MADISON INSURANCE TAXABLE BOND

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AS THE ECONOMY REOPENS, THE MARKETS TRY TO HANDICAP THE TIMING OF NORMALIZATION OF MONETARY POLICY

After the U.S. yield curve steepened over the last quarter of 2020 and first quarter of 2021, the curve flattened in the second quarter, driven by investor acceptance of the Fed's transitory inflation increase narrative and steeper trade unwinds. The flattening initially was focused primarily 7 years and out, with the 10-year treasury declining from 1.74% to around 1.48%. Towards the end of the quarter, the 2-year moved up from about 1.15% to 1.26% as market participants moved up the expected beginning of Fed normalization.

We anticipate the Fed continues to purchase $120 billion per month in Treasuries and Mortgage-Backed Securities (MBS), at least through the end of 2021. The taper of these purchases will be telegraphed well in advance to avoid an unwanted tightening of financial market conditions. Expect purchases necessary to maintain the expanded balance sheet to continue for the foreseeable future.

By the Fed's own estimates, inflation will have only averaged 2% for a full 24-month period by January 2022. In order to make up for the significant inflation undershoot over the past decade, the Fed will most likely wait until late 2022 or even 2023 to raise the Federal Funds rate, barring a higher inflation rate than currently expected.

The recent inflation spike, with the major contributors being used car prices, airfares, and hotel rates, is due to comparisons to a year ago when the economy first shut down. Reopening bottlenecks also contributed, but are expected to fade by summers end. However, there is a risk that inflation runs hotter than forecast through the end of the year.

During the 2nd quarter, the Barclays Intermediate Government/Credit Index returned -0.90%. Marginal to negative total returns for 2021 are expected as the curve begins to price in changes in Fed policy. A normalized yield curve is still several years out, given the Fed's current stated policy of running the economy hot for a period of time.

Fixed income purchases continue to focus on high quality corporates and taxable municipals in the 3-7yr range for most portfolios, based on risk/reward. Credit spreads are historically tight, driven by seemingly insatiable demand for bonds and the belief in the Fed's commitment to financial system stability. The biggest challenge in putting money to work continues to be the markets' seemingly insatiable demand for fixed income securities. Demand for new issues continue to exceed supply, with orders consistently exceeding deal size.

Agency MBS and structured agency bonds continue to be unattractive vs credit and taxable municipal alternatives for our insurance clients. Tax-exempt bonds continue to hang around all-time low-yield levels relative to taxable alternatives. We do not expect these relationships to change in the near term.

Looking forward, we expect fairly strong economic growth driven by reopening dynamics and continued fiscal and monetary stimulus through the end of this year. Risks to this outlook include viral variants which are resistant to current vaccines, failure to achieve reductions in unemployment anticipated by the Fed, and the current inflation uptick proving to be more established rather than transitory as characterized by the Fed.

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Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only, and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

The Bloomberg Barclays Intermediate Govt/Credit Bond Index that tracks the performance of intermediate term US government and corporate bonds.

Agency Bonds: A security issued by a government-sponsored enterprise or by a federal government department other than the U.S. Treasury.

Mortgage-Backed Security (MBS) Bonds: Bonds secured by home and other real estate loans.

Structure Agency Bonds: Security issued by a government-sponsored enterprise or by a federal government department other than the U.S. Treasury.

Bonds are subject to certain risks including interest-rate risk, credit risk and inflation risk. As interest rates rise, the prices of bonds fall. Long-term bonds are more exposed to interest-rate risk than short-term bonds. In a low-interest environment, there may be less opportunity for price appreciation.

Bond Spread is the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another.

Income from tax-exempt bonds may be subject to the federal Alternative Minimum Tax and state and municipal taxes.