward highly regulated GSIB banks (Global Systemically Important Banks) and toward highly rated issues with advantageous security positions. What we are not doing is avoiding U.S. banks simply because of bad headlines and perceived risk. This strategy is 'a day late and a dollar short' and deprives clients the opportunity to selectively add much higher yielding securities of still highly rated banks. To that end, recent events are a good reminder that diversification remains paramount and, as always, the Investment Team continues to monitor concentration risk. The same concept applies to the headline-risk prone real estate sector, where we remain cautious but continue to monitor for opportunities in beaten down but structurally attractive subsectors if the opportunity presents itself. Finally, we believe that increasing duration of fixed income portfolios is becoming more appealing at this stage of the rate cycle. As 7- and 10-year Treasury yields float around the 4% level, and inflation moderates, we see value in longer duration assets with nominal yields at decade-plus highs. ■

The opinions expressed herein are strictly those of Osborne Partners Capital Management, LLC ("OPCM") as of the date of the material and is subject to change. None of the data presented herein constitutes a recommendation or solicitation to invest in any particular investment strategy and should not be relied upon in making an investment decision. There is no guarantee that the investment strategies presented herein will work under all market conditions and investors should evaluate their ability to invest for the long-term. Each investor should select asset classes for investment based on his/her own goals, time horizon and risk tolerance. The information contained in this report is for informational purposes only and should not be deemed investment advice. Although information has been obtained from and is based upon sources OPCM believes to be reliable, we do not guarantee its accuracy and the information may be incomplete or condensed. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.