FEB. 07, 2023

ON THE RADAR

FAQs on the Markets and Economy

The Fed raised the federal funds rate by just 25 basis points (bps); what do you make of that?

The Fed continued to downshift the size of its interest rate increases. The recent move was an increase of 25 bps to 4.625%. That move follows a 50 bps hike in December and four hikes of 75 bps before that (see chart).

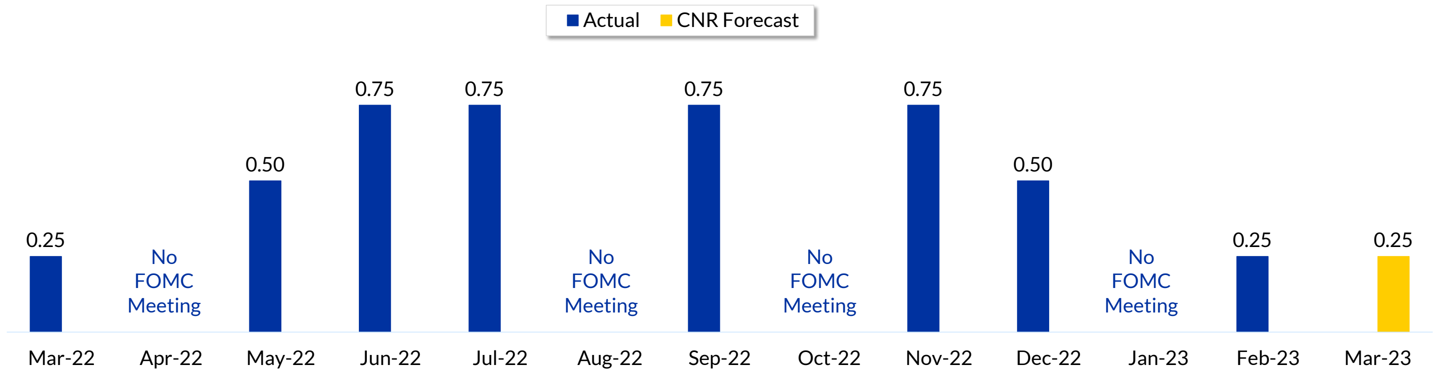
The Fed appears to have moved to the next stage of reducing monetary policy. Stage one was raising interest rates at a breakneck clip to push the funds' rate high enough into the restrictive territory. Now that some sectors of the economy are slowing, the Fed is moving into the second stage, where they "fine-tune" the funds' rate. Finally, at some point, it will reach the third stage, where the Fed will maintain the funds' rate at a specific level.

At the press conference following the Federal Open Market Committee (FOMC) meeting, Powell projected his hawkish resolve. He wanted to clarify that the Fed is not done with raising interest rates: "it would be very premature to declare victory [on inflation]." The next FOMC meeting is on March 22. There will be two more inflation reports and two more labor reports before that meeting. We expect the Fed to raise the funds' rate by another 25 bps at that meeting.

KEY QUESTIONS

- The labor report was really strong. What does it mean for Fed's policy?
- Is the latest debt ceiling standoff a concern for investors?
- How have municipal bonds fared to begin the new year?

Federal Funds Rate — Monthly Change (%)



Sources: CNR Research, Federal Reserve; February, 2023

Please note: Information is subject to change and is not a guarantee of future results.

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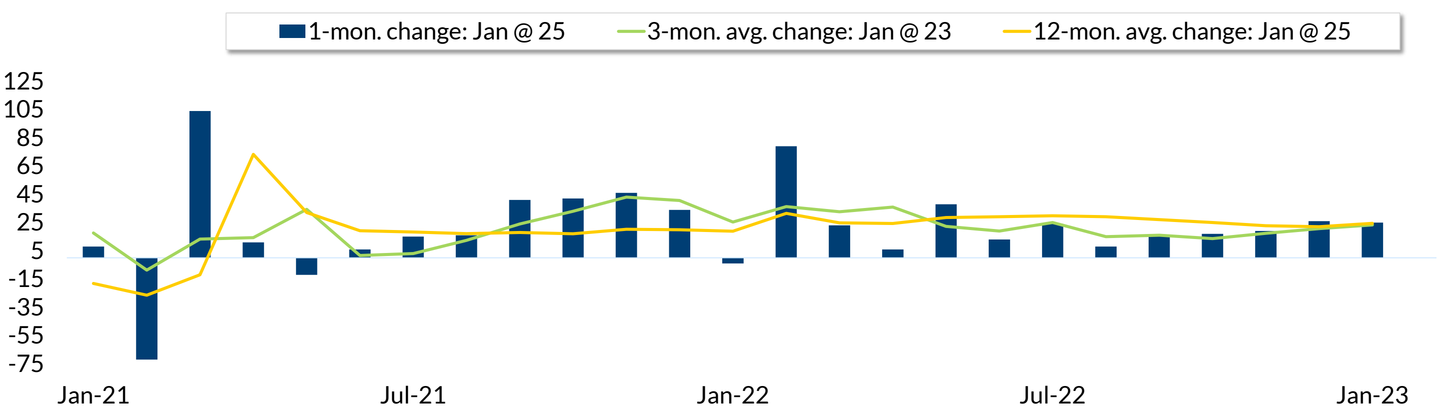
The labor report was really strong. What does it mean for Fed's policy?

There are a whole lot more people working than previously believed.

Nonfarm payrolls rose an eye-popping 517,000 in January. In addition to that, the report came with an upward revision in November and December of 71,000, followed by annual revisions that showed the growth of the 12 months ending last March was revised up by 568,000. Job growth was well diversified among industries. Even the beleaguered construction industry, in which high mortgage rates have been beaten down, continues to hire workers (see chart). And the unemployment rate fell to 3.4%, the lowest level since 1969.

The economy is still not in a recession, and this report probably pushes out the start of the expected recession, but it doesn't reverse the direction of a slowing economy. The Fed is singularly focused on inflation and will continue with its planned interest rate increases (25 bps in March and another 25 bps, probably in May). The higher interest rates will continue to pressure consumers to slow demand and businesses to reduce investment.

NFP - Construction
'000, change, seasonally adjusted



Source: Bureau of Labor Statistics, January 2023
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Is the latest debt ceiling standoff a concern for investors?

On January 19, the U.S. government officially exceeded its debt limit of $31.4 trillion, forcing the Treasury Department to begin "extraordinary measures," including suspending the sale of certain government securities, to ensure the government meets its obligations.

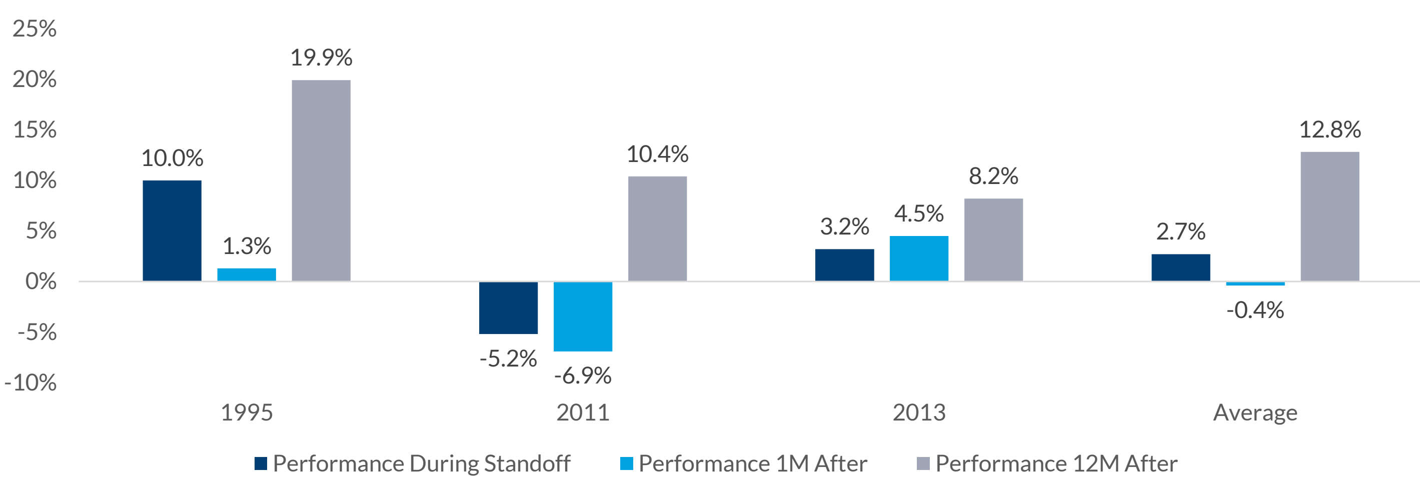
A default on the federal debt is something that has never happened in U.S. history. The implication of such an event for financial markets and the overall economy is hard to quantify, but would likely be significant, including spiking bond yields, higher borrowing costs, falling consumer confidence, financial market turmoil, and recession.

So far, there's little sign that the market is worrying too much about the threat of a serious crisis. However, with both parties holding small majorities in Congress, getting a deal done in the current political environment is likely to prove more difficult than normal, and we expect market sentiment to grow more negative at some point ahead. In 2011, a chaotic fight over raising the debt limit pushed the federal government near default, caused a sharp stock market downturn, and ultimately prompted credit rating agencies to downgrade the national credit rating.

Extraordinary measures won't last forever, with the current best guess that Treasury will exhaust its resources sometime between late summer and early fall. Nonetheless, there is historical precedent for Congress to come together last minute, typically with concessions from both sides. Since 1960, the debt ceiling has been raised 78 times in the U.S., including 20 times since 2001 alone. This will likely prove to be the case this time, with a deal to raise the ceiling ultimately agreed to alongside a combination of modest spending cuts and tax increases acceptable to both parties.

However, we are closely watching developments in Washington to assess the risk of the current standoff to both the economy and financial markets. From an investment perspective, investors should be aware the current standoff could be another source of volatility for financial markets in the coming months. However, so long as a resolution is eventually reached, these episodes tend not to be a long-term driver of market performance. In the last several instances of more severe debt-ceiling showdowns, including 2011, markets were higher in the 12 months after the debt ceiling was resolved.

S&P 500 Performance & US Debt Ceiling Standoffs



Source: FactSet

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How have municipal bonds fared to begin the new year?

Municipal bond investors have good reason to cheer as the asset class is off to a healthy start this year.

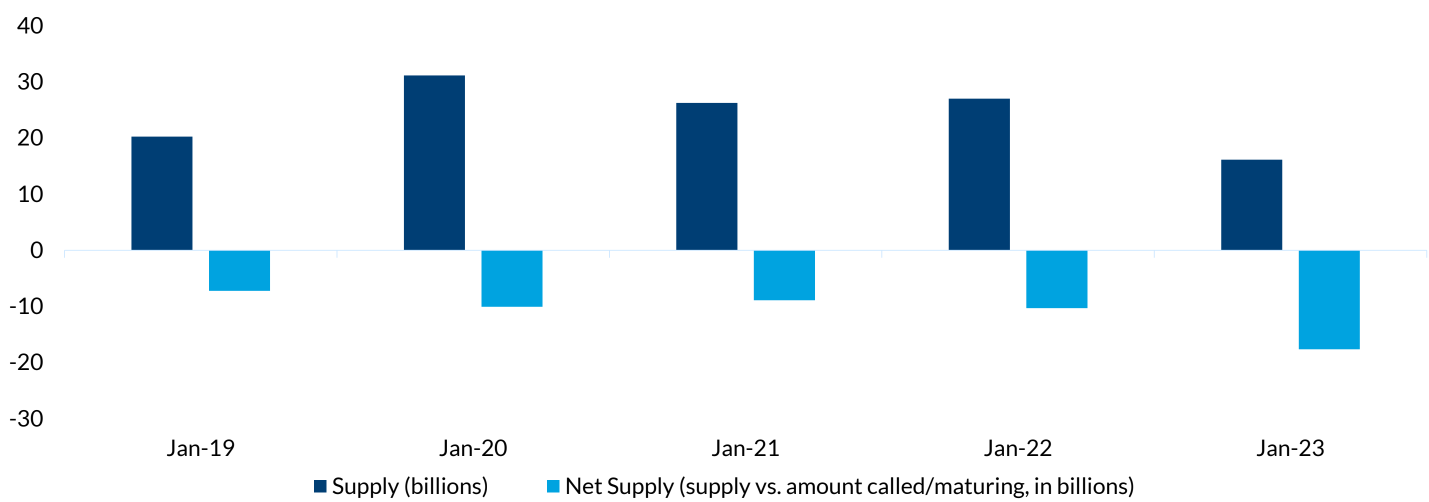
The performance of investment grade (IG) and high yield (HYM) municipal bonds has benefitted from a bounce in prices from various technical trends occurring within the market. Per Bloomberg, the total returns of the IG and HYM indices were 2.87% and 4.44%, respectively, last month (January), which were the highest monthly gains since 2009.

Cumulative returns since November 2022 have recovered more than 50% of the losses incurred by municipal investors during the first 10 months of last year.

U.S. Treasury yields declined by more than 35 bps last month, helping to drag down municipal yields across the curve. At the same time, municipal bond mutual funds experienced net inflows for three consecutive weeks, a sharp reversal from record outflows recorded in 2022. Further supporting the municipal bond market is an unusually quiet supply calendar that continues to underwhelm investor demand. Net negative supply (i.e., the difference between supply and maturities/redemptions returning to investors) of more than $17 billion in January is expected to persist at least into February, with a similar deficit anticipated, per Bloomberg.

While municipal investors continue to assess relative value opportunities across the curve and within market sectors, nominal yields remain interesting, with the yield-to-worst on IG and HYM indices above 3% and 5.4%, respectively. Despite recent compression in the yield curve, municipal investors are favorably positioned to capture attractive tax-efficient cash flow. Municipal bonds continue to offer income, relative safety, and portfolio diversification attributes for a cross-section of investors, particularly those with a longer-term view.

January 2023 Supply vs. Historical Supply



Source: Bloomberg, Jan. 31, 2022

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INDEX DEFINITIONS

S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market cap because there are other criteria that the index includes.

Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the U.S. Dollar-denominated, high-yield, fixed-rate corporate bond market.

Moody's Investors Service, often referred to as Moody's, is the bond credit rating business of Moody's Corporation, representing the company's traditional line of business and its historical name. Moody's Investors Service provides international financial research on bonds issued by commercial and government entities.

CPI: The Consumer Price Index (CPI) measures the monthly change in prices paid by U.S. consumers. Changes in measured CPI track changes in prices over time.

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