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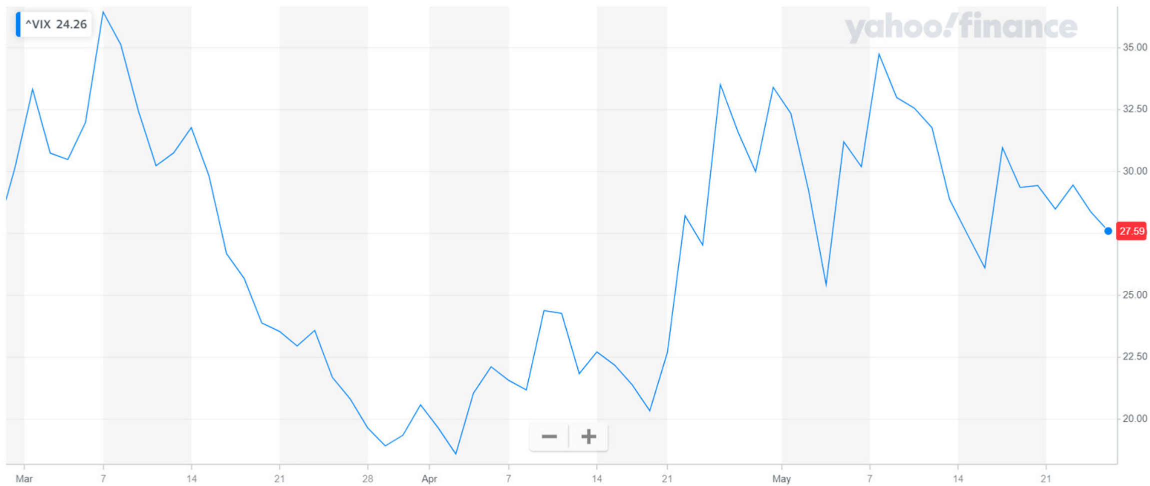
Week in Review

Friday, May 27th, 2022

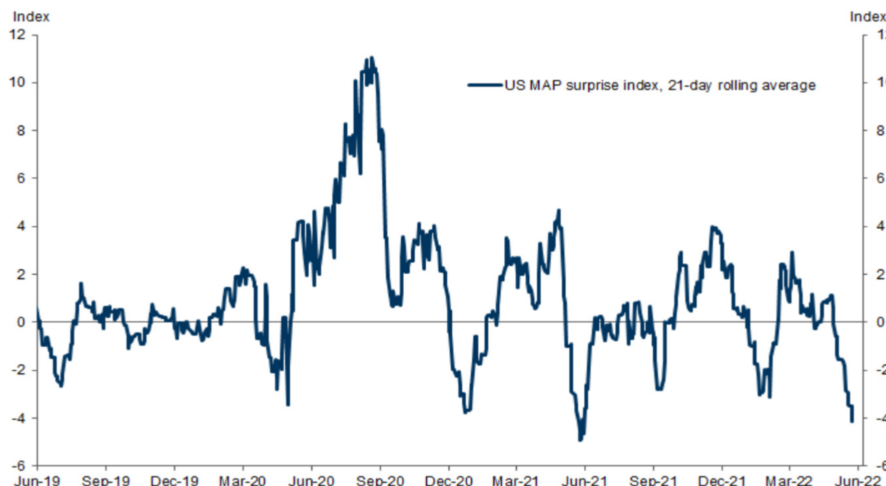
1. Market Volatility Down as Adjustments for Future Economic End Points Potentially Discounted

Over the past few weeks, financial markets have seen downward pressure and high volatility as data on inflation, slowing economic growth, and corporate outlooks, initially greeted with fear, have now been digested and incorporated into expectations. This has resulted in a pullback in the CBOE Volatility Index that was hitting elevated levels.



Source: Yahoo Finance

While volatility and fear have subsided somewhat, the path forward remains influx. One end point is outright recession in which case risk assets such as equities would likely remain under pressure, but bond yields would likely move lower as well creating positive fixed income returns. Supportive of the growing risk of recession are data points that suggest U.S. growth has materially softened in late April and May. An aggregate index of these data points is produced by Goldman Sachs in their US MAP Surprise Index which is now at its lowest level since last summer's Delta wave of Covid.



Source: Goldman Sachs Global Investment Research

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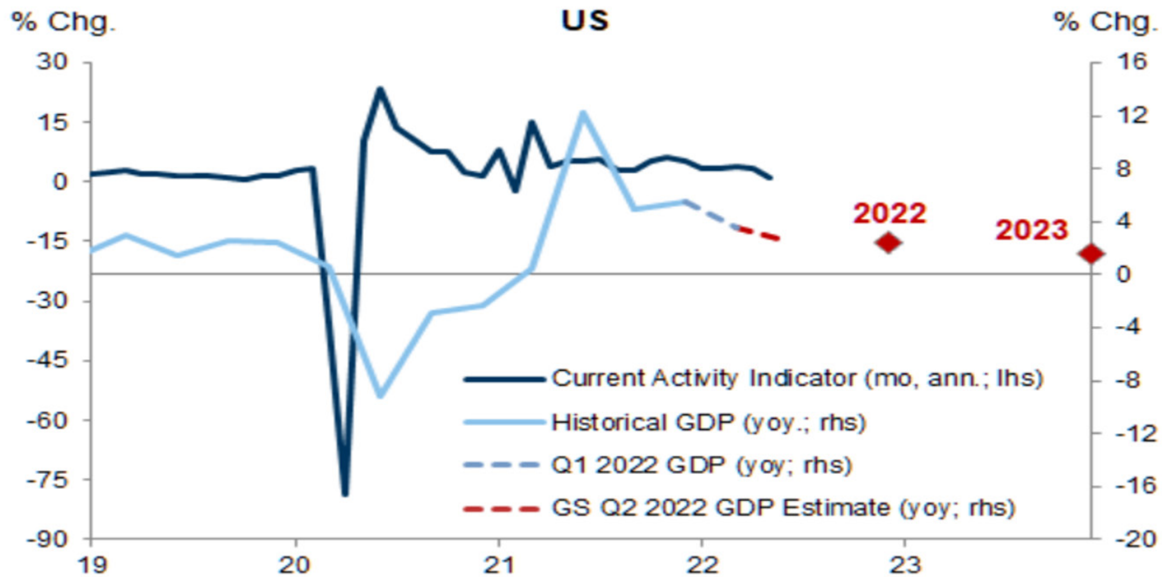
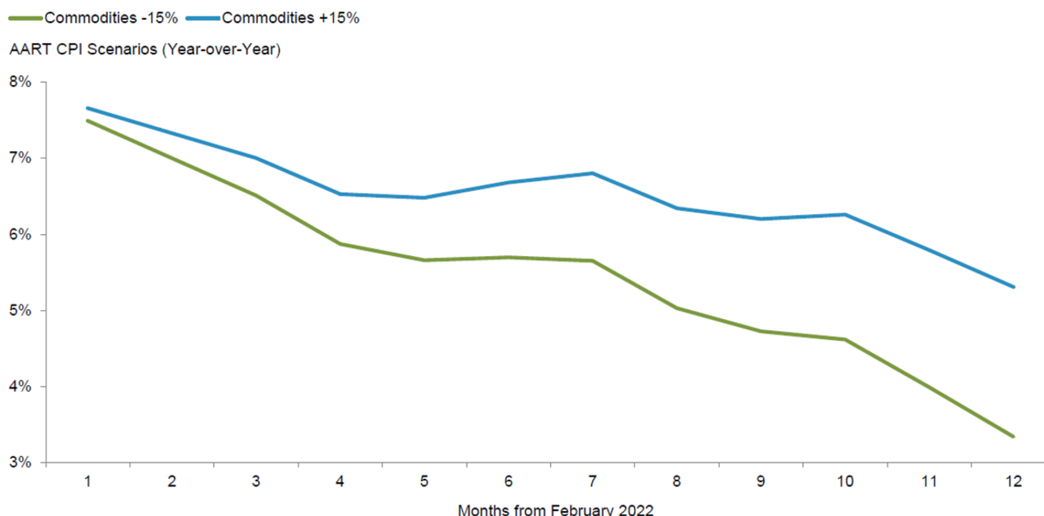
Another endpoint scenario would be that the Federal Reserve's tightening policies curb inflation while skirting a recession, benefiting both equities and bonds. The starting point of consumer strength in savings and a strong labor market in the U.S. as we stand is supportive of this scenario. That being said, consistent downgrades of U.S. growth expectations through 2023 as the year has progressed have reduced the margin for maintaining positive growth.



Source: Haver Analytics, Goldman Sachs Global Investment Research.

Both above endpoint scenarios would be manageable by financial markets if accompanied by peak inflation. Another more concerning end point would be if the Fed is unable to bring inflation under control resulting in stagflation. Stagflation could be negative for financial assets as valuations would be compressed by higher interest rates with anemic growth unable to provide an offset. While a risk, slower economic growth, improved supply chains, and increased labor participation will be an important offset to inflation and suggestive that we potentially have hit peak inflation. Change in energy costs going forward will also be an important determinant of the pace of inflation.

Impact of Commodity Prices on Inflation Estimates



CPI: Consumer Price Index. Commodity prices are represented by the Bloomberg Commodity Index (BCOM) and their hypothetical changes over the next year are assumed to occur equally throughout the year. Source: Bureau of Labor Statistics, Bloomberg, Haver Analytics, Fidelity Investments

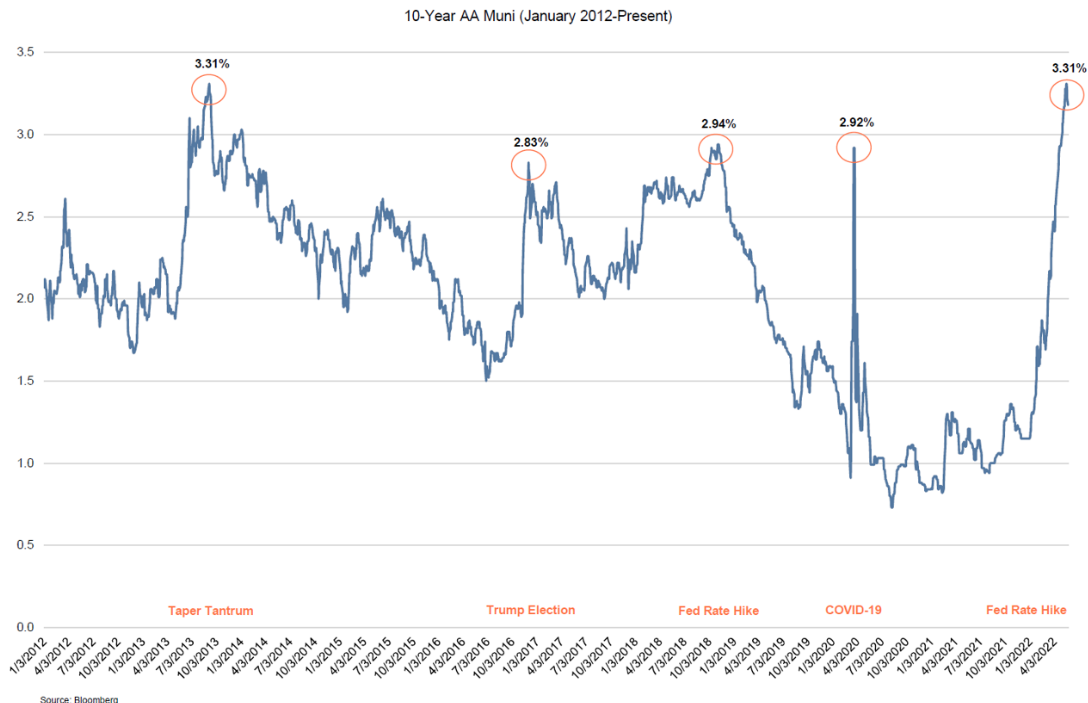
Source: Fidelity Investments

The reduction in market volatility is not in itself a determinant of the ultimate path for the economy and financial markets. However, it is a welcome indicator that the evolving data both positive and negative is being priced into the market providing a lower risked base from which to move forward.

2. Muni Market Pricing Indicative of Historical Market Dislocations

Municipal bonds have a history of consistently positive performance through a variety of interest-rate environments and have featured low correlations with other asset classes and experienced less frequent and smaller yield moves than taxable bonds but higher yields than other government securities. In 2022, rising treasury yields have led to negative returns for municipal bonds pushing yields to levels consistent with historical dislocations.

The chart below illustrates recent moves of 10 year AA Municipals over the past decade. Most recently, in just the past 2.5 years there have been two significant disruptions where yields popped – notably, 2.92% (March 23rd, 2020), at the onset of the pandemic, and 3.31% (May 18th, 2022). These disruptions historically have not lasted very long.



Source: Belle Haven Investments

While the recent move in municipal bonds is readily explainable by the rapid rise in treasury yields consistent with inflation and Fed tightening, the level of yield realized is also consistent with attractive entry points for fixed income investors. Predicting the path of interest rates given the dynamics between inflation and economic growth is difficult but the market has currently priced in a level of yield that is at least relatively attractive from a historical perspective.

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Thinking Ahead

This week saw some abatement of the recent volatility in the financial markets as data contributing to a changing landscape has likely been digested despite the ongoing uncertainty for the ultimate track of the economy and inflation. In any case, historical precedent suggests at least a relatively attractive valuation level for some assets such as municipal securities, and other high-quality assets have been created.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.

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