MID YEAR UPDATE – IT'S ALL ABOUT INFLATION

Introduction

In a recent update, Pearl Creek Advisors reported that the "Historic Low-Interest Rate Era" over the past 8 years may be over. Even in February of 2021, an entire year earlier, we reported that "the Fed's continued easy monetary policy could cause higher inflation", which would eventually lead to much higher borrowing costs. And it looks like the Fed's extended easy monetary policy, combined with $5 Trillion of economic stimulus has indeed led us to that outcome, with the U.S. economy posting the highest inflation levels in 40 years.

Setting the Stage - 2021

In early 2021, based on warnings from some economists, Pearl Creek Advisors reported in its February 2022 Market Update that the Fed should consider a moderate increase in interest rates. Despite the market signaling nervousness about higher inflation with the 10-year treasury rising significantly at the end of 2020 and early 2021, the Fed elected to not raise the Fed Funds Rate, which was at 0.25%, and repeatedly said it was committed to keeping interest rates low for the foreseeable future.

As a result, the markets and the people monitoring them believed that interest rates would remain low well into 2021. And they were correct. And they believed that inflation for the next several years would remain at about 1% a year, well below the Fed's target of 2%. On this point they were very wrong.

So, based on the above, Pearl Creek Advisors forecasted that non-profit senior living borrowers would enjoy low tax-exempt borrowing rates well into 2021. And they did. But PCA also suggested that all bets were off going into the end of 2021 and into 2022. So, what happened?

Inflation Raises Its Ugly Head

This past November, consumer prices rose 5.7% from a year earlier, rose to 7% in December and accelerated to a 7.5% annual rate in January, the highest level in four decades. And it did not slow down, reaching 8.5% in March, before decreasing to 8.3% in April. Although economists still disagree on whether the current inflation is being caused by strong demand dynamics or limited supply dynamics (See PCA February Market Update), the fact remains that we are in a very high inflationary environment.

Although the rate of inflation fell in April, it still remains above 8%. But because the rate of inflation fell from 8.5% in March to 8.3% in April, some economists believe inflation has peaked, and should start moderating. However, as the Cleveland Fed president said, "I will need to see several months of sustained downward monthly readings of inflation before I conclude that inflation has peaked."

The Fed's Response Now

As inflation concerns heated up, the Fed began to take action at its March 2022 meeting by raising the Fed Funds Rate 25 basis points from 0.25% to 0.50%. Many of us thought that was too little. So, the Fed finally got more aggressive at the next meeting and raised rates another 50 basis points creating a current Fed Funds Rate of 1.00%. Many economists now believe the Fed Funds Rate will have to go to 3.5% to curb the current rate of inflation. That is a lot of Fed rate hikes, which has spooked the stock market.

The Fed has finally admitted that its response to rising inflation was too slow with Fed Chairman Powell saying, "If you had perfect hindsight you'd go back and it probably would have been better for us to have raised rates a little sooner." No kidding!

> Long-term interest rates for tax-exempt borrowers are not only dictated by inflation and the outlook for inflation, but also by the amount of cash tax-exempt mutual funds have to spend on the deals that do come to market.

The Fed has also indicated that additional hikes of 50 basis points are likely as it tries to bring inflation under control. And has not ruled out a 75 basis point hike if inflation continues at its current level. But even the Fed has said that many factors that are driving events now are beyond the central bank's power to influence. For example, continued supply chain disruptions, rising energy prices due to the Ukraine conflict, and an extremely tight labor market (which the Fed Chairman described as "an unhealthy level") continue to put pressure on the price of goods and services. And to top it off, the average American continues to spend, trying to satisfy pent up demand for experiences that had to be delayed during the pandemic.

The First Half of 2022

As pointed out, the Fed was too slow to raise short term interest rates. As a result, at the end of January we saw inflation continue to rise and long term interest rates rise with that inflation. Although the 10-year treasury got no higher than 1.65% during 2021, it began to increase steadily in early 2022 reaching 2.0% in early February. It has continued to increase since then, reaching a high of 3.12% on May 5th. The good news is that the yield curve remains very flat on the long end with the 30-year treasury peaking at 3.23%.

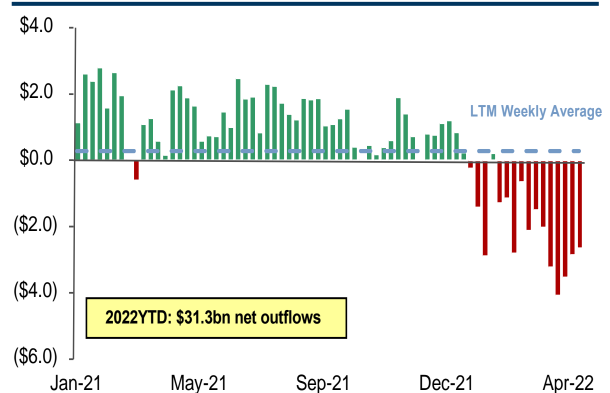
Of interest to non profit borrowers, the all important 30-year tax-exempt MMD Index has followed suit. Although averaging 1.54% for all of 2021 and getting no higher than 1.80% during the year, it started a steady increase in early 2022, and is now hovering around 3.0%, which means significantly higher borrowing costs for non profits.

Because the stock market now realizes that the Fed means business in trying to bring inflation under control, there has been a big sell-off in the stock market with the Dow experiencing its largest percentage drop since 2020, which was created by a sell-off caused by the pandemic. The current sell-off is due to the market's worries about inflation. This translates to higher production costs, (especially labor), higher borrowing costs due to the Fed raising interest rates, and the possibility of a recession down the road because the Fed's actions could slow down the economy too quickly and too deeply.

Of more importance to tax-exempt borrowers, is the massive sell-off we have seen in tax-exempt mutual funds, the primary buyer of tax-exempt bond transactions. This sell-off is being caused by a fear that rising inflation will cause interest rates to go up, causing bond prices to plummet. So, investors are getting out of the tax-exempt bond market to avoid massive losses. The year-to-date exit has been huge with 12 consecutive weeks of outflows causing YTD outflows of over $31 billion.

To put this into perspective, the two worse years before 2022 were 2011 and 2013. In 2011, tax-exempt mutual funds experienced $17 billion in cash outflows. In 2013, the worst year on record, tax-exempt mutual funds experienced 31 straight weeks of outflows, causing $37 billion of total outflow for the year.

Weekly Bond Fund Flows ($bn)



As a comparison, we are only 18 weeks into 2022 with tax-exempt mutual funds already experiencing $31 billion in cash outflows! And there seems to be no end in sight. So, this could be a record year of cash outflows from tax-exempt mutual funds. What does this portend for borrowers? The short answer is higher rates.

When tax-exempt mutual funds have a lot of cash to invest and few deals to buy, this excess cash in mutual funds creates more demand for tax-exempt bonds because those funds have to put that cash to work. And because they can only invest in tax-exempt bonds, that extra demand pushes tax-exempt bond rates down relative to treasuries. And also causes credit spreads to narrow, meaning lower rated credits obtain interest rates closer to highly rated credits.

Just the opposite occurs when bond funds have little cash and that cash is dropping because of outflows. When that occurs there is little cash to buy new deals, which suppresses demand for those deals. And when demand goes down yields on bonds have to go up to entice bond funds to buy. This also causes credit spreads to widen, causing rates to go even higher, especially for lower rated and non rated credits.

To illustrate how far rates have increased over the past few months, two senior living tax-exempt bond transactions came to market recently (a Virginia A-Rated and a New York BBB+ Rated) with 30-year bonds carrying yields-to-maturity of over 4.50%, as compared to a 27-year yield-to-maturity of only 3.33% for a BBB+ rated senior living transaction that came to market in January. That is an increase of approximately 120 basis points in a little over three months!

In addition, because bond funds have to raise cash to cover all of that outflow, they are being forced to sell bonds they already own in the secondary market at depressed prices with yields on the longer maturities of non-rated credits ranging from 5.25% to 6.0%, which is significantly higher than secondary trades three months ago.

This dynamic also raises yields in the market on new deals even further - to the point that non-rated deals may be difficult to get done, which may explain why no non-rated senior living deals have come to market during the past seven weeks. A $64 million non-rated senior living forward delivery transaction was supposed to come to market recently, but may have been pulled due to higher rates. And a non-rated $36 million Illinois senior living deal is scheduled to come to market this week. That transaction will be a good benchmark to determine how far interest rates have gone up for non-rated credits.

In addition to higher interest rates on fixed rate bonds, interest rates on bank transactions have also increased significantly, and may go up further. Pearl Creek was involved in a Cinderella Refunding in 2021 in which a non-rated borrower obtained a 12-year synthetic fixed rate of 3.59% for a current refunding and a 12-year synthetic forward rate of 3.66% for the Cinderella Refunding. Those rates in today's market would be above 4.10%.

The Rest of 2022 and into 2023

So, where are we headed? Due to factors beyond the Fed's control, the rate of inflation is not likely to fall to the Fed's target rate of 2.0% any time soon. However, the good news is that sometime in the next 12 months, it will very likely fall to around 4.0%, which is not exactly great news. What will the Fed do then? The hope is that inflation keeps heading down to the 2% target by itself. But there are reasons it will stay around 4% or even drift higher. That wouldn't be acceptable to the Fed, and opens the door to even higher interest rates than markets now expect, more market carnage and a weaker economy.

And speaking of a weaker economy, most economists now believe that there will be no "soft landing." What that means is that the U.S. economy will experience a recession when this high inflation ends. The hope will be that it will be a short recession. But that would most likely not occur until well into 2023.

In the meantime, will tax-exempt bond rates continue to rise in 2022? As mentioned in the last market update, two factors will impact tax-exempt interest rates going forward. The first being long term treasury rates. And the second being tax-exempt mutual fund inflows and outflows.

Long term treasury rates will be dictated by the financial markets' expectation of long term inflation. The current swap market is very flat, which indicates a belief that the current high inflation situation is temporary, which seems contradictory to all indicators right now. Maybe the market believes that once supply chains get back to normal and people exhaust pent-up demand, inflation will decrease on its own. That, combined with aggressive Fed action, they believe, will bring down inflation. This would mean that the yield curve will continue to flatten with short term rates increasing and long term rates increasing very little or even going down. This would be good news for long-term tax-exempt borrowers.

Although the current swap market and many market participants believe this inflation spike is temporary, PCA is not so sure. In talking to senior living providers around the country, staffing shortages are very real. And increasing food costs continue to put pressure on expenses with food costs going up by as much as 20% in some markets. And we may be seeing a permanent change in labor force dynamics, which could lead to stubborn inflation.

With regard to bond outflows, retail investor psychology will have to change. For that to change, news headlines will need to change. So, based on recent forecasts and headlines, PCA sees a continued net outflow of cash from tax-exempt bond funds well into 2022. So, assuming that the Fed continues to raise rates and net outflows continue with bond funds, we should see a continued increase in long-term tax-exempt bond rates, despite what the swap markets are indicating.

We may also see more volatility in the tax-exempt bond market for the remainder of 2022. The increases will occur in spurts, with the market stable for a few weeks, following by a lot of volatility and another step up in rates. This has almost always been the pattern in rising interest rate environments. The hope is that interest rates stabilize towards the end of 2022 and begin to decline again in 2023.