Uncertainty Cultivates Volatility

Investors have uneasily maneuvered around the volatile markets triggered by the 2020 pandemic, subsequently rekindled by the 2022 inflationary turmoil and escalating recessionary threats. The days of calm and predictable market boredom seem like distant memories. The uncertainty behind the volatility seems universally shared from experts to novice investors with plausible evidence backing extremely different economic suppositions.

So what does the future hold for fixed income investors? Fortunately for fixed income buyers, it is not as complicated as the muddled media messages and opposing expert insights portray. We will examine various fixed income strategies and simplify the assessment process. In the midst of this volatility, fixed income has reached wider spreads and higher yields creating larger cash flow streams and greater income opportunities. Investors seeking income have been tormented by decades of minimal yields, little opportunity and few choices. The current higher yields and numerous options provide renewed means to help solidify portfolios’ core fixed income allocations.

Volatility Indexes

Sources: Bloomberg VIX Index, MOVE Index as of 8/18/2022; Raymond James
The Consequence … Higher Yields

Investors have been confronted with day-to-day market swings and their mood has shifted as data and sentiment wriggle between fears of a recession and the realities of inflation. Regardless of one’s financial status, higher gas prices or escalating food costs are not desirable. The Fed has affirmed their mandate: price stability and maximizing employment. Their focus stands on getting inflation down through raising the Fed Funds rate, the tool being employed to accomplish this. By raising rates, the Fed proposes to cool the economy enough to slow demand and thus slow/stop the rise in prices. The unintended consequence is that they can push the economy into a recession, and although unwanted, it isn’t likely to deter them from their mandate.

The 2020 pandemic initiated an unprecedented event, the partial or complete shutdown of various manufacturers, corporations and businesses. The consequences may have permanently changed how consumers fill their basket of goods and services. Despite enduring demand, the supply problems continue to linger and hinder the economy with increasing prices. There is no guarantee that the Fed will be able to control certain aspects of inflation, specifically how quickly supply chain and labor cost issues are resolved. At the end of the day, if the Fed pushes rates high enough, they run the risk of slowing economic output and putting an end to any argument about whether the economy is in a recession.

Although volatility persists, a positive side effect to fixed income has been the ability for investors to significantly increase portfolio yields. The additional income is always welcome especially as we come off of 40+ years of general interest rate decline. Price sensitive followers will note that bond prices are coming down and hindering total returns. We will point out that a vast majority of our readers utilize the fixed income allocation in their portfolios for principal preservation and to offset the risks taken with growth assets. Although rates are not at their peaks, the graph above demonstrates that 2022 has been a tale of two halves (the first four months vs. the second four months) and rates over the last four months are perched in an attractive yield range.

Not surprisingly, as interest rates rise, the stock market tends to stall. The significance of keeping appropriate asset allocations has been accentuated by this year’s market volatility. Stocks have repositioned into a lower price range, somewhat expected as interest rates rise. Now, with interest rates at
improved levels, keeping balance is more rewarding for income buyers.

A common query centered around projected future Federal Reserve rate hikes is whether it could be advantageous to wait for the Fed to hike rates before investing, thus taking advantage of the higher rate environment they create. First, it can be difficult and somewhat speculative business to attempt to time markets. There always exists an array of economic factors, geopolitical events, domestic affairs, regulatory reforms, health crises, etc. waiting to alter our economy’s course and our well-planned strategy. Second, the Fed does not necessarily control all points on the yield curve when they make a change to the Fed Funds rate. Sometimes the anticipation of a Fed move in itself provokes a market move so that on the day that they actually hike or reduce rates, the market demonstrates little or no additional movement. Sometimes the “pre” market move is overstated and the longer end of the curve actually reacts in an opposite direction than would be implied. Note that for the last two 75bp Fed hikes (June 15 & July 27), the 10 year Treasury price rallied (yield went down) revealing counterintuitive behavior. There are other Fed actions that caused the market to move in a more streamlined or anticipated way. The point is, don’t get caught up in trying to anticipate what will happen especially when the market is presenting in-hand benefits for fixed income investors.

We are in such a market. Spreads are wider than 10 year averages and at the same time Treasury yields are near 10 year highs. As a result, spread products like corporate bonds and municipal bonds are boasting strong relative yields. Lots of fixed income opportunities are obtainable and being executed in this market. Read on as we get more specific.
Market Perspective (Total Return vs. Income Investing)

Which fixed income market have you experienced so far in 2022? Or rather, from which perspective have you experienced 2022’s fixed income market? If your fixed income allocation consists of total return packaged products with no maturity date, it has likely been a rough ride so far this year. As yields have surged higher, prices have fallen sharply, leading to poor total return performance across most of the fixed income landscape. Without a stated maturity date and price, returns are dependent on price movement. When prices fall, performance suffers. Yet, from the perspective of an income investor with individual bonds, interim price movement does not have that dramatic negative effect. No matter how far the price of bonds fall (barring default), when holding the bond until maturity: the coupon cash flow doesn’t change, the maturity date doesn’t change, the maturity value doesn’t change, and the income earned doesn’t change.

The Bloomberg US Aggregate Bond Index is a broad representation of the fixed income market. These graphs depict two sets of data points from the same index and visually demonstrate their inverse paths. The red line shows the price movement trend, which has been steadily lower and shows a year-to-date drop of 8.7%. Total return investors are greatly affected and focused on this price movement as it accounts for much of their return. The yield graph’s green line displays the yield-to-worst trend of the index. The mirror opposite of the two graphs highlights of the inverse relationship between price and yield. The index yield has increased by 193 basis points so far this year.

The yield graph represents a notable opportunity for fixed income investors. The increase in yields (using the index as a representation) means that an investor is now able to purchase a portfolio of bonds that could earn over 3.50%, whereas at the beginning of the year, that same portfolio would have only yielded ~1.75%. The opportunity has doubled. Opportunities abound across the fixed income landscape. Yes, yields are higher which means that prices are lower and total return has suffered in 2022. Yet, for income investors who have money to invest in individual bonds, now could be an opportune time to lock in yields that haven’t been available in years.
Consider Reinvestment Risk

The two types of risk that often come to mind for many investors considering fixed income investments are credit risk *(the risk of default)* and duration/interest rate risk *(the risk that a rise in interest rates will decrease the price of a bond)*. While these are definitely important risks to be aware of, another real and important risk overlooked by many investors is reinvestment risk. When reinvesting, there is the risk that cash flow (either principal or coupon payments) will have to be reinvested at a lower yield than the original acquisition yield of an investment. For example, a bond purchased at a 3.00% yield experiencing falling interest rates during the holding period, is exposed to reinvesting cash flow (interest and principal payments that are received) into lower yielding bonds. While reinvestment risk can never be eliminated, there are strategies that can help to mitigate the reinvestment risk effects on a portfolio’s long-term investment objectives.

One popular strategy entails building a bond ladder, which naturally distributes cash flows over a range of time (months or years). For example, a 1 to 10 year bond ladder can be built to comprise ~10% of the portfolio maturing each year, which allows for cash flow reinvestment to be spread fairly evenly over a 10 year timeframe. A bond ladder’s maturity distribution may mitigate interest rate risk similar to the way that instead of holding one issuer name, purchasing multiple issuer names mitigates credit risk. Diversification of cash flows, obligors, or any other bond feature lessen the effects of any singular action or moment.

Given the high level of uncertainty in the markets, a common inclination for many investors is to move their fixed income allocation into ultra-short-term, ultra-high-quality bonds (i.e. 1-year Treasuries). While every investor has unique liquidity needs, long-term goals, risk tolerances, and market outlooks, a portfolio of 1-year Treasuries might not optimize longer term returns. First, as discussed above, this exposes an investor to a large amount of reinvestment risk in one year. If we enter or are in a recession over the next year, history suggests that yields could push lower. This means that investors purchasing 1-year securities could be subject to reinvesting at a lower yield as those bonds mature. Second, intermediate maturities offer some of the most attractive yield levels in years. This holds true in most fixed income sectors including both the corporate and municipal sectors whose yield curves have remained steep in the face of a flat-to-inverted Treasury curve. Investors can lock in attractive yields for multiple years and reduce any near-term reinvestment risk posed by the near-term uncertainty markets are currently facing.

Not only do bond ladders help to mitigate reinvestment risk, but as stated above, intermediate-maturity ladders offer attractive yield opportunities across a range of products. The table shows the yields available across a range of hypothetical corporate, municipal, and brokered CD ladders.

<table>
<thead>
<tr>
<th>Maturity Range</th>
<th>Avg. Maturity</th>
<th>Credit Quality</th>
<th>12/31/2021</th>
<th>9/22/2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 5</td>
<td>3</td>
<td>AAA</td>
<td>6.2%</td>
<td>2.44%</td>
</tr>
<tr>
<td>1 to 10</td>
<td>5.5</td>
<td>AA</td>
<td>6.0%</td>
<td>2.55%</td>
</tr>
<tr>
<td>1 to 15</td>
<td>8</td>
<td>A</td>
<td>6.0%</td>
<td>2.72%</td>
</tr>
<tr>
<td>5 to 10</td>
<td>7.5</td>
<td>BBB</td>
<td>6.0%</td>
<td>2.83%</td>
</tr>
</tbody>
</table>

*TEY is based on the top federal tax bracket (37%) plus the Medicare surtax (3.8%).

Yields shown are illustrative only and subject to change, calculated using the arithmetic means based on the maturity range combined with the credit quality percentages, and are not inclusive of sales, credit or fees. Sources: Bloomberg LP, Raymond James.
Investor Strategies in Today’s Volatile Market

This section features several strategies which have recently been employed. The specific details may be different than the actual trades and are configured to more generically illustrate working concepts that may benefit a more comprehensive example to be readily applied. The recaps are for illustrative purposes only. Individualized detailed proposals can be created for your personal goals and needs.

**Tax-Exempt Municipal 4.00% Coupon @ Par**

Tax free income is especially appealing for investors in a high tax bracket. Tax-exempt municipal bonds with 4.00% coupons at par (dollar price of $100.00) provide investors in the 37% tax bracket with ~6.35% tax equivalent yields. The ability to execute this trade has fluctuated but comes to favor when the general interest rate environment rises (Treasuries go down in price). The outcome is:

- Locked in 4.00% coupon. A $250,000 portfolio runs $10,000 annual tax free cash flow.
- Investors in the 37% tax bracket earn tax equivalent yields of ~6.35%.
- Average maturities and durations fluctuate depending on market conditions. In the sample portfolio illustrated, the average maturity was 18.3 years with a duration of 8.2.

### Extending Tax-Exempt Cash Flow

An investor sold short maturity municipal bonds with 2.00% and 3.00% coupons in exchange for longer call dated or longer maturity municipal bonds with 4.00% coupons. Market prices, supply and demand variances prohibit exact duplication but the general strategy allows an investor to increase the cash flow, lock in the cash flow for longer and depending on market prices (short maturity municipal bonds have been in high demand and may obtain favorable prices), there may be little to no out-of-pocket capital needed to complete the transaction.

- Increase cash flow.
- Extend cash flow for a longer period.
- Potential for little or no additional capital required.

**Altering Tax-Exempt Structure For Yield**

A slight variation to the previous bond strategy involves selling 2.00% - 3.00% coupons in the 5-7 year part of the curve (traded near par). The strategy exchanges 4.00% coupons at a slight premium with maturities in 13-14 years but with call date features much shorter. A small amount of additional money was injected to cover the slight premiums. The net effect was a 60bp pick up in yield with similar durations.

- Increase cash flow.
- Increase yield.
- Maintain similar duration and average maturity

**Positioning Taxables For 5.00% Yield-to-Worst**

Adding some duration has its reward in this market. This strategy has been used by investors seeking more income. A modest duration extension (8.2) in investment-grade (Baa/BBB) corporate holdings in the sample below provided substantial income and cash flow for the investor. The average coupon of 5.18% was purchased.
at a slight discount.

- Cash flow $25,883/annually on $500,000 face value portfolio (coupon avg = 5.177%)
- Average Price = $99.55
- Yield-to-Worst = 5.453%

**Harvesting Tax Losses**

Investors seeking to take losses for tax reasons have utilized coupon swaps. In this case, ~3.00% coupons with 12-18 year maturities offered slightly discounted market prices. In exchange, 3.75% - 4.00% coupons with maturities ranging from 20-30 years were purchased. The transaction required a small amount of additional cash to maintain face value but kept similar yields, increased cash flow and maintained a similar duration, all while harvesting losses. *(Always consult your tax expert when making tax-related investment decisions.)*

**Corporate 4.00% at Discount**

Some investors want to stay short while capitalizing on the steeper part of the corporate curve. Yields have amply increased, granting greater than 4.00% yields in investment-grade corporate bonds with good cash flows (=>4% coupons) and modest durations of under 4.

- Low duration of 3.96
- Average Price = $98.79
- Yield-to-Worst = 4.55%

**Cash Alternatives (Corporate/Treasury)**

Desires for cash alternatives can be met under current market conditions. Although the Treasury curve remains flat to inverted, the corporate curve is relatively steep from 0 -10 years in maturity. Consequently, investors have options to “park” short term cash while earning additional income.

- < 1 year maturity (corporate)
  - Average Price = $100.22
  - Yield-to-Worst = 3.55%

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<td>Market Principal</td>
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<td>Annual Cash Flow</td>
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<td>Average Coupon</td>
</tr>
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<tr>
<td>Yield to Maturity</td>
</tr>
<tr>
<td>Duration</td>
</tr>
<tr>
<td>Average Rating</td>
</tr>
</tbody>
</table>

*Sources: Tradeweb Markets LLC as of 8/21/22*

- < 1 year maturity (Treasury)
  - Average Price = $98.64
  - Yield-to-Worst = 2.84%

<table>
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*Sources: Tradeweb Markets LLC as of 8/21/22*
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 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 requisite redemption period.
- Create needed liquidity.
- Isolate personal biases.
- Use appropriate asset mix.
- Diversify.
- Rebalance when applicable.

<table>
<thead>
<tr>
<th>Product Attributes</th>
<th>How does this fit?</th>
<th>Additional Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury</td>
<td>Minimal credit risk. State and local tax exempt.</td>
<td>Can I benefit from the state tax exemption? Am I seeking safety and liquidity over maximizing yield?</td>
</tr>
<tr>
<td>Certificates of Deposit Brokered</td>
<td>FDIC insured. Ability to diversify with multiple issuers.</td>
<td>Do I need higher safety of principal? Typically more attractive yield versus Treasuries.</td>
</tr>
<tr>
<td>Municipal Tax-exempt</td>
<td>Tax exempt income with favorable long term credit standing.</td>
<td>The higher the tax bracket, the greater the tax benefit. The high credit quality is often viewed favorably.</td>
</tr>
<tr>
<td>Municipal Taxable</td>
<td>High quality, taxable alternative.</td>
<td>High credit quality alternative taxable investment. Investors in a lower tax bracket not benefiting from tax-exemption but still seeking the high quality and diversification offered by municipal bonds.</td>
</tr>
<tr>
<td>Investment Grade Corporates</td>
<td>High quality, relatively good liquidity and competitive yields.</td>
<td>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.</td>
</tr>
<tr>
<td>Preferred Securities</td>
<td>Appeal to investors seeking higher yields and/or high cash flow</td>
<td>This may benefit the portfolio as a higher yielding component with more risk versus true fixed income alternatives.</td>
</tr>
</tbody>
</table>
Fixed Income Strategy Resources

Doug Drabik - Sr. Fixed Income Strategist  
Drew O’Neil - Fixed Income Strategist  
Rob Tayloe - Fixed Income Strategist  
Josh Milrad – Jr. Fixed Income Strategist

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 39 fixed income locations with more than 450 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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- Fixed Income Weekly Primer (PDF)
- Municipal Bond Investor Weekly (PDF)
- Fixed Income Quarterly (PDF) Weekly Index Monitor (PDF)
- Weekly Interest Rate Monitor (PDF)
- Fixed Income Introduction to ESG Investing

Investment Types/Expertise Include

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

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**Bond Market Commentary**

**Fixed Income Solutions**

**Consider Your Options**

From corporate bonds to brokered CDs to municipal bonds, there are good values to be found across the fixed income landscape. While product choice is always an important decision, current fixed income market dynamics mean that investors may want to take time to consider the ideal product for their individual situation. Typically, in a “normal” market, higher tax bracket investors don’t have to give up their choice for a second thought as tax-exempt municipal bonds are going to provide the best value given their tax advantages. Recently due to supply imbalances and very strong demand for municipal bonds on the short end of the yield curve, prices have been driven so high that even with their tax advantages, many investors may be better off from an after tax yield perspective by purchasing a taxable product, such as corporate bonds, for another maturity investments.

![Comparison of Yields](https://www.raymondjames.com/assets/bond-market-commentary.png)

The yield curves below highlight these current market dynamics. The solid blue line is the A-rated corporate bond curve. The dashed gray line is the A-rated municipal bond curve displaying the taxable equivalent yield for someone in a 45.0% federal tax bracket (37.5% + 3.5% Net Federal Income Tax). As you can see, even factoring in the top tax bracket into the calculation, A-rated corporate bonds offer a yield advantage on the short end of the yield curve.

![Comparison of Yields](https://www.raymondjames.com/assets/bond-market-commentary.png)

What does this mean for investors considering a short-term municipal portfolio? Perhaps consider a taxable bond portfolio. Corporate bonds are illustrated above, but taxable municipals, brokered CDs, and Treasuries could all present excellent opportunities depending on investor needs. For many investors, extending out further on the curve might also be appropriate. As the graph shows, intermediate and long term municipals still present the traditional taxable equivalent yield advantage that high tax bracket investors are familiar with. With longer term municipal yields at
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, 1m10y and 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.


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.

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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.

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The value of fixed income securities fluctuates and investors may receive more or less than their original investments if sold prior to maturity. Bonds are subject to price change and availability. Investments in debt securities involve a variety of risks, including credit risk, interest rate risk, and liquidity risk. Investments in debt securities rated below investment grade (commonly referred to as “junk bonds”) may be subject to greater levels of credit and liquidity risk than investments in investment grade securities. Investors who own fixed income securities should be aware of the relationship between interest rates and the price of those securities.

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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.

Investment products are: not deposits, not FDIC/NCUA insured, not insured by any government agency, not bank guaranteed, subject to risk and may lose value.

New issues are offered by Official Statement only, which describes the security for such issue and which may be obtained in any state in which the undersigned may lawfully offer such issue.

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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.

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