PEARL CREEK
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Capital Formation | John Franklin

AUGUST 2022 MARKET UPDATE - HAS THE RUN-UP IN RATES ENDED?

Introduction

In its April 2022 Market Update, Pearl Creek Advisors predicted continued inflation, despite the financial markets indicating otherwise. Early in the year, investors also pulled records amount of cash out of bond funds – the primary buyers of tax-exempt bonds. This led PCA to state that "there will be continued volatility and upward pressure on rates in the tax-exempt bond market for much of 2022." So, where are we now and where are we headed?

A Period of Extreme Volatility

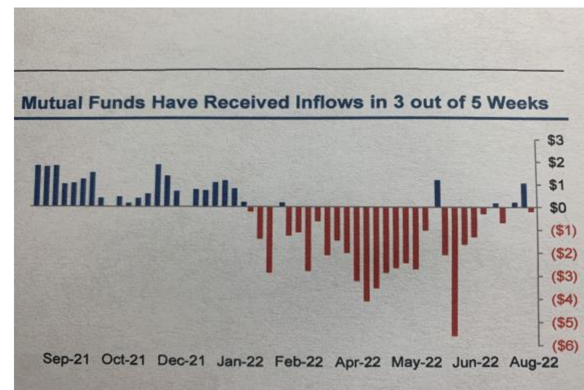
The tax-exempt bond market continues to be negatively impacted by stubborn inflation with rate increases by the Fed and continued cash outflows from tax-exempt bond funds. This created a lot of volatility in the tax-exempt bond market through June of this year with the 30-year MMD index increasing from 3.0% in April to a high of almost 3.50% at the end June. This coincided with the Fed raising the Fed Funds Rate by 75 basis points in June, the first time it has done so since 1994.

That same week, the tax-exempt bond market had its worse cash outflow of the year, losing almost $6 billion in assets, creating forced selling. This exacerbated illiquidity for lower rated bonds, increasing credit spreads on BBB and lower rated credits. BB credits traded in the secondary market in the 5.90% range at the end of June compared to 5.40% in May. Non-rated credits fared worse with secondary trades as high as 6.60% to 6.70% at the end of June compared to 6.00% in May. One new deal came to market during the height of the volatility – a large non-rated start-up project with the 30-year bond getting priced to yield 6.75%. In 2021, that same bond would have been priced closer to 4.5%.

Has the Bond Market Stabilized?

Since the end of June, some stability has returned to the tax-exempt bond market. Both long-term treasuries and long-term tax-exempt bonds rallied with interest rates returning to those lower May 2022 levels. The 30-year tax-exempt MMD index is now near 3.0% with secondary trades also returning to May interest rate levels.

This recent rally is partially due to cash returning to tax-exempt bond funds, with three of the past weeks seeing net positive cash inflows. The question is will it last?



Source: Goldman Sachs

Another reason for the rally was the expectation that the Fed would not increase interest rates as aggressively as initially predicted because the economy was technically in a recession for the first half of 2022, causing many to believe that inflation had peaked. A recession is defined as two straight quarters of negative GDP growth.

However, some skeptics believed that the recession was a false alarm because the service component of the economy was still growing, and the goods component of the economy was slow only because companies had produced too many goods and were slowing production to decrease 2 years of inventory. And it looks like those skeptics may have been right. Inflation is still running at over 8% and the recently released July jobs report defied expectations of an economic slowdown with U.S. employers adding over 525,000 jobs last month, well above expectations. This has dropped the unemployment rate to 3.5%, a 50-year low matching pre-pandemic levels. So, will the current stability in the tax-exempt bond market remain through the end of the year?

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What Can We Expect?

During the past 40 years, 30-year tax-exempt rates have been lower than they are currently for only 15% of the time. For the past 15 years, that percentage increases to 40%, reflecting easy monetary policy since the 2008-09 great recession

The jobs report followed another 75-basis point increase by the Fed at the end of July, increasing the rate to a current level of 2.50%, back to its pre-pandemic level, but much higher than the pandemic level of 0.25%. This has caused an inverted treasury yield curve meaning that the normal relationship between short-term interest rates and long-term interest rates where long term rates are higher than short term rates has reversed. With short-term rates now higher than long term rates, the current 2-year treasury rate is at 3.26%, compared to 2.85% and 3.12% for the 10-year and 30-year respectively.

This is important to tax-exempt borrowers because treasury rates do influence tax-exempt bond rates. Long-term tax-exempt bond rates have historically traded at 87% of long-term treasuries. However, because of easy monetary policy over the past 15 years, that relationship has been closer to 100%, which is close to where it is today. With that said, the relationship has dipped below 70% at certain times in the past. This relationship, along with “bond inflows and outflows” are referred to as “technicals” when predicting the direction of tax-exempt interest rates. And one could argue that there is room for improvement in the technicals, which would translate into lower long-term tax-exempt interest rates.

However, inflation continues to be a problem. But because the treasury yield curve is inverted, it means that the financial markets believe that the current high inflation levels will soon come down. However, the markets have been wrong in the past. Just look back at 2021, WHEN THE FINANCIAL MARKETS THOUGHT THAT THE FED WOULD NOT HAVE TO RAISE INTEREST RATES UNTIL 2023.

And because of that “recession false alarm”, market participants are second guessing how aggressively the Fed will continue raising interest rates. Many now believe that the Fed will raise rates another 75 basis points at their September meeting, which would be unprecedented and will likely cause more market volatility with upward pressure on interest rates. That realization has already spooked the stock market.

Another Consideration

Due to the current macroeconomic challenges impacting not-for-profit entities, investors and banks are being more selective in who they lend to. This is creating a wide divergence in borrowing rates for various lower rated credits, especially for hospitals and Life Plan Communities. Expense growth will probably continue due to rising supply costs and labor pressures, particularly for nurses. Even if broader inflation cools, investors and banks now believe that the sectors’ labor expenses will reset at a permanently higher level. So, before approaching lenders, be clear with how your organization plans to address these challenges, especially if you provide acute care, post-acute care or SNF services. Your long-term strategy will impact your ability to borrow at attractive rates.

Interest rates for a borrower are not only dictated by the outlook for inflation and the amount of cash tax-exempt bond funds have to spend, but also the outlook for the industry in which the borrower participates and how well that borrower is positioned in that industry