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June 30, 2021

Second Quarter Fixed Income Letter to Clients

The second quarter can be summed up by the sharp reversal in the trend of intermediate-term and long-term US Treasury yields and inflation expectations, which both fell. The US Treasury 10-year bond began the quarter at a yield of 1.74% and ended the second quarter at 1.45%; while the long end of the yield curve began the quarter at 2.24% and closed at 2.00%. The Fed's updated consensus for the timing of new rate hikes moved ahead to 2023, as compared to the prior projection of 2024. So, the Fed's slightly hawkish shift has provided market participants with some new information. In our view, the markets got a bit overextended with the first quarter jump in longer term rates and inflation expectations, and the second quarter reversal seems to reflect the possibility that U.S. growth and inflation rates may have peaked for the time being. While inflation is being addressed seriously by the markets and the Fed, there is now growing consensus that there is not a fundamental change in the "real" economy. Rather, it seems that the market got ahead of itself in pushing rates up too fast in the first quarter.

We feel that over the next few months, interest rates will remain within the range established over the past year. That said, we do anticipate market moving economic indicators come October. At that time, we'll be able to assess the strength of the labor force and wage pressure with much greater accuracy than now given that federal stimulus unemployment payments will expire at the end of August.

Tax-free municipal bond prices were firm throughout the second quarter. The S&P Municipal Bond Index has returned 0.86% year to date. In addition, year to date we have seen very strong inflows into municipal bond funds. Municipal Bond prices are historically rich at this time, but given the dynamics at work in today's environment, they could get even richer. And that's what we will continue to watch for.

We maintain a neutral position on the yield curve. Specifically, we continue to add to high quality positions using a 10-year laddered approach, while being a bit more heavily weighted on the shorter end of the curve.

Evan Slater
Fixed Income Portfolio Manager