PARAMETRIC

Municipal Bond Market Insight | September 2022

Powell: "These Are the Unfortunate Costs of Reducing Inflation"

Key takeaways

» August cooled fixed income markets as yields resumed their march higher. Economic data came in above expectations, with no indication that the economy is slowing down in the face of aggressive action from the Federal Reserve.

» After posting strong returns in July, the municipal market saw outflows accelerate and yields shift between 40 and 70 basis points higher. The Bloomberg Municipal Bond Index returned -2.19% for the month, bringing year-to-date performance to -8.62%.

» A hybrid vehicle composed of an SMA with a mutual fund component can offer investors a way to augment yield by taking on some high-yield exposure.

» The markets will likely continue to express volatility as we digest new economic data and move closer to the next Fed meeting in late September.

Parametric
800 Fifth Avenue
Suite 2800
Seattle, WA 98104
T 206 694 5575
F 206 694 5581
www.parametricportfolio.com

General market update

Despite the warm weather, August cooled fixed income markets as yields resumed their march higher. Economic data came in above expectations, with no indication that the economy is slowing down in the face of aggressive action by the Federal Reserve. Inflation readings from August 10 noted a 0.00% month-over-month increase and year-over-year readings below the surveyed levels. Federal Open Market Committee (FOMC) officials, speaking in Jackson Hole, Wyoming, reiterated their determination to increase short-term rates and further tame inflation. In spite of stronger than expected economic news, the equity markets sold off in August as well. The S&P 500® returned -4.08% and the NASDAQ saw a decline of -4.53% in aggregate.

After posting strong returns in July, the municipal market saw outflows accelerate and yields shift between 40 and 70 basis points (bps) higher. The Bloomberg Municipal Bond Index returned -2.19% for the month, bringing year-to-date performance to -8.62%. While municipal bonds may feel like "the best-looking house in an ugly neighborhood," they actually outperformed US Treasuries in August, as well as investment-grade (IG) corporate bonds. The strong technical environment, with lower seasonal supply and elevated reinvestment flows, supported outperformance compared with other high-quality fixed income asset classes.

The markets will likely continue to express volatility as we digest new economic data and move closer to the next Fed meeting on September 21. At the time of this writing, the market expects a 75-bps rate increase. It's likely that markets remain choppy in the meantime. As nominal yields once again push close to year-to-date highs, fixed income investors may see opportunities to put capital to work at attractive levels.

A structure to enhance yield in fixed income SMAs

When it comes to fixed income investing, high-net-worth investors have long appreciated the advantages of separately managed accounts (SMAs). The certainty and definition that comes with owning individual bonds is a key benefit for investors' safe-money allocation. SMAs can provide customized exposure to fixed income asset classes in ways that alternative vehicles can't. They can also allow for tax-loss harvesting tailored to the individual investor's needs, which can create tax alpha and improve after-tax returns.

Figure 1: Fixed income returns as of 8/31/2022

	MTD return	YTD return
Bloomberg Muni Index	-2.19%	-8.62%
Bloomberg US Treasury Index	-2.48%	-9.98%
Bloomberg US Aggregate Index	-2.83%	-10.75%
Bloomberg US Corporate Index	-2.93%	-14.21%

Source: Bloomberg, 8/31/2022. For illustrative purposes only. It is not possible to invest directly in an index.

Figure 2: AAA municipals YTD as of 8/31/2022

Year	Current	MTD change	YTD change
2-year	2.28%	+68 bps	+204 bps
5-year	2.32%	+52 bps	+173 bps
10-year	2.59%	+38 bps	+156 bps
30-year	3.29%	+40 bps	+180 bps

Source: Thomson Reuters Municipal Market Data, 8/31/2022. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 3: US Treasury yields as of 8/31/2022

Year	Current	MTD change	YTD change
2-year	3.45%	+55 bps	+272 bps
5-year	3.28%	+59 bps	+203 bps
10-year	3.13%	+48 bps	+163 bps
30-year	3.26%	+28 bps	+137 bps

Source: Bloomberg, 8/31/2022. For illustrative purposes only. Not a recommendation to buy or sell any security.

Because SMAs tend to have relatively concentrated positions, we don't believe they're appropriate for taking on exposure to less liquid portions of the fixed income markets, notably high yield (HY). For these types of markets, building a highly diversified portfolio is more important, aggregating trade positions among multiple clients can matter more, and having a longer-term perspective may be necessary. A mutual fund could be the most efficient way to access these markets. While there are many excellent HY funds out there, the fund structure fails to deliver the same benefits as an SMA.

A hybrid vehicle composed of an SMA with a fund component might be the solution. It can offer investors a way to augment yield by taking on some high-yield exposure while maintaining many advantages of an SMA. Using municipals as an example, investors can add incremental yield in a 70% SMA/30% fund approach.

Investors could maintain two separate accounts, one for individual bond positions and one for mutual funds. However, a hybrid vehicle offers the advantage of consolidated positioning and reporting. It simplifies tax reporting and can significantly reduce any concentration risks that could occur from two independently managed investments. Hybrids can also be cost-effective because they often use a dedicated no-fee fund component. For example, Parametric offers a fixed income investment strategy that uses mutual funds with no-fee share classes.

Supply

Muni issuance in August totaled $33.6 billion, down approximately 23% from the issuance seen in August 2021. This decrease was attributable to several issuers delaying new deals amid the rising rate environment. We can likely expect this delay to continue through the remainder of the year, given the potential for additional rate volatility and the tremendous amount of aid municipalities have received over the past two years. Total issuance year to date through July is $272.8 billion, down approximately 14% from 2021's issuance through August. Notable tax-exempt issuers that came to market in August were the City of New York, the Georgia Ports Authority, and the New York City Transitional Finance Authority.

Key economic data

Change in nonfarm payrolls (Aug)	+315k
Unemployment rate (Aug)	3.7%
Core CPI—YoY change (Jul)	5.9%
Core PCE—YoY change (Jul)	4.6%
Average hourly earnings—YoY change (Aug)	5.2%
Real GDP annualized (Q2 2022)	-0.6%

Source: Bloomberg, 7/29/2022.

Economic outlook

Recent economic data suggests that the labor market remains tight, the consumer continues to spend, and high inflation is sticky. Nonfarm payrolls increased by 315,000 in August, and hiring continues at a strong pace. However, according to the Bureau of Labor Statistics, there are over 11 million job openings but only 5.5 million people currently seeking a job. This mismatch is likely to keep pressure on wages. Despite lower gasoline prices in recent months, other prices, including food and services, continue to rise. Without a noticeable trend of weaker data or tighter financial conditions, the Fed will commit to higher rates. The overnight borrowing rate stands at 2.33% at the time of this writing, with expectations for a 75-bps increase to more than 3% when the FOMC meets on September 21.

The Federal Reserve Bank of Kansas City hosted last month's annual Jackson Hole Economic Symposium, where central bankers, economists, and monetary policy leaders meet to discuss the global economy. These participants all agreed that higher interest rates are necessary to contain inflation. Fed chair Jerome Powell took a hawkish tone in his remarks, noting that FOMC actions will likely "bring some pain for households and businesses." Markets took the hint, with the S&P 500® losing 6.5% of its value since that meeting, while interest rates are approximately 30 bps higher.

About

Parametric Portfolio Associates® LLC ("Parametric"), headquartered in Seattle, is registered as an investment advisor with the US Securities and Exchange Commission under the Investment Advisers Act of 1940. Parametric is a leading global asset management firm, providing investment strategies and customized exposure management directly to institutional investors and indirectly to individual investors through financial intermediaries. Parametric offers a variety of rules-based investment strategies, including alpha-seeking equity, fixed income, alternative, and options strategies. Parametric also offers implementation services, including customized equity, traditional overlay, and centralized portfolio management. Parametric is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley, and offers these capabilities through offices located in Seattle, Boston, Minneapolis, New York City, and Westport, Connecticut.

Disclosures

This material may not be reproduced, in whole or in part, without the written consent of Parametric. Parametric and its affiliates are not responsible for its use by other parties.

This information is intended solely to report on investment strategies and opportunities identified by Parametric. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. We believe the information provided here is reliable but do not warrant its accuracy or completeness. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Past performance is not indicative of future results. The views and strategies described may not be suitable for all investors. Investing entails risks, and there can be no assurance that Parametric will achieve profits or avoid incurring losses. Parametric and Morgan Stanley do not provide legal, tax, or accounting advice or services. Clients should consult with their own tax or legal advisor prior to entering into any transaction or strategy described herein.

Charts, graphs, and other visual presentations and text information were derived from internal, proprietary, or service vendor technology sources or may have been extracted from other firm databases. As a result, the tabulation of certain reports may not precisely match other published data. Data may have originated from various sources, including, but not limited to, Bloomberg, MSCI/Barra, FactSet, or other systems and programs. Parametric makes no representation or endorsement concerning the accuracy or propriety of information received from any third party.

There is no assurance that a separately managed account ("SMA") will achieve its investment objective. SMAs are subject to market risk, which is the possibility that the market values of the securities in an account will decline and that the value of the securities may therefore be less than what you paid for them. Market values can change daily due to economic and other events (natural disasters, health crises, terrorism, conflicts, social unrest, etc.) that affect markets, countries, companies, or governments. It is difficult to predict the timing, duration, and potential adverse effects (portfolio liquidity, etc.) of events. Accordingly, you can lose money investing in an SMA. Corporate debt securities are subject to the risk of the issuer's inability to meet principal and interest payments on the obligation and may also be subject to price volatility due to such factors as interest rate sensitivity, market perception of the creditworthiness of the issuer, and general market liquidity. When interest rates rise, the value of corporate debt securities can be expected to decline. Debt securities with longer maturities tend to be more sensitive to interest rate movements than those with shorter maturities. Company defaults can impact the level of returns generated by corporate debt securities. An unexpected default can reduce income and the capital value of a corporate debt security. Furthermore, market expectations regarding economic conditions and the likely number of corporate defaults may impact the value of corporate debt securities.

An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads, and a lack of price transparency in the market. As interest rates rise, the value of certain income investments is likely to decline. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. While certain US government–sponsored agencies may be chartered or sponsored by acts of Congress, their securities are neither issued nor guaranteed by the US Treasury. Mortgage- and asset-backed securities are subject to credit, interest rate, prepayment, and extension risk. Derivative instruments can be used to take both long and short positions, be highly volatile, result in economic leverage (which can magnify losses), and involve risks in addition to the risks of the underlying instrument on which the derivative is based, such as counterparty, correlation, and liquidity risk. Diversification does not guarantee profit or eliminate the risk of loss.

Investment strategies that seek to enhance after-tax performance may be unable to fully realize strategic gains or harvest losses due to various factors. Market conditions may limit the ability to generate tax losses. Tax-loss harvesting involves the risks that the new investment could perform worse than the original investment and that transaction costs could offset the tax benefit. Also, a tax-managed strategy may cause a client portfolio to hold a security in order to achieve more favorable tax treatment or to sell a security in order to create tax losses. Prospective investors should consult with a tax or legal advisor before making any investment decision.

The views expressed in this report are those of the authors and are current only through the date stated at the top of this page. These views are subject to change at any time based on market or other conditions, and Parametric disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions are based on many factors, may not be relied on as an indication of trading intent on behalf of any Parametric strategy. This commentary may contain statements that are not historical facts, referred to as "forward-looking statements." The strategy's actual future results may differ significantly from those stated in any forward-looking statement, depending on factors such as changes in securities or financial markets or general economic conditions.

Parametric is headquartered at 800 Fifth Avenue, Suite 2800, Seattle, WA 98104. For more information regarding Parametric and its investment strategies, or to request a copy of Parametric's Form ADV or a list of composites, contact us at 206 694 5500 or visit www.parametricportfolio.com.

27547 | 9.13.2022