INDEPENDENT THINKING
A NEW PERSPECTIVE

EVERCORE Wealth Management
Trust Company
THE NEW STANDARD IN WEALTH MANAGEMENT

A Fixed Income Update

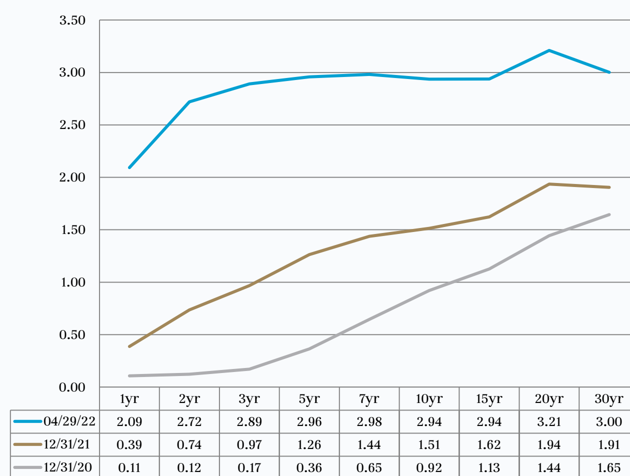
May 5, 2022

Interest rates in the United States and other developed countries are sharply higher so far this year as central banks try to combat inflation. Further rate hikes are anticipated as inflation, sparked by supply chain disruptions and other consequences of the pandemic, is now further fueled by energy and commodity price increases resulting from the war in Ukraine. While we believe that most of the Fed tightening is already priced into the market, more volatility may still lie ahead.

In the interim, surging yields have generated the worst year-to-date fixed income returns since 1980 with the Bloomberg U.S. Aggregate Bond Index down -9.50% year-to-date through April 30 and the Bloomberg Managed Money Short/Intermediate Municipal Bond Index down -7.35% for the same period.

As measured by Consumer Price Index (CPI), inflation is now running at roughly 8.5%, its highest reading since the late 1970s. After two years of maintaining a near zero overnight rate, the Federal Reserve started raising rates with a 25 basis point hike on March 16 followed by a 50 basis point tightening on May 4. The Fed Funds rate is currently (as of 5/4/22) 0.75% and the two-year Treasury yield is 2.72% (as of 4/29/22) (see Chart 1), indicating that the market expects the Federal Reserve to substantially tighten monetary policy over the next few years. Currently, based on the slope of the yield curve, the market is pricing in a Fed Funds rate of 2.9% by February of 2023. While it is yet to be determined whether the increase in interest rates will temper the pace of inflation, it is the Fed's goal to bring it down closer to its 2% objective.

CHART 1: U.S. TREASURY YIELDS



	1yr	2yr	3yr	5yr	7yr	10yr	15yr	20yr	30yr
04/29/22	2.09	2.72	2.89	2.96	2.98	2.94	2.94	3.21	3.00
12/31/21	0.39	0.74	0.97	1.26	1.44	1.51	1.62	1.94	1.91
12/31/20	0.11	0.12	0.17	0.36	0.65	0.92	1.13	1.44	1.65

Source: Bloomberg, MMD.

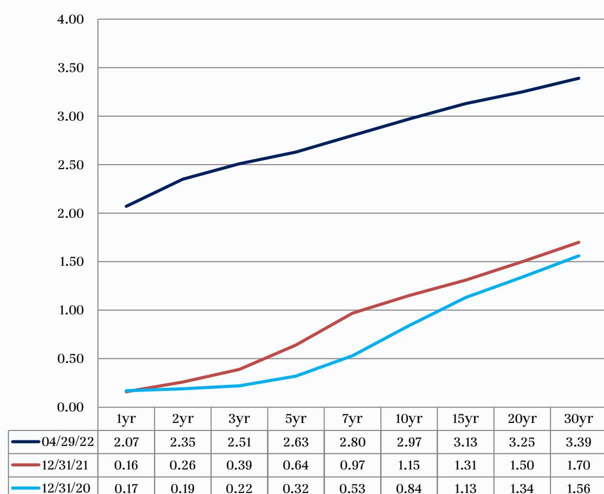
While no one likes to experience price declines in their bond portfolio, the best outcome for long term bond investors would be a prolonged period of sustained higher interest rates. We continue to recommend owning bonds as they remain a valuable building block in an investor's portfolio, due to the

income that they provide and their diversification benefits, strong credit characteristics, and relative price stability. In our main municipal composite, we have thus far in 2022, managed it to its lowest duration since its inception to help protect client principal.

Where appropriate, sharp increases in rates will allow us to reinvest upcoming maturities at higher yields, while the paper losses on more recent purchases will permit us to conduct tax swaps on longer holdings to harvest losses and to offset gains. (Tax swaps involve selling one bond at a loss and replacing it with another similar security, thereby realizing the loss to be used against any present or future gains while simultaneously replacing the income stream.)

For example, a three-year AA rated tax-free municipal bond was yielding as little as 40 basis points just six months ago and can now be purchased at a yield of 2.51%, the taxable equivalent of roughly 4% for investors in the highest tax bracket. The same bond due in 10-years was trading at 1.15% in the fourth quarter of 2021 and can now be purchased at a yield of roughly 3% (see Chart 2).

CHART 2: AA MUNICIPAL YIELDS



	1yr	2yr	3yr	5yr	7yr	10yr	15yr	20yr	30yr
04/29/22	2.07	2.35	2.51	2.63	2.80	2.97	3.13	3.25	3.39
12/31/21	0.16	0.26	0.39	0.64	0.97	1.15	1.31	1.50	1.70
12/31/20	0.17	0.19	0.22	0.32	0.53	0.84	1.13	1.34	1.56

Source: Bloomberg, MMD.

In the months ahead, we will be watching the shape of the yield curve and corporate credit spreads closely for any hints of a future recession. While we do not anticipate a recession as a result of the Fed's actions during the immediate quarters ahead, the likelihood of an economic slowdown sometime in 2023 or 2024 are increasing. Our goal is to take advantage of these higher yields and extend our portfolios, where appropriate to a more neutral stance with respect to our benchmarks before then. Near-term patience will be necessary as interest rates may rise further, but this environment allows investors to take advantage of attractive entry points amid price fluctuations in anticipation of moderating inflation levels to be expected down the road.

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