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Market Perspectives from Fixed Income Solutions

Controlling Your Income In Retirement

Whether you are about to retire or it is still years away, how you control your income and cash flow in retirement is a worthy concept to contemplate. The average person has roughly forty working years to accumulate enough wealth for retirement. But the vision you have for your retirement income can change based on events both in your control (e.g., selection of investments) or out of your control (e.g., catastrophic medical situation). Fixed income can be a stable contributor to your retirement income vision.

It may be easier for those approaching retirement to appreciate strategic portfolio alignment but it may be less stressful for those with ample time before retirement to execute a well-designed retirement plan. Growth assets such as stocks, can net larger returns than fixed-income alternatives; however, they usually come with periods of negative returns. More risk can come with more volatility which can mean larger swings in both directions. If a portfolio strategy lacks a fixed income allocation, there is likely less control over its long-term performance.

"…holding a bond to its maturity is controlled 100% by the investor. There is no better way to control your income."

Once individual bonds are purchased, if held to maturity and void of default, the income and cash flow produced as well as the maturity date and value are not affected by interest rate swings, supply and demand, or any extraneous event such as a pandemic. Defaults are unlikely events for investors holding high-quality investment-grade bonds and holding a bond to its maturity is controlled 100% by the investor. There is no better way to control your income.

As one approaches retirement, controlling your income may become even more significant. Barring default, individual bonds are among the most predictable investments in providing a *known* income level, *known* cash flow, and a *known* date when the principal is returned. It may come at the price of forgoing the greater growth potential associated with equities, but it also historically has less risk associated with downturns in the market. Knowing your income, cash flow and principal return date can help you control your income in retirement.

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PORTFOLIO EVALUATION

Tom James, Raymond James' chairman emeritus, offers *20 Keys to Better Investing* including: "Work with your advisor to develop a financial plan and asset allocation that will guide investment decisions. Review it at least annually with your advisor, inform him/her of any changes to your financial profile, economic circumstances or risk tolerance, and ask for the meeting notes for your records." Like vehicles, investment portfolios need periodic maintenance. Often, investment objectives change or balances stray from the intended allocation percentages. It is prudent to review portfolios recurringly and realign them back towards their intended purpose or fine-tune holdings if necessary. The recent rally in equities, which has rapidly increased overall equity dollars held, may have created the need to rebalance the portfolio's asset mix back to intended levels of proportion.

Treasury rates are near 15-year high levels. **It could be a great time to lock in current rate levels.** Individual bonds that are held to maturity provide the benefit of knowing income and cash flow outcomes – an attractive option in this attractive rate environment. Although fixed income investors do not necessarily seek the gains of price appreciation (because bonds are often held to maturity), total returns may be a secondary benefit. This is because if there is a retracement in yields, bonds held will experience price appreciation (there is an inverse relationship between bond yields and bond prices).

The Treasury curve is inverted. Short maturities (inside 1 year) yield more than all other maturities. With spread products (such as corporate bonds and municipal bonds) longer maturing bonds can provide more yield versus shorter maturity bonds. The corporate yield curve is relatively flat; however, it is elevated versus the Treasury curve. High-quality investment-grade corporate bond yields in the maturity range of 7–15 years can yield in the mid-5.0% range.

The tax-free municipal curve is upward-sloping and steep outside of 10 years with the most attractive range being 15+ years. This means that bonds get a larger incremental yield increase for maturities between 15-30 years. Tax-equivalent yields vary greatly depending on an investor's federal tax bracket and state of residency. The higher the federal tax bracket, the greater the benefit derived from tax-exempt bonds. Also, the higher the state tax rate, often the greater the benefit derived when buying issues from that state. Tax equivalent yields for bonds in longer maturities can range from 5.35% to over 8.00% in high-quality credits. It may be tempting to choose the shortest, highest-yield bonds; however, with yields hovering at elevated levels compared to the past 15 years, it may make sense to lock in for longer.

Fixed income portfolios can be strategically designed with individual bonds. Above-market cash flows can be created with higher coupon premium bonds. For income-seeking investors, concentration to yield will optimize return. Investors can buy bonds based on geographic location, cash flow desires, income, creditworthiness, call protection, or other security features. Flexibility of choice and characteristics may optimize each buyer's tailored long-term strategy. Portfolio construction may include but is not limited to maturity, cash flow, and/or duration diversification. Laddered portfolios may provide the means to diversify reinvestment risk. Duration parameters may curb market price volatility effects.

Total Return or Income Buyer?

Total return is the most talked about strategy yet may be the least used for fixed income investors. Total return combines dividends or interest earned with price performance. This is very commonplace with equity holdings. Buy low – sell high.

Many investors employ a buy-and-hold strategy for bonds. This takes price performance out of the equation, making interest earned a known income quantity. Regardless of interest rates changes, geopolitical events or any other extraneous event outside of a default, income is locked in through a buy and hold investment strategy. Buying high quality bonds makes default an unlikely event. Statements change with the market but income earned is fixed.

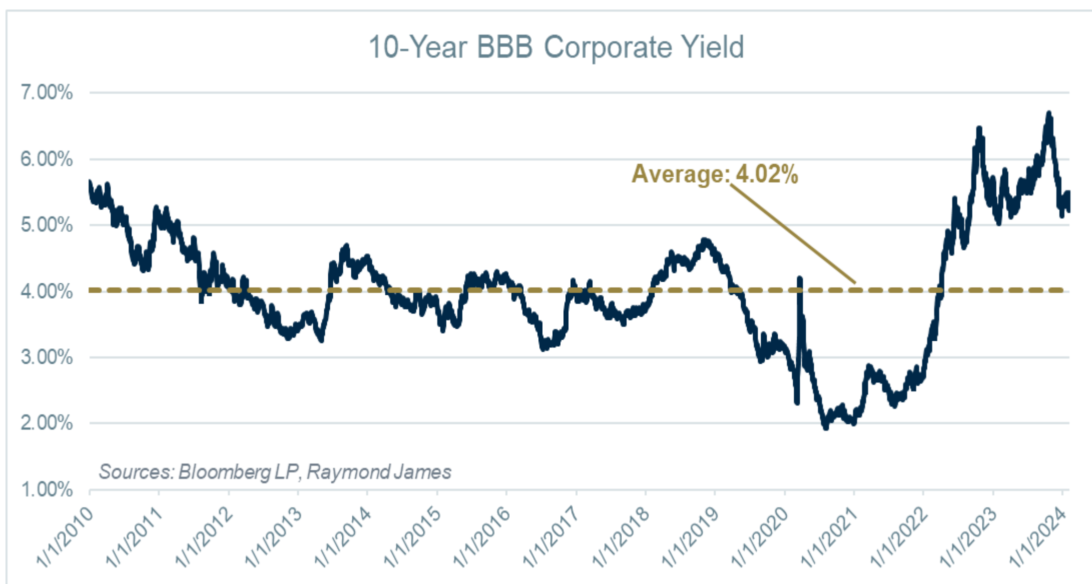
Raymond James provides individual fixed income portfolio evaluations through the Fixed Income Solutions group, part of your financial advisor's support team. Fixed income portfolio evaluation is designed to evaluate and optimize each investor's portfolio.

OVERCOMING ANCHORING BIAS

Anchoring bias is a psychological effect where one tends to anchor expectations based on a past (oftentimes first) interaction with something. For example, if a car salesperson pitches a $50,000 price but then goes and talks with his manager to "see what he can do", an ensuing $45,000 price may register in the brain as a good deal. The salesperson "anchored" expectations to a price of $50,000 with the first offer. This effect can be even stronger with the passage of time. If one bought a car 10 years ago for $25,000 and discovers the same model today is priced at $45,000, it is going to seem expensive because the anchored expectation is fixed on $25,000.

Why talk about the psychology of buying cars in a fixed income publication? Anchoring bias can have an effect on investment decisions and corresponding long-term consequences. Anchoring to past yield levels can cause investors to hesitate or sit on the sidelines because current yield levels are below some past psychologically fixed anchor. If one had first entered the Treasury market in the 1990s, it is conceivable that an anchored bias developed that 10-year Treasury yields should be in the 7% to 8% range. Our opinions and biases are shaped by our personal experiences. If our psychological "normal" dictates that 10-year yields are in the 7 to 8% range, it might result in sitting on the sidelines and waiting for Treasury yields to return to "normal". Depending on the current market, an investor could be waiting a long time or it may never come to fruition during one's investment timeline.

More recently, anchoring bias has been coming up frequently with investors who remember seeing yields peak last October and for one reason or another, did not invest at that time. While yields are still attractive from a historical perspective, they are lower than last October which is causing investors to hesitate to invest at current yield levels. Investors who have anchored their yield expectations to higher levels that were previously available might have a natural inclination to wait for yields to return to these levels before investing. The problem with this thought process is that yields might not move back higher. This past yield anchor is preventing some investors from taking advantage of the attractive yields that are still available. Just because things were more attractive a few months ago doesn't mean that what is available today is not a good opportunity.



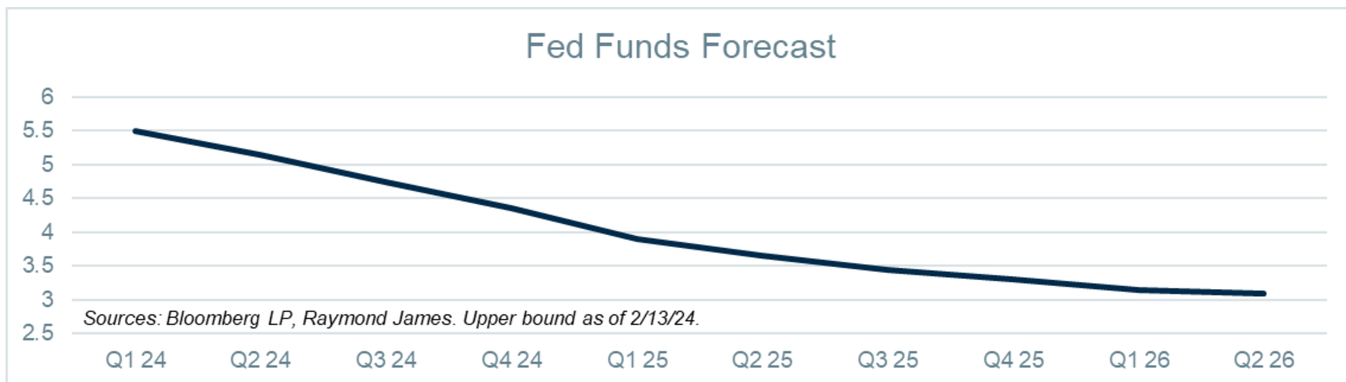
The graph shows the 10-year BBB corporate yield since 2010. Are you anchored to one of the peaks experienced last year? If you are, this anchor might be preventing you from investing at **yields that are still at some of the most attractive levels** we have seen in roughly 15 years. The yield is currently 5.50% which is ~150 basis points higher than the average over this timeframe. Just because the market is not at its absolute peak, it does not eradicate the great opportunity to lock in elevated yields.

THE INVESTMENT "HARE" OR "TORTOISE"

Short-term yields are at some of the highest levels in the past 20 years. These yields have generated huge investor interest and brought considerable money into short-term fixed income investments over the past year and a half. These investments are, by structure, maturing at some point in the near future, at which point a decision must be made about what to do with the bond proceeds. Many investors have been choosing to simply reinvest into another short-maturity investment, essentially just rolling these maturing proceeds back into the same investment. This strategy is prudent for money earmarked as a short-term cash alternative. For money intended to be a long-term buy-and-hold income generator, there are some potential pitfalls with this strategy. The most prominent in the current market is reinvestment risk.

For long-term fixed income allocations, a primary benefit is the known aspects that a portfolio of individual bonds can provide known cash flow, known income, and known principal return date. The longer the maturity of a bond, the longer the cash flow streams and income are locked in.

Reinvestment risk is the risk that maturing bond proceeds will have to be reinvested into a lower-yielding bond. For example, if you buy a 6-month T-bill today at a 5.05% yield and it matures in August when a 6-month T-bill yields 4.00%, the rolldown will produce less income. If the plan is to keep rolling short-term instruments until the yields are no longer attractive and then reinvest into longer maturity bonds, you might miss out on a great opportunity assuming long term yields have also fallen. By the time short-term yields are no longer appealing, longer-term yields likely will not be as attractive as they are today. Choosing to invest in short-maturity bonds is not necessarily a lower-risk option versus extending out on the curve. The duration of your portfolio will be lower, which means less price volatility, but your reinvestment risk will be higher. Interest rate risk is being swapped for reinvestment risk. If you are a buy-and-hold investor, price volatility will have no bearing on your returns, whereas reinvestment risk could have a substantial impact on long-term returns. Buying short-term bonds for a long-term investment horizon is an allocation choice that assumes yields are moving higher.

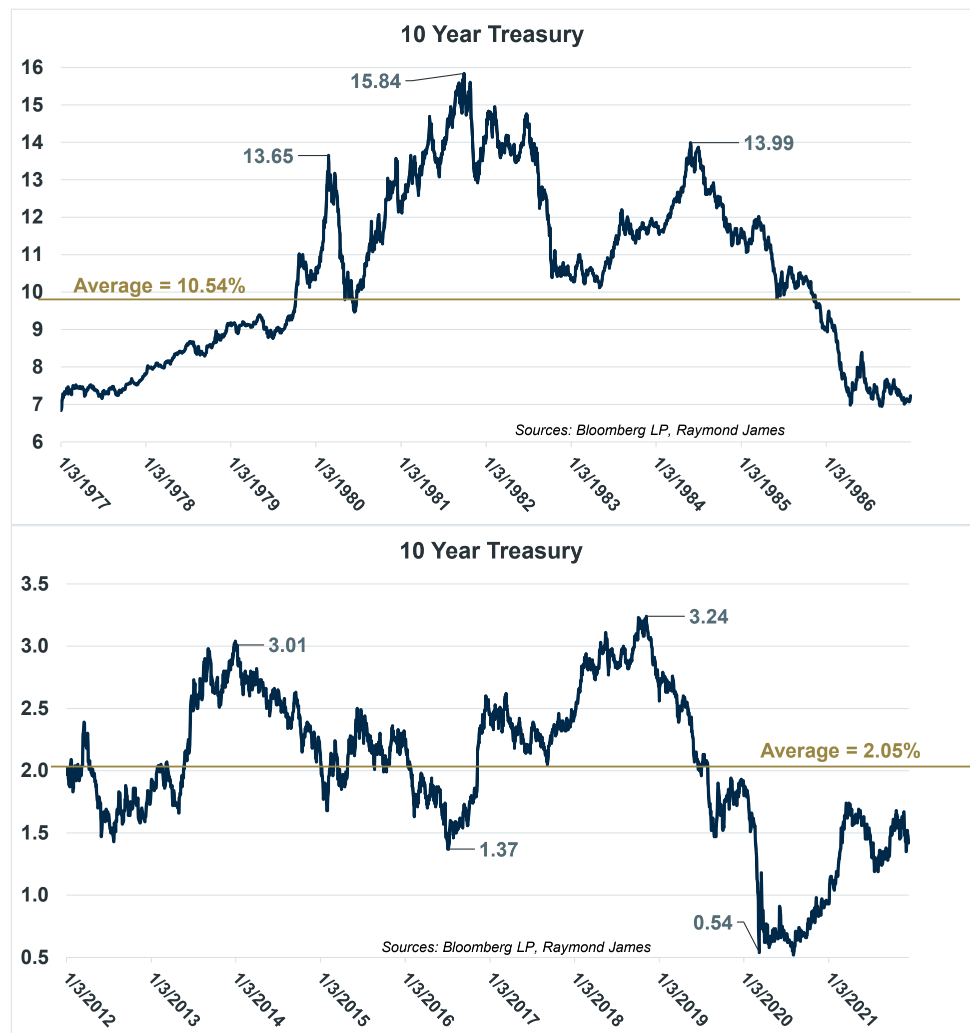


Sources: Bloomberg LP, Raymond James. Upper bound as of 2/13/24.

Short-term yields tend to be heavily influenced by the Fed Funds rate. The chart reveals the consensus estimate for Fed Funds through mid-2026 according to Bloomberg. If, like these forecasters, you believe that yields are more likely to trend lower than higher, extending out of the curve and purchasing longer-maturity bonds is likely a good strategy. Intermediate and long-term yields across most of the fixed income landscape remain at some of their highest levels in the past 15+ years. If you have a long-term investment horizon, passing on the dangling carrot and locking into yields for longer could be the best long-term strategy.

CONTROLLING YOUR INCOME PERSPECTIVE

During the 10 years from 1977 through 1986, the 10-year Treasury peaked at 15.84%. Over the entire period, the 10-year Treasury averaged 10.54%. Yet many investors bypassed this opportunity. Why? Perhaps the fear of the unknown or the thought that they didn't want to miss out when rates went even higher.

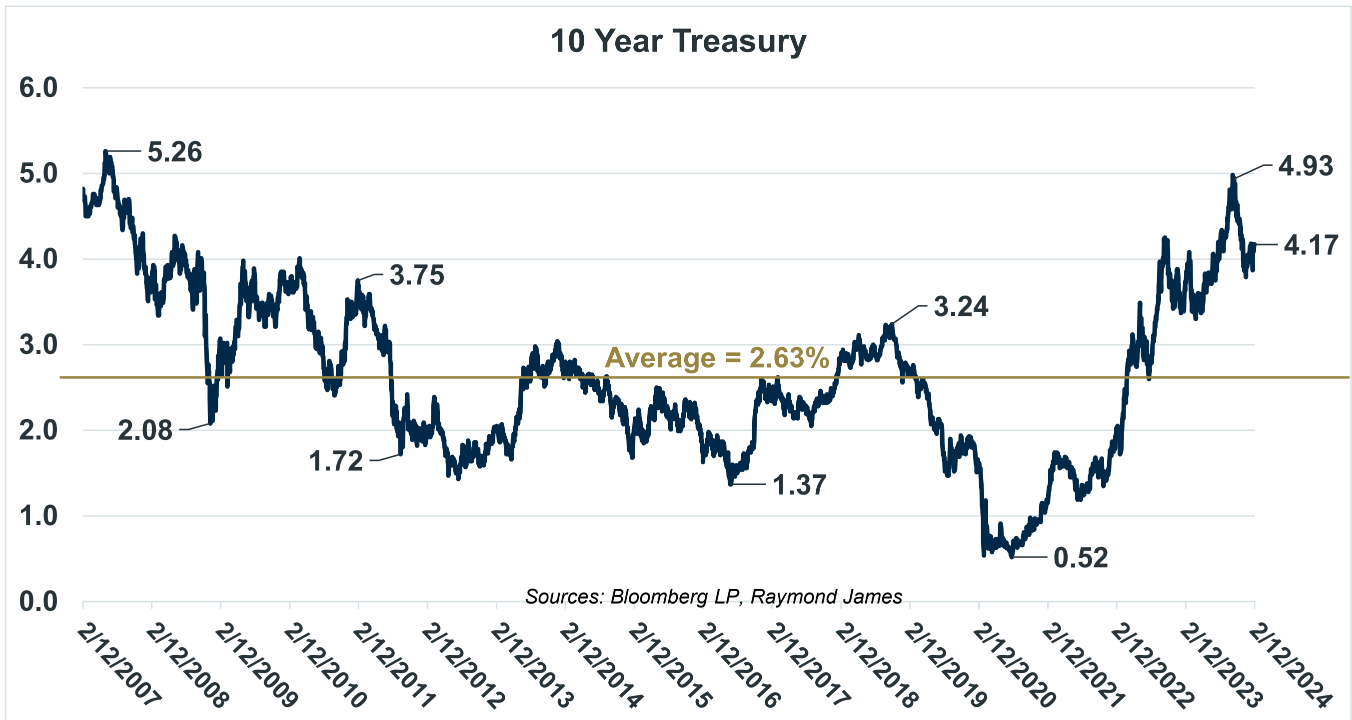


During the 10 years from 2012 through 2021, the 10-year Treasury peaked at 3.24%. Over the entire period, the 10-year Treasury averaged 2.05%. If investors had an opportunity to invest at 5.00%, many would have jumped at the opportunity.

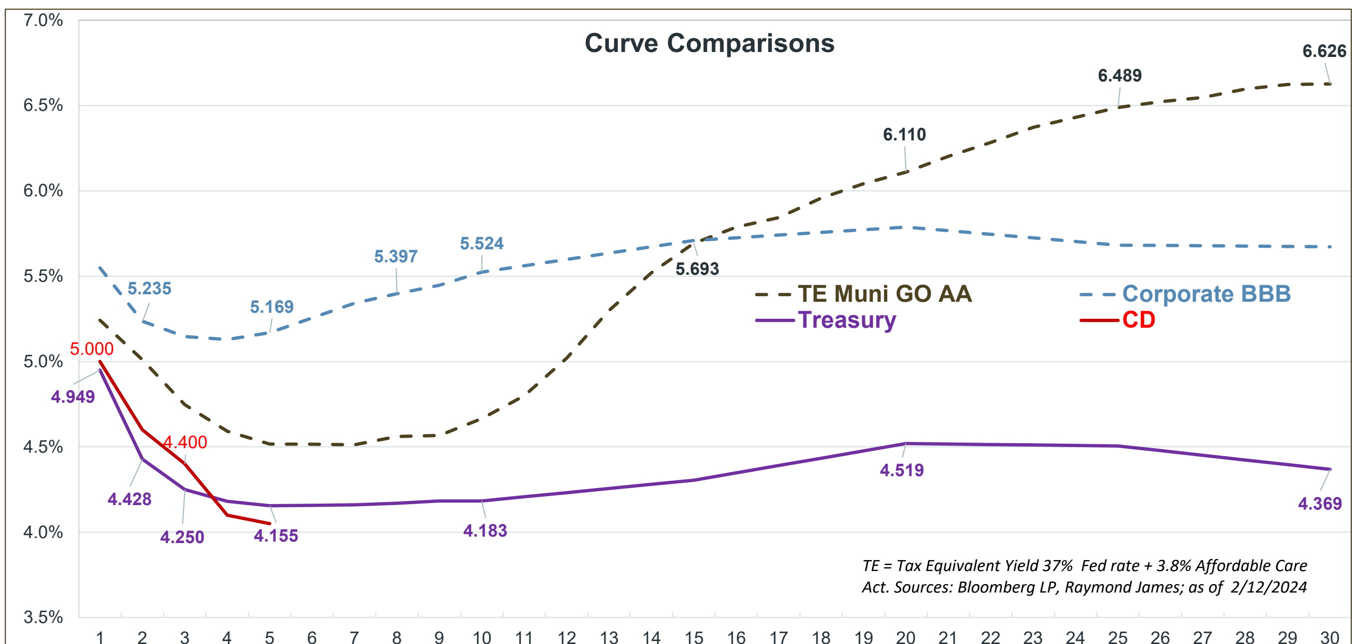
Whether we are in a high interest rate cycle or a low one, investors often sit on the sidelines waiting for the future opportunity. But there is no guarantee that the future opportunity is going to be better than the present one.

Waiting 40 years for some "thinkable" rate environment is not an option. Most of us have roughly 40 years to accumulate enough wealth for retirement. Operating within the interest rate cycle during our working year tenure is our only reality. Fixed income, whether interest rates are at 10% or 2%, provides the portfolio with a method to protect the wealth accumulated in a way most other investment options do not. As we approach retirement, the mind shift is one from growing our assets to maintaining them.

Our reality is that interest rates have hovered at moderately low levels for decades. Although this limits growth potential, it does not deter fixed income's ability to preserve wealth. The fixed income assets employed today also benefit from the high interest rates available relative to those that have been available over the span of this economic cycle.



The Treasury curve provides a base rate from which other fixed income products pivot. The creditworthiness and maturity of alternative fixed income products are major contributing factors to the ultimate income levels each will provide. Much of our clients utilize high-quality investment-grade securities to constitute their fixed income holdings. After all, this portion of the portfolio is often compiled to preserve wealth, balance riskier growth assets, and ultimately serve as the “known” commodity of investor assets. Today’s interest rate environment provides value across the maturity spectrum which includes high-quality corporate options within 15 years and high-quality municipal options between 15 years and 30 years of maturity for high tax bracket investors.

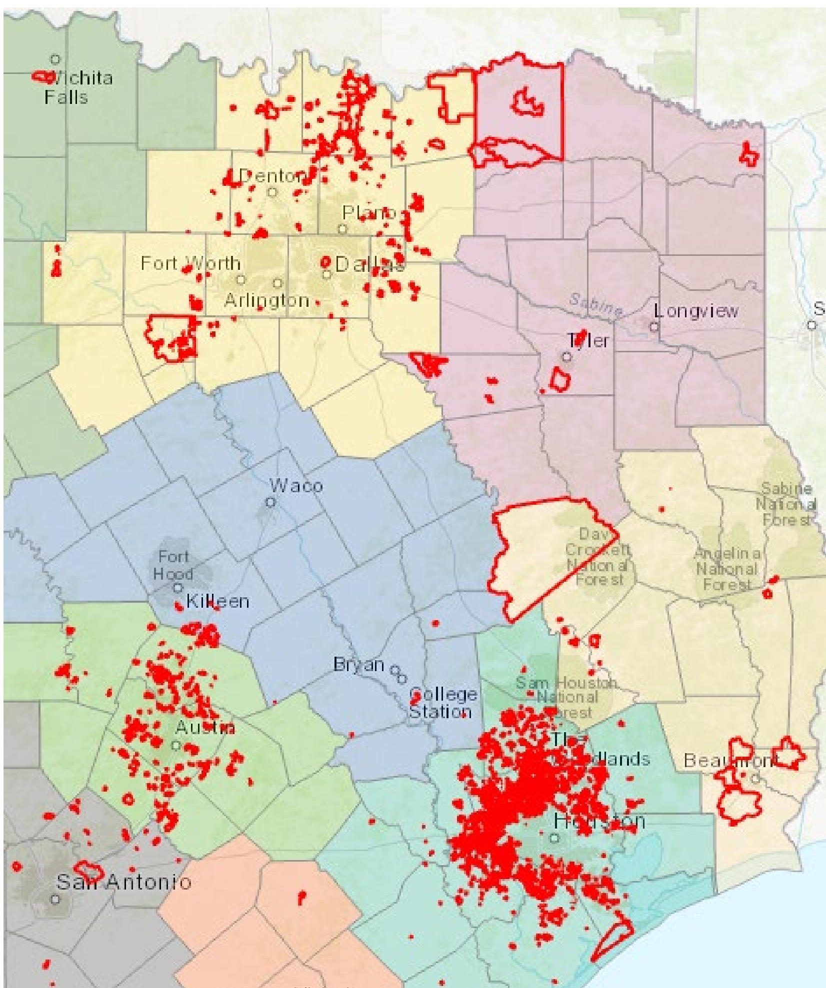


STUCK IN MUDs *(authored by Ted Ruddock, Managing Director, Head of Fixed Income Private Wealth)*

In the never-ending search for yield, one sector many investors find attractive is municipal utility districts (or MUDs as we affectionately refer to them). These are a "special case" of traditional water and sewer bonds that are the foundation of the municipal bond market. The state of Texas boasts plenty of opportunities with more than 1,200 active MUDs throughout the state. They have been used to develop numerous, well-known, master-planned communities including The Woodlands, Clear Lake City / NASA, First Colony, and Sienna Plantation among others. There are plenty of lesser-known MUDS as well.

Exactly what is a MUD? It's a political subdivision in the state of Texas authorized by the Texas Commission of Environmental Quality (TCEQ) to provide water, sewage, drainage, and other utility-related services within the MUD boundaries. These districts are typically formed outside traditional city limits, where no municipal services are currently offered, and serve defined developments, either residential, commercial or mixed-use. They are governed by a separate board and levy taxes based on property values. MUDs issue essential service municipal bonds, typically to build water and wastewater infrastructure.

Many MUDs are backed by unlimited ad-valorem taxes on properties within the district. This is one of the strongest security features for bondholders in the municipal market. Even with that security protection, many MUDS are also insured. Why is that? The MUDs frequently have an underlying rating in the lower A to BBB rating category, primarily because the properties within the district are being developed and not all have been sold. Thus, many MUD issuers choose to enhance their bonds with bond insurance, providing bondholders with additional protection, and raising the rating into the AA category.



Source: Texas Commission on Environmental Quality - TCEQ

MUDs vary in size, but they generally serve master-planned communities of a few hundred households. The map provides a partial view of the numerous MUDs throughout Texas. The Houston area displays a concentration, but there is an increasing number of high-growth areas around Austin and Dallas-Fort Worth as well. Even after the devastating impact of Hurricane Harvey, no MUDs in the greater Houston area defaulted on their outstanding debt, once again highlighting the resiliency of investment-grade municipal bonds.

MUDs offer value for investors who are comfortable taking on a minimal level of additional credit risk.

EXPLORING APPROPRIATE CREDIT QUALITY

The credit quality of the issuer is one of the most, if not the most, important considerations when choosing an investment for a fixed income allocation that is intended to preserve wealth. Understanding the potential for default can help to ensure that an appropriate level of risk is being taken when purchasing bonds. While the risk of a default can never be eliminated, choosing high-credit quality issuers may help to minimize the chances of a default. High-quality, investment-grade credits make a default on a bond highly unlikely.

Analyzing historical data can provide valuable insights and help to ensure that investment choice aligns with personal risk considerations. Although the past is not a guarantee of future results, knowledge and trends are helpful in identifying more likely outcomes. The chart shows the average default rate over a rolling 5-year period for corporate bonds from 1983 to 2022. The ratings listed above the red line are investment-grade. The ratings listed below the red line are speculative-grade, also known as high-yield or junk bonds. The Default Rate column is the Moody's reported statistics. Looking at data from the opposite point of view may help to put things in perspective, so the "Non-Default Rate" column was added. This shows the percentage of time that a bond in each rating category did not default over a 5-year period. For example, if you owned an A-rated corporate bond, there is a 99.3% chance that the bond did not default over a given 5-year period.

Average Corporate Cumulative 5-Year Default Rates from 1983 to 2022

Rating	Default Rate	"Non-Default Rate"
Aaa	0.06%	99.94%
Aa	0.29%	99.71%
A	0.70%	99.30%
Baa	1.45%	98.55%
Ba	8.13%	91.87%
B	20.52%	79.48%
Caa-C	32.32%	67.68%
Investment-Grade	0.88%	99.12%
Speculative-Grade	19.28%	80.72%
All	7.37%	92.63%

Sources: Moody's, Raymond James. From 1983 to 2022, issuer-weighted, global corporates.

These numbers help to explain why many investors choose to allocate the fixed income portion of their portfolio to investment-grade corporate bonds. Investments intended to preserve wealth boast a ~99% "success rate". They almost always do exactly what they are intended to do. Even at the low end of the investment-grade spectrum (Baa-rated bonds), a 98.55% non-default rate combined with the yields available represents an attractive risk/reward dynamic for investors.

Defaults rarely happen overnight. Deteriorating credit tends to do so over extended periods. This often allows investors time to react, allowing investors to sell the bond well before a company defaults or time to evaluate whether the changed credit quality of the issuer still aligns with an investor's risk tolerance level.

Contrarily, evaluating speculative-grade statistics highlights the increased risk. Crossing over the threshold by one rating category, from Baa to Ba, reveals a consequence of a fivefold increase in the average default rate. Jump down one more category and the numbers increase to 1 in 5. These bonds have a place in some portfolios, but for the capital preservation portion of a portfolio, investment-grade bonds are much better suited to many investors' risk tolerance.

Source: Moody's Investor Service Annual default study, April 14, 2023.

MARKET OVERVIEW – KICKING THE CAN DOWN THE ROAD *(February 5 Bond Market Commentary)*

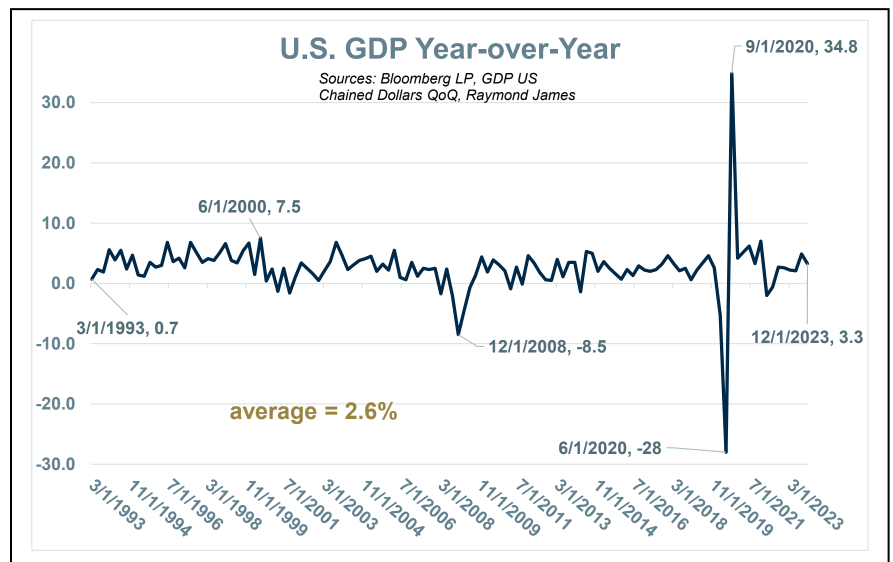
The world had a pandemic – COVID-19. This pandemic unfortunately and unbiasedly took lives, created widespread fear, and rocked the economic world. The U.S. threw a lot of money at this challenge, enacted government backstops to protect businesses and individuals, and intensified spending, all to keep the economy moving in a positive direction. Much of the action was likely necessary and consequences have emerged but is its path of economic impairment behind us or has its impact merely been kicked down the road?

It would be hard to argue that the Federal Reserve and government actions implemented during the COVID pandemic weren't warranted. Shutting down businesses and interrupting services, which occurred to an extreme extent, carry potential catastrophic consequences. One could argue that these Federal Reserve and Government actions may have averted a longer recession if not a depression.

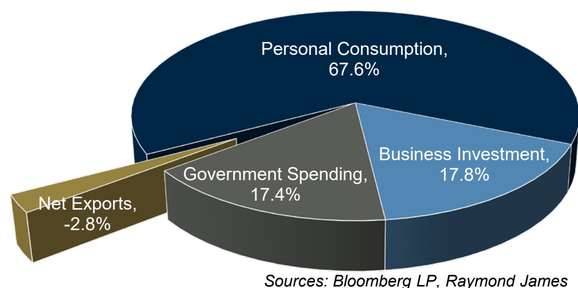
Now several years from the pandemic's dawn but still dealing with its aftershocks, what does the economy look like? Is inflation under control? Have we averted a more vigorous recession? How is the Fed likely to interact with the markets? Are interest rates going to change? What about consumer behavior? What fixed income opportunities exist in light of our economic fate?

U.S. GROSS DOMESTIC PRODUCT

The good news is that the United States economy seems resilient in the aftermath of the world's pandemic. The last Gross Domestic Product (GDP) released at 3.3% was roughly 27% above the last 30-year average.



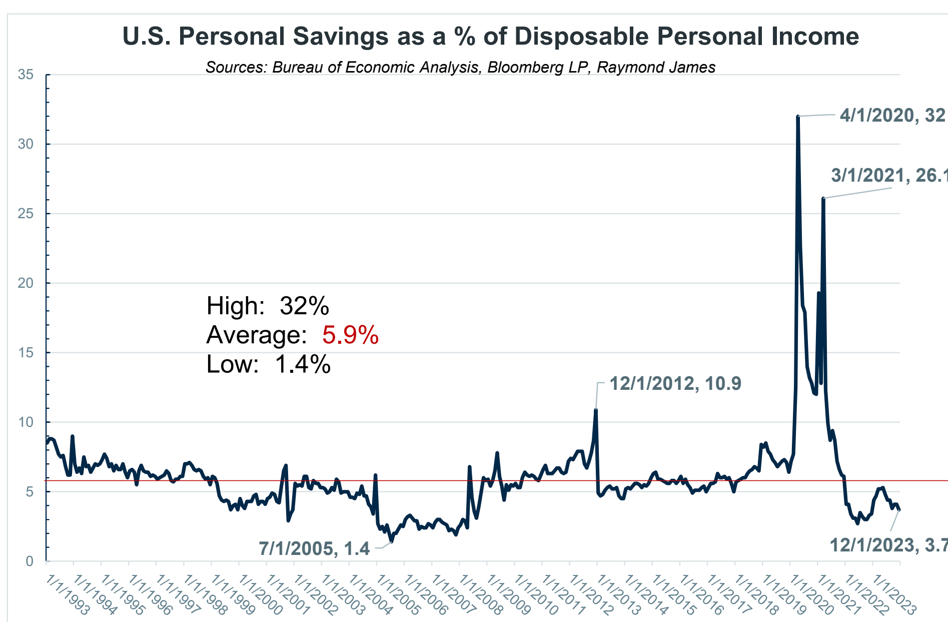
There are four components of GDP: Personal Consumption (consumer spending on goods and services), Investment (business spending on fixed assets and changes in private inventories), Government spending (spending by federal, state and local governments), and Net EXports (exports minus imports) or [C + I + G + NX = GDP].



The U.S. is sometimes referred to as a consumer-driven economy denoting that nearly 70% of the nation's GDP is designated as personal consumption. But the truth is that the components of GDP overlap and attributing a cause-and-effect to any isolated component is like isolating a grain of sand. Without company investment in products and services, consumers don't have goods to purchase. Consumer demand does not necessarily translate to increased employment. Employees are expensive investments for companies so temporary demand will not necessarily trigger business hires. Conversely, economic trouble, such as a pandemic, can push businesses to reduce costs or spending or worse, shutdowns. The 2020 pandemic-driven business retrenchment led to a recession - but a very short

one. Why did the economy escape a deep long-drawn-out recession? It can be argued that policy-induced resources kept the economy from total collapse. Government intervention provided household income support in the form of direct cash and debt deferral or outright dismissal. In all, the federal government made $2.6 trillion in funds available. Cash infusion of this magnitude does not disperse so easily.

The extraordinary efforts made to support the U.S. economy and financial system through the COVID pandemic have led to strong economic growth over the past few years, even relative to other developed economies around the world. The U.S. economy is up over 5% compared to pre-COVID numbers even after factoring in the extraordinary levels of inflation experienced over the same timeframe. Using the same methodology and adjusting for inflation, the economic output of Japan, the United Kingdom, and the Eurozone are all < 1% higher than pre-COVID. Whether the stimulus to the U.S. economy helped us completely escape a deep recession or simply pushed it further into the future is yet to be determined.

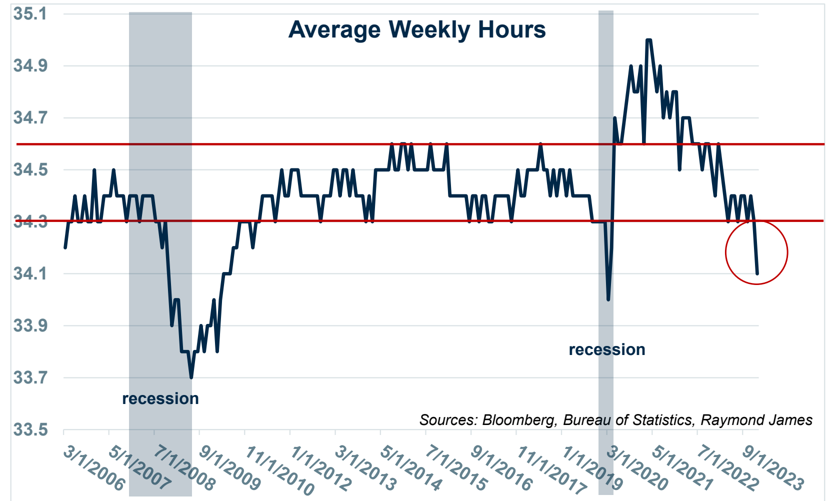


PERSONAL SAVINGS

The government's support combined with the business shutdowns gifted consumers with cash and deferred expenses but left consumers with limited outlets with which to spend it. The circumstance led to abnormally high levels of excess personal savings. Understanding of and constraints on the pandemic took hold and from mid-year 2021 through mid-year 2022, consumers spent money at a rapid pace, more than making up for their forced sideline retreat. Average savings as a percent of disposable income fell below 30-year averages. In itself, falling savings sums are not all damaging. After all, consumer spending is a major component that has helped to hoist the U.S. GDP to harmonious levels. However, continued savings depletion combined with growing debt may have consequences that have not surfaced yet. And it is not only consumer debt but government debt that is on the rise.

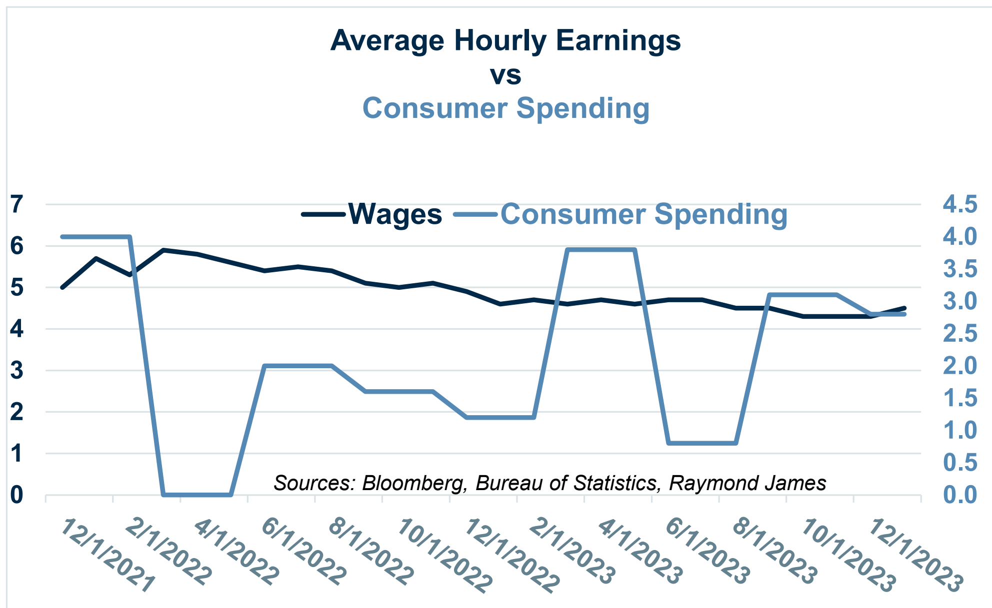
To put some global context on household savings, the Eurozone, United Kingdom, France, Germany, South Africa and Canada all boast higher current savings now versus pre-COVID. Japan and the United States are two countries with lower savings now when compared to pre-COVID levels. The level of savings is not as important as the answer explaining why savings are directionally headed down. Are U.S. consumers spending on borrowed dollars? Wages are not keeping pace with spending pushing savings down and debt up.

WAGES, EARNINGS & SPENDING

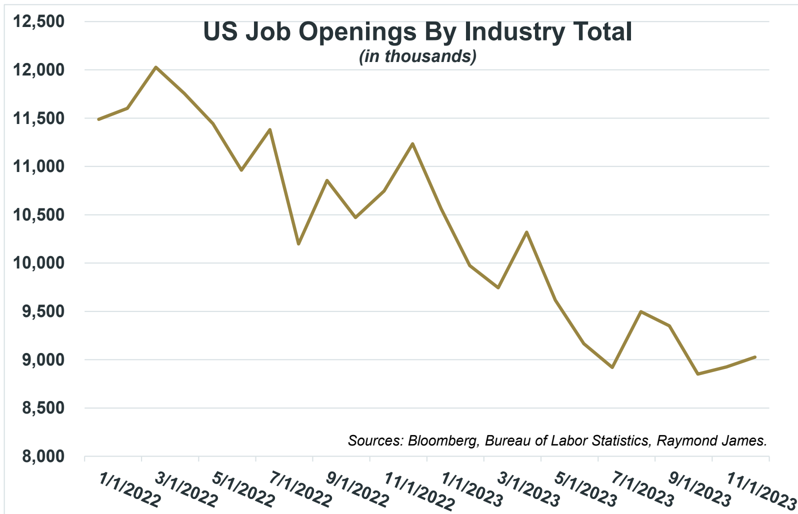


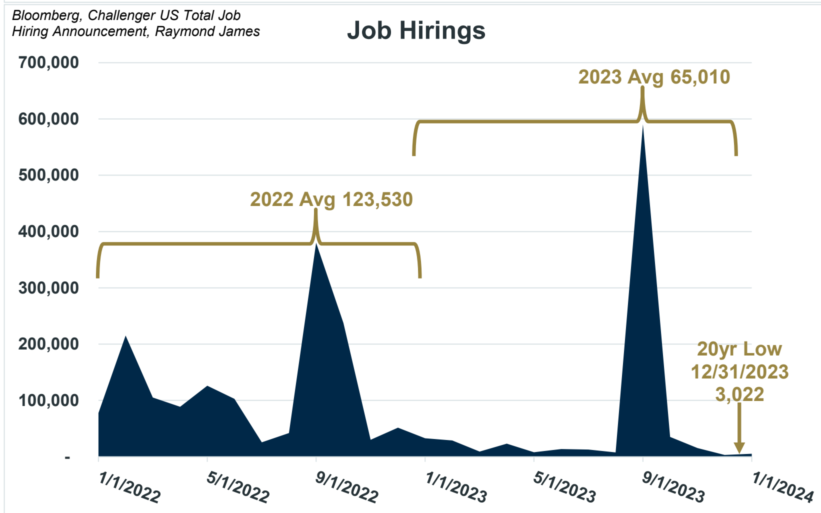
The numbers get tough to digest and I would suggest that nearly every opinion can be backed by choosing the right set of data. For example, the recent average hourly earnings releases were positive or up. Yet the trend since March 2022 has been down. In addition, the average weekly hours worked was down. Other than the present, there are only 2 ranges of time where the average weekly hours of employees have dipped below 34.3 and each of the last two times it was during a recession. Even if workers earn more per hour, the number of hours worked helps determine net earnings. Since production is up, it can be rationalized that workers are being more productive working fewer hours and taking home less money relative to their production. The following chart reveals another cautionary signal. When consumer spending exceeds wage growth, consumers are either borrowing money (going deeper into debt) or depleting savings. Earnings relative to consumer spending are currently very tight.

EMPLOYMENT



The change in the Nonfarm Payroll index has been very positive lately, indicating a strong job market. According to certain employment data releases, the economy is pushing along at full employment. There are, however, different employment indicators that build an apprehension against being too comfortable with headline euphoria. The household survey and payroll survey numbers don't sync. The payroll survey counts jobs while the household survey counts the number of employed individuals. Someone holding several jobs will be counted several times in the payroll survey but once in the household survey.



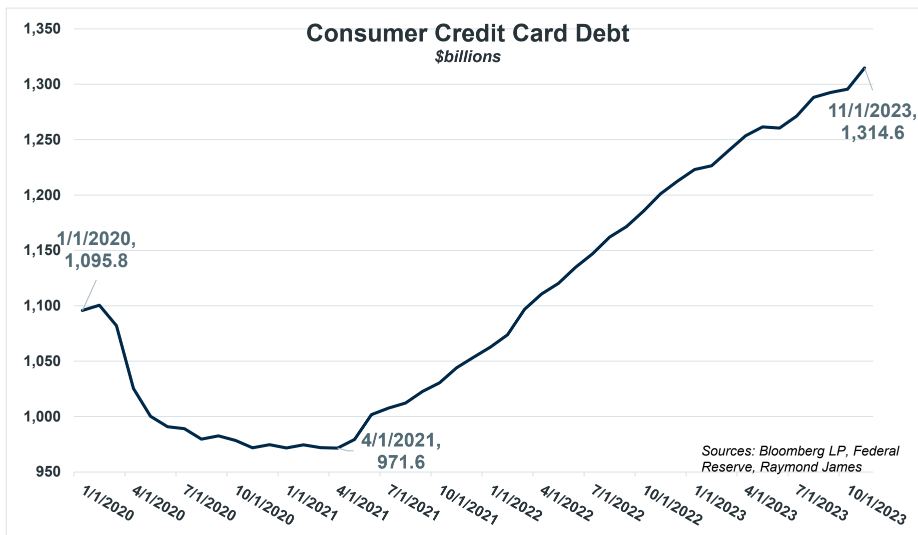


The JOLTS (U.S. job openings by industry total) has declined since 2022. The Challenger US Total Job Hiring Announcement which tracks additions to the payroll that occur hit an all-time low in December (the number has been tracked for 20 years). Adding to the confusion are reports of layoffs in multiple sectors such as IT and journalism.

Unemployment numbers are not driven by demand but instead are a function of unemployment eligibility. During COVID, many eligible laid-off workers exhausted their eligibility for unemployment benefits; therefore, if they are unemployed now, they are not counted. New entrants to the job market are also not eligible.

According to the Challenger US Total Job Hiring Announcement, fewer jobs are being added by employers. The average number of additions to the payroll was nearly halved in 2023 from 2022. December 2023 marked a 20-year low.

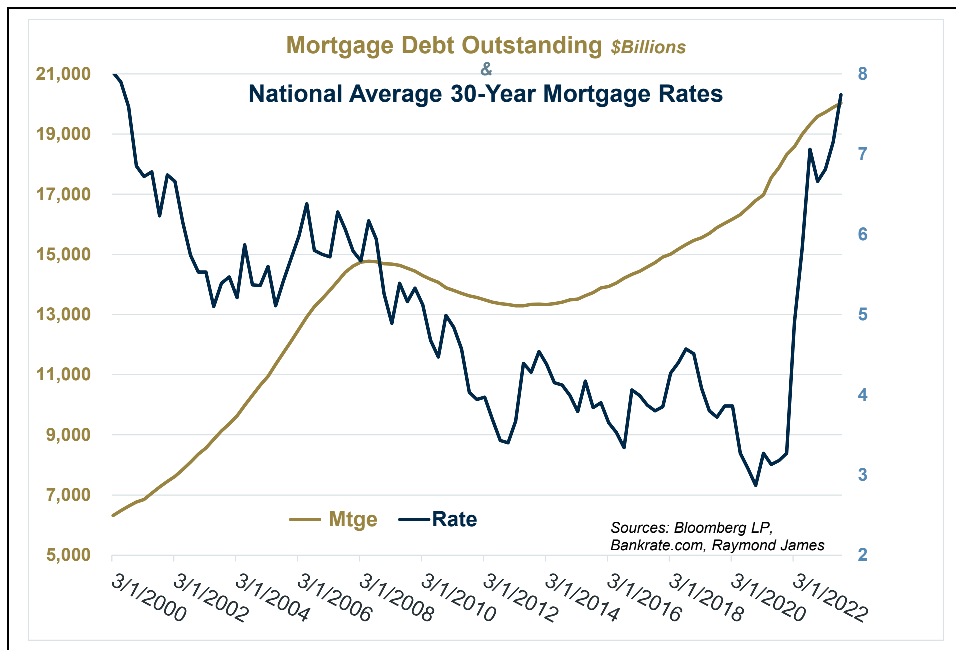
Another data point that is difficult to quantify but anecdotally could be very significant is the so-called 'labor hoarding' that has taken place since the COVID-19 pandemic. During the pandemic, due to a combination of factors, many companies had a very difficult time hiring the employees that they needed for their company to operate fully and efficiently. As a result, and due to the shortage of eligible candidates, many companies have been reluctant to lay off workers even though they might not necessarily be needed right now to have a supply of labor should the hiring market get difficult again. When/if the economy takes a turn for the worse, the "regular" layoffs that take place during a recession could be multiplied due to the already over-staffed payrolls for many companies.



DEBT

Consumer credit card (revolving) debt is more than 20% higher than pre-pandemic levels. The pace at which credit card debt has risen is alarming. Though the 30+ and 90+ day delinquency rates are below long-term averages, they have been on a steady rise since the middle of last year. Since hitting a 17-year low amid the 2021 pandemic, 90+ day delinquencies are up 83%. Delinquencies have maintained or increased in 23 of 28 months reported after the low in August 2021.

Mortgage debt has also been on the rise. Mortgage debt steadily increased from 2000 up to the Great Recession of 2008. The debt declined for a period between 2008 – 2014, before once again rising in 2015 and picking up the rate of increase from 2021 to the present. There now exists over $20 trillion in mortgage debt in the United States.

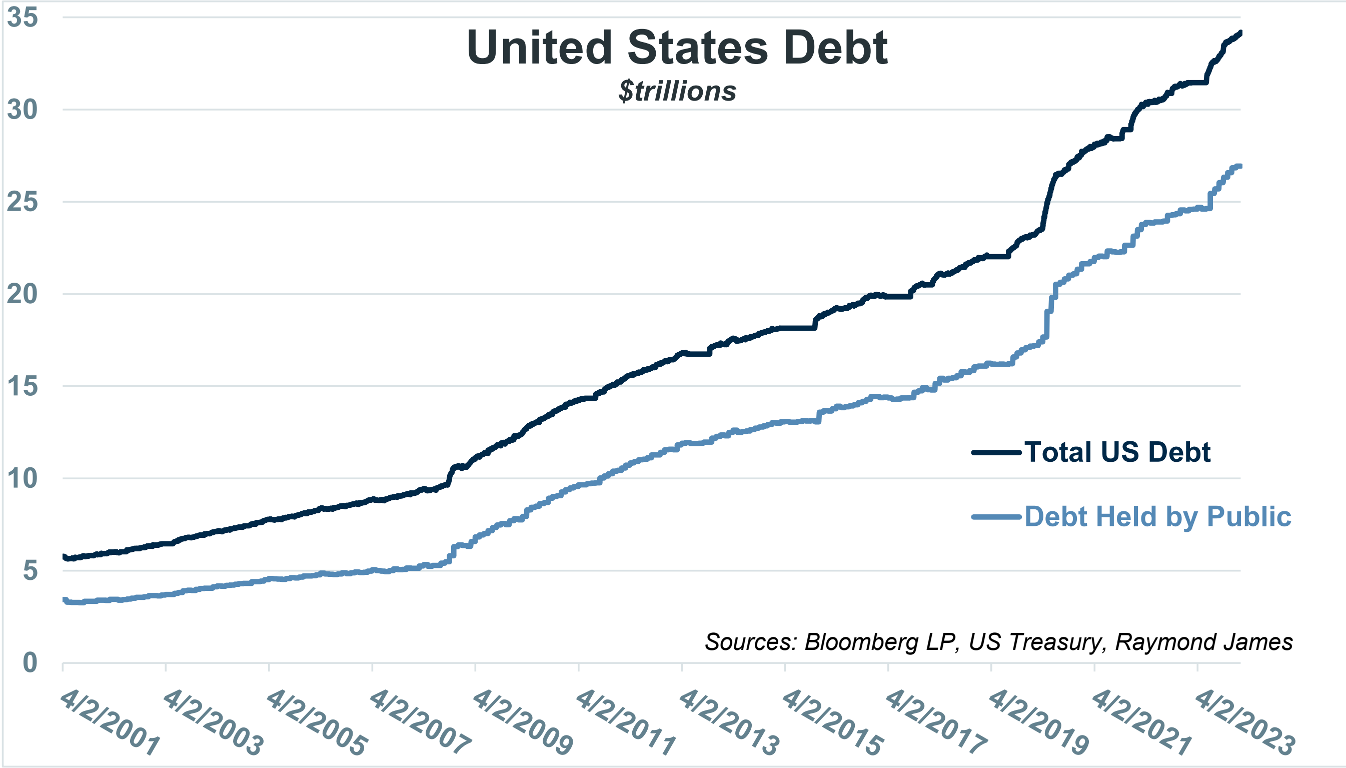


In the last 2 years, the average mortgage interest rate has increased from 3.3% to around 7%, thus making newly issued mortgage debt more costly to consumers.

This same phenomenon is occurring with our growing national debt. The issuance on refinancing debt is more costly in this higher rate environment. In addition, financing new debt is done at a higher cost. Although the total public debt owed by our government is ~$34 trillion, if you exclude the debt one part of the government owes to another part of the government (e.g., Social Security), the federal debt held by the public is $26.9 trillion. Given our U.S. population of just under 336 million, if the debt was divided equally, each citizen would be responsible for $80,434.

While near-term, outside of the political posturing, the level of outstanding debt we have as a nation is likely not a major concern. Potential problems could arise if the issue is not addressed. The United States' debt as a percentage of GDP is near the highest it has ever been. Total debt is currently 120% of GDP, and while it spiked to over 130% as COVID was peaking (when the economy shut down and stimulus flowed into the economy, financed by debt), the current level is very high relative to historical levels. The average from the mid-1960s to 2019, just before COVID, was ~57.5% which is less than half of the current ratio. A historical

graph shows a noticeable spike just after the Great Recession, from ~60% to ~100% and then another spike during COVID, from ~100% to ~120%. Returning to the 50-60% range of the early 2000s seems like a mountainous undertaking when looking at the current state of things. The potential long-term negative effect that this could have on the economy is wide-ranging, but as debt rises, the cost of servicing this debt (interest payments) also rises meaning financial resources that could have been spent in other economic stimulating ways (infrastructure, education, defense, etc.) has to be spent on paying interest instead. Interest as a percentage of the U.S, federal budget is ~2.4%, which is the highest it has been in over 20 years and marks a sharp increase from just a few years ago (it was ~1.22% at the end of 2015).



TACKLING THE 800 POUND GORILLA IN THE ROOM

There are a lot of numbers to digest and an endless number of angles to view the data from. No matter how the players digest, disguise, or defer, the debt has not disappeared. As a consumer, our discretionary income is based on our income less fixed expenses. When debt goes up, we must spend less on discretionary items as bigger chunks of our revenue (paycheck) go towards that debt, or eventually we go bankrupt. Now the first argument that will ensue is that the government is “different”. And they are… to an extent. The government has something none of us do (at least legally) – the printing press. Quantitative easing has given us some history as to how the Fed uses this tool to prop up the economy. However, there can be long-term negative implications to adding money into the economy.

Consumers were provided reasons to feel wealthy as a consequence of actions and events that occurred during and after the pandemic. Lost jobs during the pandemic have been filled. The government put money directly into consumer’s bank accounts. There were deferrals on rent and student loans as well as backstops on credits and businesses. Home values experienced a robust surge. The S&P Index experienced a positive annualized total return of 28% over the last 14 months. Average earnings got a bump in 2021. In addition, discretionary spending nearly ceased during the pandemic. As the crisis subsided, consumers had bulging pockets of money and an appetite to use it. And they did.

The scale is tipping quickly to the other side as consumers have spent money as if they did have a printing press. Credit card debt is at a record high. Home values are leveling off. Government backstops are gone and deferred debt (rent, student loans, etc.) is being called in. Although inflation is off its highs, it is still higher than desired. A falling inflation number does not mean prices are cheaper. It means that prices are not increasing at as fast a pace, yet they are still increasing. Also, the prices that did increase during the worst of the inflationary period are still high. If a gallon of milk went from $2.00 to $3.50, and inflation is falling, it may cost $3.52 or so under falling inflation, but not back to the $2.00 amount. So, whether you believe inflation is going down or stagnating, things just cost more today. Wages have not kept pace, the cost of goods and services is up, and consumer debt has risen. This formula does not work forever.

The government debt is a growing problem too. When the country runs at a deficit, it means that expenses exceed revenues. Tax collection is the major source of revenue. Expenses include healthcare, Social Security, defense, infrastructure, etc. The U.S. typically runs at a deficit (expenses higher vs. revenue). To pay the difference, the government borrows money. The cumulative borrowing and the stimulus packages add to the nation’s debt. In theory, the government can keep printing money to cover expenses but the more money in circulation, the more inflation. The value of existing dollars is cheapened and it takes more dollars to buy the same product or service. The more dollars in print, the more interest the government owes to holders of this debt. Again, this formula does not work forever. At some point, the government would spend all its revenue on interest alone.

The government runs a surplus if it spends less than it takes in. This is politically unpopular. Does the government spend less on entitlement programs: welfare, Social Security, Medicare...? The government can raise taxes (revenue). This is also politically unpopular. Constituents typically don’t want to pay more money out of their paychecks. Printing money is inflationary. Inflation is a sort of tax. When things cost more, it can be more punishing to middle and lower classes who can less afford to have less buying power.

The government can also lower taxes. Although this cuts revenue, it puts more money in the pockets of businesses and consumers. Consumers can spend more creating demand for products and services and entice businesses to grow to meet demand.

So, for now, we just keep kicking the can down the road. We like to think that politics does not interfere with what is best for our economy but the truth is that politicians want to get re-elected and a choice to cut spending or raise taxes can be counter-productive to that goal. At some point, debt becomes unsustainable. Some sacrifice must be made to avoid this catastrophe. It is a vicious circle though because no politician wants to institute a politically unpopular solution. For now, consumer debt is highly likely to curtail consumer spending which in this author’s opinion will not end in a soft landing that seems to be the latest mantra. So,

the economy's first hurdle might be dealing with an economic slowdown induced by consumer behavior. This slowdown will likely invite the Fed to lower interest rates.

One last point to keep in mind in case all of this sounds very doom-and-gloom: recessions are part of a normal economic cycle. They are not something to be scared of but rather something to be prepared for. Recessions are in our future but so are periods of strong economic growth. Rather than fear what might lie around the corner, prepare for it today so that when it comes, you are ready and positioned to continue to succeed. A combination of factors such as inflation, corresponding FOMC action, stimulus, and economic growth have worked together to create a very attractive yield environment for investors. There is currently an opportunity to lock in attractive yields in high-quality assets that can help buffer the negative effects that a recession can bring to many parts of a portfolio.

Yet through all of this data and information, one thing remains in this current market. The high level of income available via fixed income is an opportunity that may eventually be gone. The government's debt issue is a long-term problem that must be addressed before it reaches a point of no return. These long-term issues will likely be moved in various directions as economic band aids provide temporary relief. Fixed income is a long-term strategy and the current economic condition suggests that locking into some stability may help investors weather the economic storm. There exists a twofold benefit to doing so. First, with elevated yields, investors can lock into strong income levels that will not be affected by economic turmoil assuming no default and holding investments to maturity. Second, if interest rates should decline, investors will likely be provided strong total returns as the value of fixed income held appreciates.

The can has been kicked down the road several times but it feels like the end of the road is in sight.

KNOW WHAT YOU CAN OWN

Most individual bonds provide investors with a few prominent features that are difficult to find in other product types, most notably: known cash flow for the life of the security, known income (yield) at the time of purchase, and a known date when the principal will be returned. While most individual bonds provide these benefits to investors, there are many types of individual bonds, each having different features and applications within a portfolio. As an investor, sometimes it's difficult to know which product is most appropriate for a particular situation. Below are listed attributes that may illustrate how various products might work within a portfolio. Identify acceptable risk factors.

- ✓ Define desired income.
- ✓ Create required cash flow.
- ✓ Identify the requisite redemption period.
- ✓ Create needed liquidity.
- ✓ Isolate personal biases.
- ✓ Use appropriate asset mix.
- ✓ Diversify.
- ✓ Rebalance when applicable.

	PRODUCT ATTRIBUTES	HOW DOES THIS FIT?	ADDITIONAL CONSIDERATIONS
TREASURY	Minimal credit risk. State and local tax exempt.	Can I benefit from the state tax exemption? Am I seeking safety and liquidity over maximizing yield?	Although credit risk is minimal, market risk increases with lengthening maturity.
CERTIFICATES OF DEPOSIT BROKERED	FDIC insured. Ability to diversify with multiple issuers.	Do I need higher safety of principal? Typically more attractive yield versus Treasuries.	$250,000 per issuer per tax ID maximum size for insurance. Sales prior to maturity subject to interest rate risk and liquidity risk.
MUNICIPAL TAX-EXEMPT	Tax exempt income with favorable long-term credit standing.	The higher the tax bracket, the greater the tax benefit. The high credit quality is often viewed favorably.	Diversification can be attainable yet the liquidity is lesser versus other alternatives due to limited issue sizes. Subject to credit and interest rate risk.
MUNICIPAL TAXABLE	High quality, taxable alternative.	High credit quality alternative taxable investment. Investors in a lower tax bracket not benefitting from tax-exemption but still seeking the high quality and diversification offered by municipal bonds.	Diversification can be attainable yet the liquidity is lesser versus other alternatives due to limited issue sizes. Subject to credit and interest rate risk.
INVESTMENT GRADE CORPORATES	High quality, relatively good liquidity and competitive yields.	The breadth of the corporate market can allow for extensive diversification from credit ratings to multiple sectors. Generally liquid. Flexibility to create desired cash flow and income levels.	Wide range of issuers with various degrees of credit risk. Credit risks can fluctuate during holding period although this will not alter designated cash flow, income or redemption periods.
PREFERRED SECURITIES	Appeal to investors seeking higher yields and/or high cash flow	This may benefit the portfolio as a higher yielding component with more risk versus true fixed income alternatives.	Preferred's are subordinate to debt securities but placed ahead of common stock in the corporate structure. Being perpetual or very long dated exposes them to increased price volatility. Not a hold-to-maturity alternative.

FIXED INCOME STRATEGY RESOURCES

Doug Drabik - Sr. Fixed Income Strategist
Drew O'Neil - Fixed Income Strategist
Rob Tayloe - Fixed Income Strategist
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The Fixed Income Strategy Group provides market commentary, portfolio analysis, and strategy to Raymond James financial advisors for the benefit of their clients and prospects. We are part of the larger 14-person Fixed Income Solutions group within the Raymond James' Fixed Income Capital Markets Group's 38 fixed income locations with more than 480 fixed income professionals including trading and public finance specialists nationwide. This publication does not constitute Fixed Income research, but rather it represents commentary from a trading perspective.

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- Weekly Interest Rate Monitor (PDF)

Investment Types/Expertise Include

- Treasuries/Agencies
- Brokered CDs
- Corporate bonds
- MBS/CMOs
- Tax-exempt municipals
- Taxable municipal bonds
- Preferred securities

RAYMOND JAMES February 12, 2024

Bond Market Commentary

Fixed Income Solutions

Product Flexibility

DREW O'NEIL
Director,
Fixed Income Strategist

One of the major benefits of municipal bonds is that the interest earned is exempt from federal income taxes. The appeal of earning money that you do not have to pay taxes on understandably piques the interest of many investors. That being said, it doesn't mean that every investor should seek out tax-free bonds for their portfolio. In many situations and for many investors, it makes sense to invest in a taxable product when the "take-home pay" on a bond after paying taxes exceeds what could be earned with a tax-free investment.

Generally, tax-free bonds are going to offer a lower nominal yield than comparable taxable bonds as the tax-free nature "compensates" investors, making the lower nominal yield relatively attractive on a taxable-equivalent yield basis.

Deciding whether tax-free bonds or taxable bonds make the most sense depends on a range of factors including current market conditions and an investor's personal situation (goals, risk tolerance, tax bracket, etc.). An investor's tax bracket is a major determining factor in choosing between municipal bonds and taxable bonds. The higher the tax bracket, the more beneficial a tax-free investment. Conversely, lower tax-bracket investors receive less benefit from a tax-free investment and therefore are generally better served purchasing a higher yielding taxable product and paying their relatively low tax rate on the income earned.

***Taxable Equivalent Yield:** The interest rate that must be received on a taxable security to provide the bondholder the same after-tax return as that earned on a tax-exempt bond.* (Source: MSRB)

This chart shows a range of hypothetical portfolios comparing corporate bond yields versus municipal taxable equivalent yields assuming a 24% federal tax bracket. What's shown generally would be expected: a lower tax bracket investor's "take-home pay" will be higher with a corporate bond portfolio than it would be with a municipal bond portfolio. While these numbers show the reality of the market, sometimes investors make choices based more on emotion than math. It is fairly common for investors to seek out a tax-exempt municipal portfolio even though they are in a lower tax bracket, simply because they do not want to pay any taxes. At the end of the day, this is generally not in their best interest from a return perspective. To put it another way: would you rather make $500,000 a year and pay no taxes or make $1,000,000 a year and pay $400,000 in taxes?

Maturity Range	Corporate	Municipal TEY @ 24%
1 to 5	**5.17%**	3.85%
1 to 10	**5.24%**	3.74%
5 to 10	**5.28%**	3.62%
10 to 20	**5.61%**	4.39%
20 to 30	**5.66%**	5.12%

Sources: Bloomberg LP, Raymond James

A credit rating of a security is not a recommendation to buy, sell or hold the security and may be subject to review, revision, suspension, reduction or withdrawl at any time by the assigning Rating Agency. Ratings and insurance do not remove market risk since they do not guarantee the market value of the bond.

VIX Index: financial benchmark designed to be an up-to-the-minute index estimate of the expected volatility of the S&P 500 Index, and is calculated by using the midpoint of real-time S&P Index (SPX)) option bid/ask quotes.

MOVE Index: this is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average volatilities on the CT2, CT5, CT10 and CT30. (weighted average of 1m2y, 1m5y, 1m10yand 1m30y Treasury implied vols with weights 0.2/0.2/0.4/0.2, respectively).

S&P Index: is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

U.S. Bloomberg Aggregate Bond Index (U.S. Corporate Investment Grade/LUACTRUU): Measures the investment grade, taxable corporate bond market. It includes USD demoninated securities publicly issued by US and non-US industrial, utility and financial issuers.

Duration is the measure of a bond's price sensitivity relative to interest rate fluctuations.

Diversification and strategic asset allocation do not ensure a profit or protect against a loss. Investments are subject to market risk, including possible loss of principal. The process of rebalancing may carry tax consequences.

Rebalancing a non-retirement account could be a taxable event that may increase your tax liability.

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U.S. Treasury securities are guaranteed by the U.S. government and, if held to maturity, generally offer a fixed rate of return and guaranteed principal value. Fixed-income securities (or "bonds") are exposed to various risks including but not limited to credit (risk of default or principal and interest payments), market and liquidity, interest rate, reinvestment, legislative (changes to the tax code), and call risks. There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices generally rise. Short-term bonds with maturities of three years or less will generally have lower yields than long term bonds which are more susceptible to interest rate risk. Credit risk includes the creditworthiness of the issuer or insurer, and possible prepayments of principal and interest. Bonds may receive credit ratings from a number of agencies however, Standard & Poor's ratings range from AAA to D, with any bond with a rating BBB or higher considered to be investment grade. Individual investor's results will vary. A credit rating of a security is not a recommendation to buy, sell or hold securities and may be subject to review, revisions, suspension, reduction or withdrawal at any time by the assigning rating agency.

Prior to transacting in any security, please discuss the suitability, potential returns, and associated risks of the transactions(s) with your Raymond James Financial Advisor.

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While interest on municipal bonds is generally exempt from federal income tax, it may be subject to the federal alternative minimum tax, or state or local taxes. In addition, certain municipal bonds (such as Build America Bonds) are issued without a federal tax exemption, which subjects the related interest income to federal income tax.

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Investing involves risk and you may incur a profit or loss regardless of the strategy selected.

Bond ladders: time-honored investment technique, in which an investor blends several bonds with differing maturities, provides the benefit of blending higher long-term rates with short-term liquidity. Should interest rates remain unchanged, increase, or even decline, a laddered approach to fixed income investing may help reduce risk, improve yields, provide reinvestment flexibility, and provide shorter-term liquidity. Risks include, but are not limited to, changes in interest rates, liquidity, credit quality, volatility, and duration.

Inclusion of these indexes is for illustrative purposes only. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance. Individual investor's results will vary.

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