MADISON INSURANCE TAXABLE BOND

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THE YIELD CURVE INVERTS AS THE FED BEGINS GROOMING MARKETS FOR 50 BASIS POINT RATE HIKES

Last year at this time the Federal Reserve's preferred measure of inflation, the Core Consumer Price Expenditure Index or Core PCE stood at 1.97%, just below their two percent target. As the world reopened from the pandemic shutdown, pent-up demand combined with global supply chain challenges pushed this inflation measure to 3.70% by the end of the third quarter of 2021 and most recently the 2/28/22 Core PCE print hit 5.70%. The dramatic increase in the rate of inflation, combined with the concern that the Ukrainian conflict will increase supply chain price pressures and morph into stickier wage inflation, has forced the Fed to respond. The Fed moved from an expected gradual normalization of the Fed Funds rate to a much more aggressive normalization regime with what many anticipate as a 50 basis point hike at their next meeting in May with the possibility of several more if inflation remains elevated over the next couple of quarters.

As the market discounted this information, we have seen a significant shift in both the shape of the yield curve as well as the nominal yield levels. Since 9/30/21, the yield on the two-year Treasury note rose from 0.76% to 2.24% (158 basis points), over that same time, the 10-year treasury rose from 1.51% to 2.40% (89 basis points), resulting in a flat yield curve.

Since the end of Q1, the two-year has risen in yield above the 10-year. This is known as an inverted yield curve, where the short-term rates are higher than the longer maturity.

There is much discussion in the marketplace and among the press as to whether an inverted yield curve can be interpreted as sending a signal to investors that a recession is coming as the Fed raises rates aggressively. Others argue a curve inversion, at least 2s to 10s, is no longer the predictive measure it once was given the unprecedented policy manipulation by the central banks, including trillions in quantitative easing. In fact, according to Federal Reserve Chairman Jerome Powell, a more accurate measure of dysfunction in the credit markets, and thus a more organic indication of weakness ahead would be a curve inversion between much shorter rates and the longer end of the curve.

Speaking at the National Association for Business Economics (NABE) annual policy meeting on March 21, Powell said, "Frankly, there's good research by staff in the Federal Reserve system that really says to look at the short – the first 18 months – of the yield curve."

While we are looking at a significant increase in yields by recent history, it is important to remember that policy is still very easy with the neutral Fed Funds rate estimated to be 2.375%. There is speculation that the fed can influence the shape of the yield curve by managing the average maturity of the securities that they allow to roll off in their quantitative tightening process.

The general rise in interest rates resulted in the Bloomberg Intermediate Government/Credit Index returning -4.51% for the quarter. We expect U.S. fixed income returns to be negative for the full year as the Fed continues to adjust monetary policy to bring down inflation. In anticipation, we continue to maintain duration shorter than the benchmark to protect principal for our insurance clients while reinvesting at yields not seen in several years. We continue to focus on short, high quality corporate bonds and taxable municipal bonds where we find the best relative value. Government mortgage-backed securities, while improving with respect to relative value versus earlier in the year, are still less attractive. We continue to closely watch tax-exempt municipal bonds as they are approaching an attractive level versus taxable alternatives.

The process of shifting from an extremely loose monetary policy to a restrictive one is not without risks but is necessary. We will closely monitor these risks and make adjustments to investment strategy as needed. Our focus on high quality, liquid securities as the Fed maintained very low rates to offset the pandemic shut-down impacts will allow our portfolios to weather the expected market volatility as these policies are reversed and shifted to an inflation fighting stance.

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

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.

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