

# The Bond Bulletin

What's happening in fixed income markets

UBS Asset Management | June 2024

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## Highlights

### **In May US municipal bond prices returned down 0.29%, down 1.91% YTD**

- In May the municipal bond market finally gave way to the weight of abundant supply in the face of limited demand
- The abundance of supply was the larger factor influencing municipal market performance
- May's new issue supply surpassed new issuance experienced in April and now stands out as the largest month for new issuance in 2024

### **US corp investment grade total returns up 1.87% in May, US high yield up 1.11%**

- YTD total return for US investment grade down 1.12%, US high yield up 1.55% at month end
- Attractive yields, a resilient US economy, and expectations the Fed will eventually cut interest rates continues to attract investors to the investment grade corporate market
- The Fed continues to communicate that rate cuts are likely the next course of action, but the timing and the amount of cuts should keep market volatility elevated

# Fixed income month in review

May was a positive month for global fixed income markets as macro data supported the US soft-landing narrative. Hopes of a soft economic landing in the US were also lifted by data on economic growth, service sector activity, retail sales, and employment. US Investment-grade and high yield closed the month at a spread level of +85 bps and +314bps, 2bps tighter and 3bps wider, respectively. For May, the total return for US investment grade corporate index was up 1.87%, while US high yield was up 1.11%. As of May month-end, the year-to-date total return for investment-grade and high yield was -1.12% and 1.55%, respectively.

During May, the US Treasury curve bull flattened as yields largely fell across the curve. The 2 year ended the month at 4.87% (-17bps month over month), while the 5 year and 7 year maturities saw the more movement at -20bps. The 10 year and 30 year yields fell nearly as much to 4.50% (-18bps) and 4.65% (-13bps), respectively. The 2 year/10 year

relationship held its inverted shape at -37bps for the month. The inversion is still well below the peak inversion we saw of -108 bps reached on July 7th, 2003. Post May, the inversion has increased to -48 bps (June 18th, 2024). During May and in sympathy with the US rate movement, corporate credit yields fell. Investment grade and high yield yields fell by 20bps and 15bps to 5.52% and 7.98%, respectively. For the month, the total return for the US Treasury index was up 1.46% with the long-end (20yr+ posting a positive 2.93% return) outperforming the short-end (3-5yr posting a positive 1.21% return).

Within commodities, metals generally trended upwards with gold and copper rallying by 1.4% and 1.0%, respectively, and continuing their strong performance since the start of the year. Oil, however, tumbled in May and WTI (West Texas Intermediate) declined by 6%, likely responding to the recent slowdown in US economic data.

## Macro outlook

In the US, headline and core CPI were down to 3.4% and 3.6% year on year in April, reflecting a genuine slowdown from the previous month. Softer readings were driven by a 6.9% drop in used vehicle prices. Producer Price Index (PPI) on the other hand was more mixed and came in above consensus expectations driven by financial services, portfolio management and air-fares.

Labor market data further dispelled inflation concerns at the beginning of May: Non-farm payrolls of 175k came in significantly below consensus expectations (of 240k), while the unemployment rate ticked up by 0.1% to 3.9%. Meanwhile, average hourly earnings growth decelerated from 0.3% to 0.2% MoM. Growth in aggregate labor income is still running comfortably above its pre-COVID trend, supporting consumer spending.

Still, April retail sales were unexpectedly weak, declining 0.3% MoM within the control group vs an estimate of +0.1%. But the 3-month trend of this volatile time series is still trending higher. Consumer sentiment indicators showed a mixed picture in May. While the University of Michigan indicator showed a significant worsening in consumer expectations, the gauge by the Conference Board improved for the first time in 2024. The former is more heavily skewed towards inflation expectations and might still show a lagged effect of negative inflation surprises in Q1, which could explain the recent divergence.

Consumer spending as a component of Q1 real GDP was revised lower, down to 2% QoQ SAAR from 2.5%, reflecting

weakness in durable goods spending. As a consequence, Q1 GDP growth was revised down to 1.3% QoQ SAAR from 1.6% initially. We maintain the view that US economic growth remains on a stable footing. Currently the Atlanta Fed GDP Nowcast estimates a very solid 3.5% growth rate in Q2. Preliminary May PMI figures by S&P showed improvement in both the manufacturing and especially the service sector, beating expectations.

The rise in the 30-year mortgage rate from below 7% at the start of the year to 7.6% at the peak in April and 7.4% currently, is showing an impact on the housing market. Building permits and housing starts generally softened and the NAHB Home Builders Index declined.

In a media appearance following the release of CPI data, Fed Chair Jerome Powell said that inflation data year to date had not increased monetary policymakers' confidence that price pressures would trend back towards target. Powell indicated that rate cuts would be delayed as it would take longer to become confident on the trend for inflation. Housing data were mixed amid the sharp rise in yields. Starts were down 14.7% month-on-month in March and building permits fell 4.3%, both far bigger contractions than anticipated. However, new home sales jumped, up 8.8% on the month, though February's reading was revised to show a much larger decline. The April preliminary flash purchasing managers' indexes disappointed, with the S&P global manufacturing PMI unexpectedly dropping just below 50 while the services PMI moderated to 50.9 from 51.7.

<sup>1</sup>See last page for further information

# Municipal fixed income

## Performance Backdrop

In April the municipal bond market finally gave way to the weight of abundant supply in the face of limited demand (Tax Day). Returns for the month suffered and the Bloomberg US Municipal Bond Index<sup>1</sup> posted its first large negative return for the year of -1.24%. The month of May succumbed to the very same supply factors. Fortunately, the beginning of a seasonal period for reinvestment provided something of a floor to the underperformance. Final returns for May were reported as -0.29% with the majority of the negative repricing cycle taking hold during the holiday shortened week prior to Memorial Day. May's return represented the second worst return for a May month in the last 10 years and left year to date returns at -1.91%.

The abundance of supply was the larger factor influencing municipal market performance. In the last 20 years there have been just three occurrences of May supply exceeding \$40 billion. Those years were 2007, 2008 and 2016. This year, May's new issue supply surpassed new issuance experienced in April and now stands out as the largest month for new issuance in 2024 at \$48.9 billion. Year-over-year May 2024's issuance was 57% larger than May 2023. For the year, annual issuance is running 38% higher year-to-date when compared to 2023. It has been our stated belief that the increased supply is partially explained as a front-loading of issuance early in the year to avoid issuing debt in the lead-up to the national election. Investors should be encouraged to take advantage of this opportunity in the new issue market. We also believe it will become more and more difficult to source bonds, at the right price, as the summer progresses and new issuance supply dries up. As the dog-days-of-summer take hold investors, without abundant new issue supply, will find themselves subject to over-priced secondary market offerings where the seller will offer little, to nothing, in the way of concession.

In general, municipal bonds underperformed treasury securities by approximately 12 basis points. Accordingly, municipal relative value metrics improved. Data provided through Bloomberg indicates municipal versus treasury ratios finished May at cheaper levels across the maturity spectrum. The 2-year ratio cheapened to 68.79% after starting the month at 64.02%. The 5-year ratio cheapened the most moving to 69.78% from 60.51%. The 10-year ratio cheapened to 69.11% from 60.95% and the 30-year ratio cheapened the least as it moved to 85.16% from 82.85%. Our thinking remains much the same, the very best value and total return in the market lies just beyond 15 year maturities. Extending as far as 30 years bring with it cheaper bonds but also unnecessary exposure to interest rates (duration) without the appropriate compensation.

Past avoidance of the market for cheaper ratios in the future, to an extent has been placated. Combining now cheaper relative value metrics with higher yields, the case can further be made for investors to put cash to work. According to TM3 data, in May the municipal yield curve experienced a month of bear flattening. 2-year yields were higher by 13 basis points. 5-year yields increased 29 basis points. 10-year yields increased 30 basis points and 30-year yields were unchanged. As it has been for an extended period, the municipal yield curve remained inverted with shorter maturity yields higher than yields as far out as ten years. We continue to reduce cash (and cash like vehicles - VRDN's) in favor of short maturity bonds (1-3 year maturities). Due to the inversion of the curve, investors can achieve income in 1-3 year maturities that can only be replicated by extending as far out as 12 years. VRDN yields have dropped but remain attractive. VRDN yields hit a high of 4.21% in May slightly lower than the 4.35% high experienced in April. Year-to-date average VRDN yields crept higher to 3.47%.

## A deeper dive into sub-index performance reveals the following:

May's best performing area of the curve was the Long Bond sub-index (22+) that generated a positive return of 0.46% followed by the 1 Year sub-index (1-2) which returned 0.24%. The worst performing area was the 10 Year sub-index (8-12) at -1.18%. The 1 Year sub-indices' performance of 0.24% in May keeps it as the only positive performing sub-index with a year-to date return of 0.37%. The year-to-date worst performing sub-indices reside inside 10-year maturities. An area of the curve we have advocated avoiding for some time. Year-to-date the 10 Year sub-index (8-12) has returned -3.04% followed by the 7 Year sub-index's (6-8) return of -2.54%.

Looking at credit, the search for yield without taking on additional duration has driven credit spread tightening throughout the year. Credit spreads are tight across the ratings spectrum, and we do not advocate going down in credit quality at any level. Within the investment grade realm the Triple-B sub-index performed the best in May with a return of 0.14%, slightly ahead of the Single-A sub-index return of -0.10%. The worst performing rating sub-index was the Triple-A sub-index with a return of -0.49% just behind the -0.36% return for the Double-A sub-index. Year to date, the Triple-B and Single-A sub-indices have demonstrated the best performance posting returns of -0.67% and -1.17%, respectively. The Triple-A sub-index has been the worst performance rating index posting year-to-date returns of -2.64%. We attribute the outperformance of the lower quality sub-indices to a crowded one-way trade which when it reverses itself will inflict just as much pain.

<sup>1</sup>See last page for further information

# Taxable fixed income

## Taxable fixed income performance

US corporate investment grade total return (as measured by the Bloomberg US Corporate Bond Index)<sup>1</sup> posted a 1.87% return for the month of May. There was performance dispersion across ratings and maturities for investment grade issuers. BBB-rated credit returned 1.94% for the month relative to AA-rated credit at 1.79%. From a maturity standpoint, three-to-five-year maturities were up 1.32%, while 10+ year maturities were up 2.82%. Investment-grade corporate index closed the month at a spread level of 85bps, 2bps tighter relative to the April close. At the end of May, the year-to-date average investment-grade corporate spread was 92 bps with a wide of 105 bps (1/3/2024) and a tight of 85 bps (5/31/2024). For context, the average investment grade corporate spread in 2023 was 125 bps with a wide of 163 bps (3/15/2023) and a tight of 98 bps (12/28/2023). At the sector level, the best performers were cable satellite, chemicals, gaming, banking and metal and mining, while restaurants, integrated, paper, aero/defense, and refining underperformed.

US short duration high yield (as measured by the ICE BofA 1-3 year BB-B Cash Pay High Yield Constrained Index)<sup>1</sup> returned 0.88% for May. During the month, the OAS for the index tightened 20 bps to close at a level of 187 bps. Double B credits widened 3 bps, while single B issuers tightened 46 bps, respectively, in May. Translating spread tightening to performance across the major ratings buckets for the short-dated high yield index, BB's were down 0.10%, while B's were down 0.34%. On a total return basis and for the broader high yield index, BB's were up 1.24%, B's were up 0.98%, and CCC's were up 0.47%. In May most sectors were up, the best performing sectors were pharmaceuticals (+5.67%), wireless (+2.31%), banking (+2.14%), electric (+2.03%), and food and beverage (+1.69%). Laggards on a relative basis were media entertainment (-1.22%), wirelines (-0.47%), cable satellite (+0.12%), airlines (+0.49%), and building materials (+0.50%).

Emerging market sovereign bonds (as measured by the J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI Global Diversified)<sup>1</sup> and EM corporate bonds (as measured by the J.P. Morgan Corporate Emerging Markets Bond Index Diversified (CEMBI Diversified)<sup>1</sup> returned 1.80% and 1.50%, respectively, during May. Over the month, the OAS for the sovereign index widened by 8 bps to 381 bps and the corporate OAS tightened 4 bps for the month to 255 bps. During the month and with respect to sovereign issuers, high grade generated +2.07% and outperformed high yield which ended the month up +1.55%. On a year-to-date basis, returns have been dominated by sub-investment grade rated sovereigns at +5.07% versus investment grade countries at -1.54%. By country, top performers for the month include Maldives, Lebanon, and Ghana while Venezuela, Ecuador and Argentina were at the bottom of the list. In terms of emerging market corporates, total returns across the credit spectrum were positive with investment-grade at +1.44% and high-yield outperforming at +1.58%. On a year-to-date basis, returns have been dominated by sub-investment grade rated corporates at +4.94% versus investment grade companies at

+1.23%. All industry sectors generated positive returns with Real Estate, Pulp & Paper and Oil & Gas being the best performers over the month.

## Taxable fixed income market update

The 2024 narrative for investment grade remains the same. Attractive yields, a resilient US economy, and expectations the Fed will eventually cut interest rates continues to attract investors to the investment grade corporate market. This pattern will remain in place until we see Treasury yields move higher, over 5% for the 10yr Treasury, or lower, towards 4%. The 10yr Treasury yield range of 4% to 5% is keeping the corporate market in the sweet spot as there is little fear of inflation trending upwards which would put pressure on the Fed to reconsider its next policy move. On the flip side, low unemployment is providing comfort that economic growth will remain positive and that corporate fundamentals will remain stable. The overall corporate yield remains attractive at roughly 5.58%, and this remains the dominant driver for credit. Corporate yields have been sitting in the low to mid five percent range for a few months, and investors remain very comfortable investing in the asset class. The narrative that the next move by the Fed will be a rate cut hasn't changed, but the recent move higher in Treasury yields has indicated more caution is warranted on when this will occur. The market continues to believe that new issue supply will slow in the second half of this year and this is supporting a general bid for investment grade credit. This supply/demand imbalance should continue to put downward pressure on corporate spreads.

High yield ended the month of May with YTW of 7.98% and an OAS spread of +314bps. Since the beginning of the year and through May, spreads have compressed -33bps (+17bps off YTD tights) while YTW is higher by 33bps. For context, in 2023 we saw a wide, a tight and an average high yield spread of 518 bps, 327 bps and 413 bps, respectively. We closed out the year at a spread level of 332 bps but backed-up 19bps during January after the more hawkish Fed comments and stronger than expected economic prints.

Supporting high yield spreads is the fact that capital markets have been resoundingly open for 2024. May printed another \$37.1bn of new deals bringing the YTD total to \$156.4bn. While year-over-year new issue growth is up an impressive +85%, < 20% represents net new supply as the bulk consists mainly of debt refinancing, keeping bond scarcity high and technicals strong. CCC's remain a minority component of new issues year-to-date.

Issuers continue to chip away at the debt maturity wall. According to a Bank of America High Yield strategist, more than 40% of the 2024-2026 debt (made of up HY bonds and broadly syndicated loans) that was outstanding one year ago has now been addressed. Although this represents a significant improvement, we are conscious that 2025's debt hurdle remains elevated by historic standards, but our concerns remain limited as access to capital remains open to address remaining financing needs. Loan-to-bond pressure for the high

<sup>1</sup>See last page for further information

yield bond space has also been reduced as record CLO issuance has materialized supporting loan refinancing needs.

At the start of the year, 2024 street default estimates to range from 2.75% to the high 5% area, while our in-house global research team projects 3.4% with healthcare and telecom sectors contributing 25% of the total. Current LTM default rate (incl. distressed exchanges) is running at 2.33%. Moody's report (March) projects global default rates to gradually decline from Q1 peak level towards a more normalized 3.3% level by year-end. Year-to-date, distressed exchanges make up nearly 23% of the default plus distressed exchange figure as struggling credits work with bondholders to find solutions outside of the bankruptcy process (for loans this is closer to 50%).

### **Taxable fixed income strategy**

The Bloomberg US Corporate Bond Index<sup>1</sup> is currently 85 bps. Corporate spreads have been range bound over the past few weeks as lack of meaningful economic data and low volatility has provided little direction to investors. The technical landscape for investment grade credit remains very positive with consistent cash inflows. The all in yields for intermediate investment grade debt are around 5.30%-5.40%.

The Fed continues to communicate that rate cuts are likely the next course of action, but the timing and the amount of cuts should keep market volatility elevated. This will provide many opportunities for investors when looking for attractive entry points. The Fed policy rate remains unchanged at 5.25% to 5.50%. This Fed rate hike cycle, which began in March 2022, has seen 10 straight hikes with a current Fed funds rate in the 5.25% to 5.50% range. The Fed paused at the June 2023 meeting, and has now pivoted to rate cuts in 2024.

In terms of sectors and for our active investment-grade strategies, we are overweight the utility sector, as we believe the sector offers attractive relative value. We remain underweight issuers that have poor ESG scores. We have an overweight in the financial sector. We continue to believe the banking sector will maintain solid fundamentals, and we favor money center banks and select large regional banks. We remain underweight the industrial sector, but we have been adding exposure to select industrial names. We remain overweight the energy sector as fundamentals within the sector remain strong, and we are overweight the technology sector as we believe valuations are attractive. We are underweight the non-cyclical sector, but within the non-cyclical sector we are overweight within the healthcare and pharmaceuticals sectors. Increased M&A activity in these sectors is being partially funded by debt which provided an attractive entry point. We are underweight the telecom, media and cable sectors. Expectations of increased M&A activity and the likelihood of additional debt issuance has turned us more cautious on the group as we wait for a more attractive entry point.

From a credit curve perspective, we are neutral the short-end of the credit curve (2-4 yrs.), and are overweight the intermediate part of the credit curve (5-10 yrs). We continue to

take advantage of the new issuance calendar but we are focusing on up-in-quality when looking to add exposure into the portfolios.

Year-to-date, the high yield market has benefited from resilient fundamentals and strong technicals. Corporate fundamentals continue to fare better than anticipated which has reduced US recessionary probabilities. In addition and over the last two years, a culmination of -14% decline in bonds outstanding coupled with a near 6% of annual coupon interest has supported strong demand from technical standpoint. As a result, capital markets remain accommodative for corporate debt financing leading to diminished default expectations. Although current spreads of +314bp are tight which makes us cautious, this high carry asset class trades at historically attractive yields of 7.98%. The previously mentioned support gives us comfort that high yield spreads could remain range bound at these lower levels similar to mid-2005-mid 2007 and 2017-2018 periods.

At current levels, given the high yield callability nature and price convexity factors, it is likely that further bond price appreciation will be limited. We would expect income/carry to make up a larger portion of returns while any positive rate action would enhance returns for incremental premiums paid for new refinancing opportunities not currently priced in.

We are keeping duration near neutral with a more wait and see approach. Rate volatility should remain elevated while markets look for a more sustainable economic data path needed to achieve lower inflation supportive of a lower rate environment. We remain up in credit quality while looking for idiosyncratic opportunities to develop. For lower quality credits, we are targeting shorter maturity bonds with strong access to capital and continue to remain focused on credit selection as tighter financial policy works its way through the economy and to borrowers.

Overall, we expect high yield technicals to moderate during the 2nd half of this year as lower quality credit stories become more in focus as many will need to term out existing debt profiles. To date, new issues have been easily absorbed and typically oversubscribed, upsized, and priced closer to the tight end of original guidance, trading up ½-1pt after pricing.

In our emerging market ladder portfolios, we have no direct exposure (sovereign, corporate and quasi-sovereign) to Russia or Ukraine. From a regional perspective, we are seeing attractive relative value opportunities in Latin America especially in markets such as Brazil, Mexico, Panama, Poland, Philippines and Colombia. On the margin, our bias is towards corporates over sovereigns and quasi-sovereigns with a current allocation of 51.75% and 48.25%, respectively. Within corporates, we have allocations to the energy, basic materials and industrial sectors. From a credit quality perspective, we remain largely investment-grade focused with 76.25% of the portfolio exposed to investment-grade and the balance in high yield issuers.

<sup>1</sup>See last page for further information

# Outlook

May's US rates market movement suggested an easier path forward for monetary policy than previously suspected, as treasury yields generally fell 15-20bps along the maturity spectrum. Rates movement was well justified by the economic mosaic unveiled last month.

Our medium/longer term conviction is that core inflation will continue to move toward target as we proceed from here. What's more, US policymakers have heavily-handedly indicated the end of the tightening cycle and the inclination to reduce rates from here or keep rates constant should inflation prove somewhat persistent, as opposed to further hikes.

Tighter valuations mark the credit landscape, but investors would be careful to note that historically tight spread levels have tended to stubbornly persevere in prior episodes akin to today's. The worst laid fears of a dour economy's potential to weaken credit fundamentals in future quarters remains non-imminent in our view and merits selectively maintaining exposures in those higher compensation names and market segments where relative value exists.

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<sup>1</sup>See last page for further information

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**The ICE BofA 1-3 year BB-B Cash Pay High Yield Constrained Index** tracks the performance of non-investment-grade corporate bonds with a remaining term to final maturity less than three years and rated BB-B and limit individual issuer concentrations to 2%.

**J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI Global Diversified)** tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities. It limits the weights of constituent countries with larger debt stocks by only including specified of their debt outstanding.

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