MADISON INSURANCE TAXABLE BOND

September 30, 2021 | Investment Strategy Letter - SMA

Back in the late spring and early summer, Delta was just an airline and most large companies had plans for staff to return to the office, at least part time, in September. As the COVID-19 delta variant began to spread, markets began to consider its impact on economic activity and central bank policy going forward. Towards the end of July and early August, the 2-year Treasury touched 14 basis points and the 10-year Treasury dipped to 1.17%, reflecting market concerns of a slow down in the latter half of the year due to Delta-driven restrictions.

After nearly 18 months of government life support, the economy was now tasked with sustaining self-sufficiency, which could falter if employment and supply chain dislocations adjust too slowly.

Recently, the International Chamber of Shipping warned: *"We are witnessing unprecedented disruptions and global delays and shortages on essential goods including electronics, food, fuel and medical supplies. Consumer demand is rising, and the delays look set to worsen ahead of Christmas and continue into 2022."*

Supply constraints have already taken a significant toll on domestic producers' ability to ramp up output to satisfy domestic consumers. And, with demand far outpacing available supply, at this point, price pressures have surged. The Fed continues to suggest recent price movements will prove transitory as the economy recalibrates. The process of restoring balance to the marketplace, however, appears to be taking much longer than previously anticipated, resulting in significant and long lasting, or at least longer than expected, inflationary pressures.

Higher-than-expected inflation measures may be signaling that price pressures are less transient than Fed expectations, potentially leading to higher rates to compensate investors for purchasing power loss. The most recent inflation data has shown the Producer Price Index (PPI) jumped 8.3% in August, the largest gain on record dating back to 2010, and the Consumer Price Index (CPI) rose 5.3% in August, down, however, slightly from the 5.4% pace reported the prior two months and the highest level since 2008.

Employment gains during the past year have been a leading catalyst for accelerated GDP growth. Most workers temporarily laid off after the pandemic hit the U.S. have been rehired, a sign of economic reopening. Many of today's unemployed lost their jobs due to business closure or workforce reduction while others have either reentered the workforce or willingly left their jobs. Employers are citing "a skills gap" for the abundance of 10 million job openings left unfilled.

Currently, economists estimate GDP will grow just under 3% on an annualized basis during the next three years. In comparison, the three-year rolling growth trend in December 2019 was under 2%. Assuming GDP is not stymied by prolonged supply chain issues or the Delta variant, the current trajectory of U.S. economic growth should eclipse pre-pandemic projections in the coming quarters.

As the market digests this data, focus has shifted back to the global reflation trade with investors anticipating the beginning of a reduction in bond purchases by major central banks, continued growth in corporate earnings and employment, as well as eventual rate increases.

Yields rose at the end of the quarter with the 10-year Treasury moving back to 1.51% and the two-year backing up to 0.2%. The Bloomberg Intermediate Government/Credit Index returned 0.04% for the quarter and -0.91% YTD. By contrast, the S&P 500® returned 1.97% for the quarter and 17.27% YTD.

For our insurance clients, in the 3rd quarter, we continued to focus on medium duration, high quality corporate bonds as well as taxable municipal bonds with similar characteristics. We are balancing the need for income with the inherent interest rate risk in this extremely low interest rate environment. We continue to target duration shorter than the benchmark, as the possibility of negative returns continues to be the primary risk on the fixed income side. Clients with the capacity as well as the risk appetite for equity exposure benefited from the equity returns driven by low interest rates and surprisingly strong earnings growth.

Key data over the next couple of quarters will be whether transitory inflation factors begin to fade, the rate of COVID case decline, and employment growth. The more quickly these data points shift back to more normal levels, the more comfortable the Fed will be moving into taper mode and ultimately raising rates. It can't happen fast enough for fixed income-focused investors in need of income.

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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.

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