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Alert: Rates Have Come Full Circle

No More Extraordinary Opportunity in Municipal Bonds

February 6, 2023

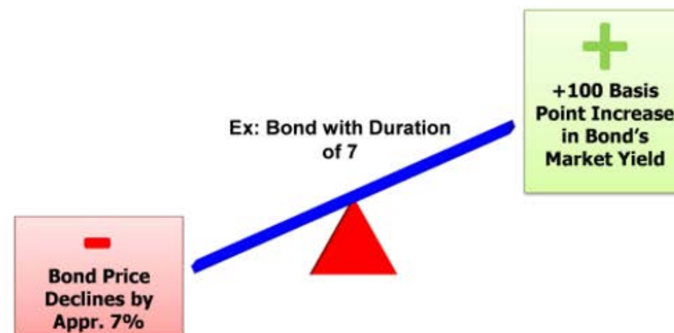
Introduction

Last October, we noted bond markets - particularly municipals - were offering investors an excellent opportunity to lock-in elevated yields for the long haul (Alert: What to Do Now? - Action Plan for the Worst Bond Market in 40+ Years, 10/20/22). In that Alert, we also addressed the common wisdom that it's unwise to extend maturities while the Fed's still tightening (hint: markets move ahead of the Fed) and explained why it was time to act.

Since then, yields have declined substantially - for example, the 10-year Treasury has dropped 85 basis points from 4.25% to 3.40%. That move is more than enough to alter the risk-reward characteristics of buying long-term bonds at current levels and we're adjusting our strategy. Read on for our current thoughts.

Flashback

Recall that a bond's maturity, or duration (as we think about it), is a measure of its price sensitivity to changes in interest rates. For example, if rates rise 1% (100 basis points), a bond with a 7-year duration will decline by approximately 7%. Offsetting this price decline are the coupon payments received from the issuer - if the same bond also pays out 3.50% per year, the net total return pencils out to a more palatable -3.50%.



Source: Treasury Partners (Alert: What to Do Now? - Action Plan for the Worst Bond Market in 40+ Years, 10/20/22)

A Sea-Change in Fixed Income

As longtime readers know, from the summer of 2020 to the summer of 2022 - when yields across the curve were near historic lows - we hardly touched any long-term debt, wary about taking on price risk for meager yields.

Starting around Q4 2022, we altered our cautious stance and began extending maturities in light of the seismic change in the investment landscape: rates had rocketed higher due to surging inflation. At long last, bonds had again reached the point where they could add investment - and not just capital-protective - value to client portfolios.

Specifically, for years investors had been forced to choose between low duration/nearly-zero yielding bonds and higher duration/meager-yielding bonds. The latter struck us as poisoned fruit because of its asymmetric value proposition:

- There was hardly any room for price appreciation, as yields couldn't realistically fall much lower.
- Conversely, the potential capital destruction (price declines) from rising rates was unacceptably high.

It was a 'heads we lose, tails we lose' scenario and ultimately would have added risk to overall portfolios. We wanted no part of it.

But as the Fed kept jacking the Fed Funds rate higher to combat inflation, long-term bonds started trading at levels that offered investors a much more appealing tradeoff. Consider that:

- If rates kept rising, downside was now more limited, since higher starting book yields provide protection against bond price declines.
- If rates fell - a scenario usually paired with a slowing economy, lower corporate earnings per share, and declining stock prices - long-term bonds would appreciate in price, providing some offset against equity losses.

The case for owning long-term bonds had dramatically improved and we acted aggressively to capture the opportunity in client portfolios, where appropriate.

Tantalizing Municipal Bond Yields

This improved risk-return proposition in bonds was particularly apparent in the municipal market. A unique technical factor - forced selling by bond mutual funds - amplified the rise in yields, leading to particularly tantalizing rates in longer-term munis (details are in Alert: What to Do Now? - Action Plan for the Worst Bond Market in 40+ Years, 10/20/22). As the below table shows, both absolute yields and relative value measures (meaning, the Muni/Treasury yield ratio) noticeably spiked from late summer through the middle of Q4 2022 - with the greatest value apparent in the longer maturities.

AAA Municipal vs. Treasury Yields and Ratios

Maturity	As of 7/29/22			As of 9/30/22			As of 10/31/22		
	AAA Muni Yield	Treasury Yield	Muni/ Treasury Ratio	AAA Muni Yield	Treasury Yield	Muni/ Treasury Ratio	AAA Muni Yield	Treasury Yield	Muni/ Treasury Ratio
3 Year	1.70%	2.81%	60%	3.09%	4.29%	72%	3.23%	4.44%	73%
5 Year	1.84%	2.68%	69%	3.13%	4.09%	77%	3.27%	4.23%	77%
10 Year	2.27%	2.65%	85%	3.26%	3.83%	85%	3.40%	4.05%	84%
20 Year	2.75%	3.22%	85%	3.75%	4.09%	92%	3.95%	4.41%	90%
30 Year	2.93%	3.01%	97%	3.95%	3.78%	104%	4.17%	4.17%	100%

Source: Bloomberg (BVAL AAA Muni benchmark curve)

While we were tantalized by the municipal bond rates in September, we were positively drooling by October. The reason was simple - in addition to spinning off a steady stream of attractive income, long-dated munis at such elevated levels offered another portfolio benefit. The average long-term annual return on broadly diversified stocks is historically 8-9% on a pre-tax basis; a 4% yield on a high-grade muni can translate into an 8%+ pretax equivalent return (*depending on investor domicile and tax bracket*). In our thinking, pretax equity market returns were available without the volatility of the stock market. Importantly, these attractive levels were achievable without having to compromise on credit quality.

We felt the value was so apparent that we were concerned the window to act would prove fleeting. Again, as we wrote last October (Alert: What to Do Now? - Action Plan for the Worst Bond Market in 40+ Years, 10/20/22): "*As investors realize how much this risk/reward relationship has shifted, we expect to see assets reallocated from stocks to bonds. We want to be 'early' and front-run this dynamic.*"

Where We Are Now

Unfortunately, yields across fixed income markets have since tumbled (particularly when the calendar flipped to 2023). The main culprit is growing anticipation of a softening economy, fading inflationary pressures, and accordingly lower Treasury rates.

10 Year US Treasury Yield

Source: Bloomberg (as of 2/1/23)

As a result, the investment calculus for adding long term bonds has (once again) changed. When we first began increasing allocations to munis and extending durations it was a contrarian bet; now we're witnessing a massive demand-driven scramble for increasingly scarce bonds which has eroded the value proposition driving our original decision to aggressively extend maturities.

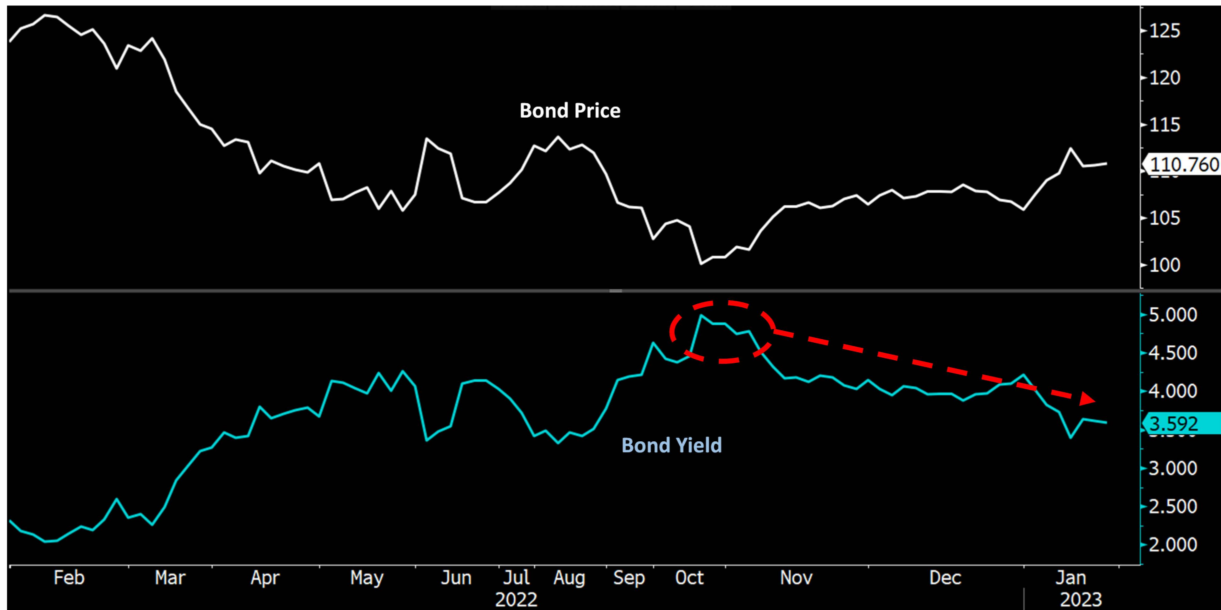
AAA Municipal vs. Treasury Yields and Ratios

	As of 10/31/22			As of 11/30/22			As of 12/30/22			As of 1/30/23		
Maturity	AAA Muni Yield	Treasury Yield	Muni/ Treasury Ratio	AAA Muni Yield	Treasury Yield	Muni/ Treasury Ratio	AAA Muni Yield	Treasury Yield	Muni/ Treasury Ratio	AAA Muni Yield	Treasury Yield	Muni/ Treasury Ratio
3 Year	3.23%	4.44%	73%	2.60%	4.05%	64%	2.58%	4.23%	61%	2.13%	3.96%	54%
5 Year	3.27%	4.23%	77%	2.65%	3.74%	71%	2.56%	4.01%	64%	2.13%	3.68%	58%
10 Year	3.40%	4.05%	84%	2.75%	3.61%	76%	2.64%	3.88%	68%	2.24%	3.56%	63%
20 Year	3.95%	4.41%	90%	3.32%	3.93%	84%	3.31%	4.15%	80%	2.98%	3.79%	78%
30 Year	4.17%	4.17%	100%	3.57%	3.74%	95%	3.63%	3.97%	92%	3.29%	3.66%	90%

Source: Bloomberg (BVAL AAA Muni benchmark curve)

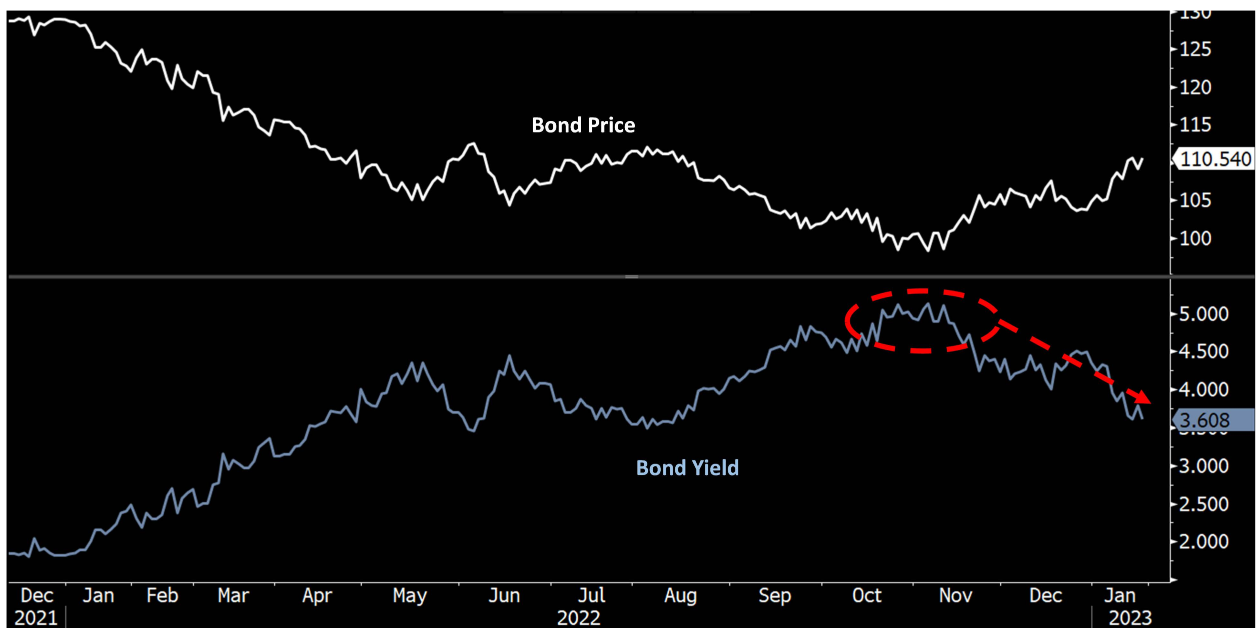
For example, longer-dated bonds we recently purchased at yields from 4.0-4.50%+, at the time anywhere from 105-120% of comparable Treasury rates, now trade at 3-3.60%, the equivalent of just 85-105% of Treasuries.

Example NY Long-Call Municipal Bond Price and Yield



Source: Bloomberg (CUSIP 64971XL71, as of 1/30/22)

Example National Long-Call Municipal Bond Price and Yield



Source: Bloomberg (CUSIP 452252PX1, as of 1/30/22)

For the past several months our thinking was clearly way out in front of the pack; now that same strategy is smack in the middle of the pack. So, we're changing our approach.

Current Strategy

Naturally, bonds that were acquired at higher levels are now locked in at above-market yields and have already generated meaningful price gains. But as we look forward, today's market realities counsel a more cautious approach.

> *"In our experience of investing through forty years of market cycles, one of the most consistent patterns is that all parabolic moves (in this case, higher) eventually tend to get walked back (in this case, move lower). Stated differently, rates might tick higher - but once the bond market gets a whiff of imminent recession, rates will likely decline significantly, irrespective of Fed policy. It pays to take advantage of these absolute levels while they're still available."*
> ***Corporate Cash Outlook 2023: Act Now,*** *12/22/22*

It's important to note that this doesn't mean fixed income markets have reverted back to the punishing realities of the ultralow-rate era. *The duration/yield tradeoffs in current bond pricing, though off their recent peaks, aren't necessarily terrible.* Longer-dated positions can still prove attractive in certain portfolios and circumstances, but it no longer makes sense to seek maximum durations in client portfolios. A more balanced approach to filling in a portfolio's effective maturity ladder - a more *typical* positioning strategy - is how we're structuring portfolios now.

As a result, we've begun adding lower-duration (shorter maturity) bonds. For example, in our tax-sensitive portfolios, rather than emphasizing a minimum of 7-10 years of call protection, we're taking on less interest rate risk by adding munis that are 2-6 years away from their first call date. While certain longer-term callable munis can still add value to portfolios, generally speaking, at current valuations, the entire muni bond curve is significantly less attractive than a few months ago. In our taxable portfolios, we continue to find value in various sectors and specific issuers within the corporate bond market in 3-10 year maturities. We're also adding corporate bonds opportunistically to our muni portfolios, where appropriate.

Our eyes are wide open to identify the next opportunity. We greatly appreciate the trust and confidence you place in us and will continue to work hard to earn that honor.

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