MONTHLY FIXED INCOME MARKET UPDATE

USAA INVESTMENTS
A VICTORY CAPITAL® INVESTMENT FRANCHISE

As of May 31, 2022

Key Takeaways

- May was another volatile month in financial markets. While the Consumer Price Index (CPI) ticked lower from its April reading, it was still higher than the market had been expecting and at "much too high" levels for the Federal Reserve (the Fed). This prompted more hawkish commentary from the Fed and an equity market sell-off. Against this backdrop of equity market drama, the Treasury curve quietly shifted lower and most fixed income indices enjoyed positive monthly performance, even as credit spreads remained volatile.
  - **Inflation:** The April CPI reading, as reported in May, came in at an annualized 8.3%. This was sequentially lower than the 8.5% the market received in the CPI reading for the month before, but still higher than expectations. The concern is that supply chain disruptions, higher energy prices, and rising commodity prices will prove enduring and therefore demand more aggressive rate hikes from the Fed.
  - **Is Monetary Policy Starting to Have Its Intended Effect?** At the Federal Open Market Committee (FOMC) meeting of May 5th, the Fed raised the Federal Funds rate by 50 basis points (bps) and guided the market to expect at least two more 50 bps increases in the coming two meetings. The Fed also indicated it would take whatever corrective action was necessary to get inflation under control.
    - Early evidence is emerging that inflationary expectations may be moderating.
    - This is because in the first few days of May, the 5-year Treasury converged with forward expectations for inflation. At that same time, the entire Treasury curve started shifting lower.
    - The movement lower in the curve was the primary driver of fixed income indices realizing positive results for the month.
    - Victory Capital interprets these events as evidence that the market is starting to give the Fed credit for getting serious about quashing inflation.
- **Volatile Credit Spreads:** Even as expectations and Treasuries were shifting, credit spreads in both investment grade and below investment grade bonds were volatile. Spreads first moved wider with a higher-than-expected inflation reading and hawkish Fed commentary, only to then tighten at the end of the month with a lower-than-expected inflation reading.
- Fixed income returns were positive across all major indices. In investment grade, a lower Treasury curve drove performance, with additional benefit from tightening investment grade credit spreads. Similarly, in high yield, a lower Treasury curve drove positive performance, but modestly wider credit spreads were an offset.
  - The Treasury curve tightened across all parts of the curve, with the largest moves in the 2- to 10-year tenors and smaller moves on the short and long ends.
  - Investment grade corporate spreads tightened 8 bps, and below investment grade corporate spreads ended wider by 15 bps, after being much wider in the month.

What does this all mean?

- We can expect the Fed to keep raising rates at each meeting in 2022 even though it looks as though the market is starting to give credit for intent. CPI readings, Fed rate hikes, and communications after FOMC meetings will drive market volatility.
- Fixed income returns year-to-date have been negative, as have equity returns. However, we remind readers of the time-tested diversification benefits of fixed income and that, over the last five cycles, our analysis shows that fixed income returns were positive during Fed hiking cycles.

What to watch this month – three narratives

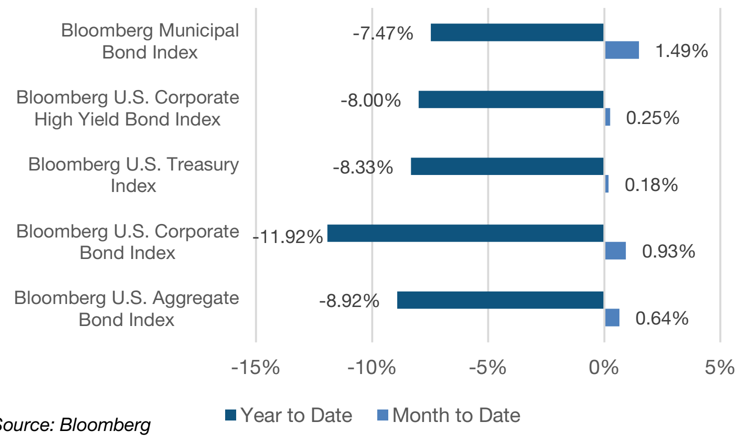
- **First,** are inflationary pressures abating? Will inflation, per the May CPI reading, (expected June 10th) stay elevated, or will it decline and, if so, in which categories?
- **Second,** how is the Fed's monetary policy developing? The next FOMC meeting is scheduled for June 15th. While a 50 bps rate increase is broadly expected, we will be reading attentively the accompanying commentary for the timing and magnitude of ensuing hikes.
- **Third,** supply chain issues. How are oil and natural gas prices developing in response to the hostilities in Ukraine? In what way are the lockdowns in China having an impact on domestic consumption and the export of consumer goods to Western markets?

Muni Minute

- The municipal bond market monthly returns in May were 1.49% according to the Bloomberg Municipal Bond Index. This was a reversal from several negative months of returns to start the year.
- Returns were aided by a decline in muni rates. The 10-year muni 'AAA' rate decreased from 2.92% to 2.61% in May.

Performance as of May 31, 2022

Returns (%) for Fixed Income Indices



Source: Bloomberg

Past performance is no guarantee of future results.

Index returns do not reflect management fees, transaction costs or expenses; one cannot invest directly in an index.

Credit Market Monitor

				Quarter		Change		
Asset Class	Yield	Spread	Trend	Tight	Wide	MoM	QoQ	YoY
U.S. Treasury	2.80	0		0	0	0	0	0
U.S. Corporate	4.22	129		109	148	-5	8	46
U.S. Corporate High Yield	7.17	402		309	481	24	44	108
CMBS	3.80	101		80	104	13	17	42
ABS	3.37	85		39	85	16	41	60
A	3.95	105		89	123	-7	3	40
BBB	4.54	161		134	180	-2	14	54
BB	5.71	261		214	333	-11	-8	35

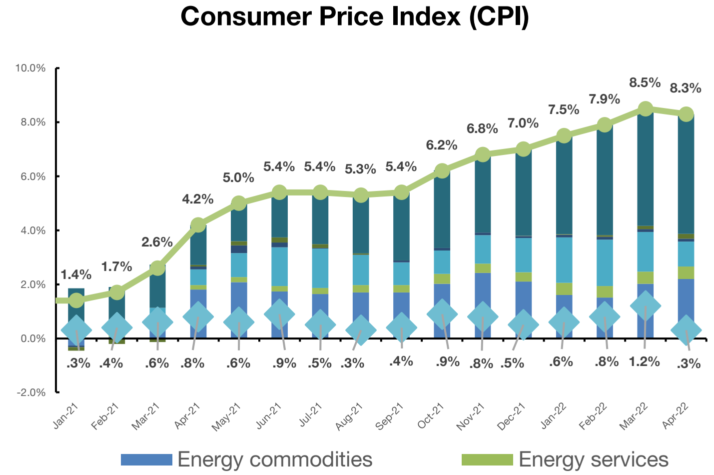
Source: Bloomberg; Asset Classes represented by: ICE BofA US Treasury & Agency Index, Bloomberg US Agg Total Return Value Unhedged USD, ICE BofA US High Yield Index, ICE BofA, US Fixed Rate CMBS Index, ICE BofA US Fixed Rate Asset Backed Securities Index, Bloomberg US Agg A Total Ret Index, Bloomberg US Agg Baa Total Ret Index, Bloomberg Ba US High Yield TR Index

Bonding over Bonds

Our video series on the fixed income markets

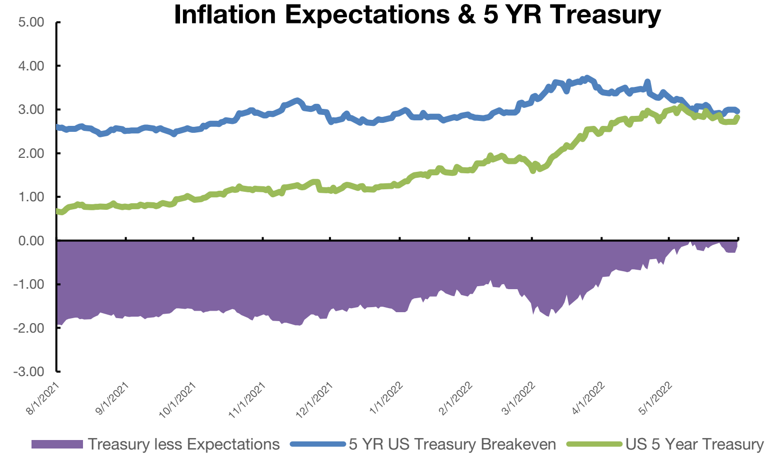
In our #BondingOverBonds video series, each week experts discuss notable activity in the fixed income markets: Watch Now

The Month in Charts



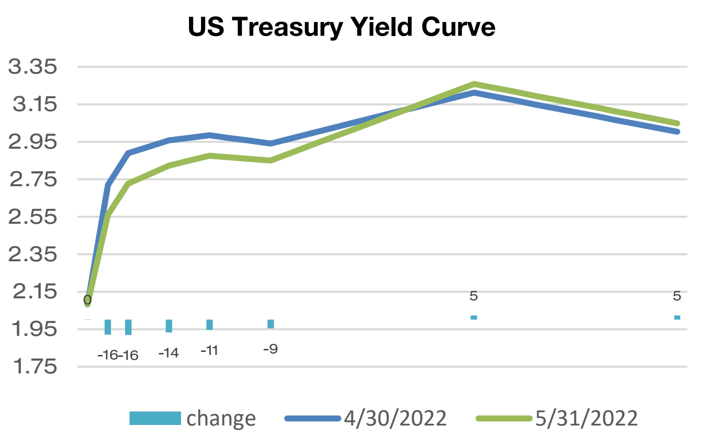
Source: U.S. Bureau of Labor Statistics

Consumer Price Index (CPI) : While the April numbers, announced in May, showed a downtick in inflation vs. March, it was higher than expectations, and still "much too high" for the Fed. Initially showing up only in the COVID-related sectors of the economy like energy, used cars, and travel, inflation has become apparent across all sectors of the economy. Its elevated level, as well as its broad-based nature, supports a more hawkish tone from the Fed.



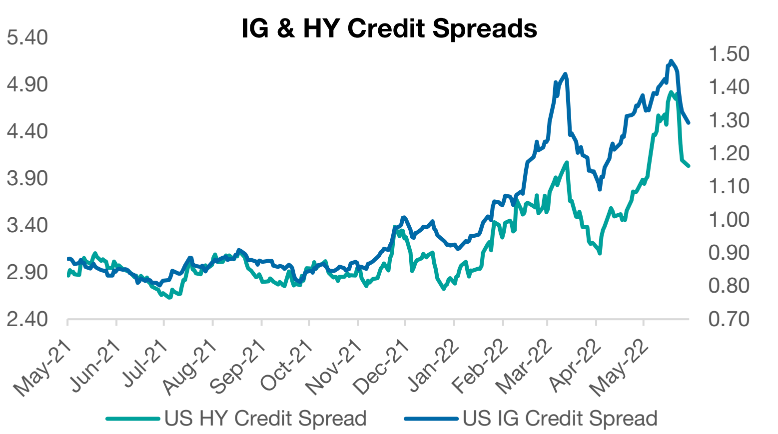
Source: Bloomberg

Inflation Expectations Moderate: While inflation concerns persist, forward looking inflation expectations, as measured by the 5-year US Treasure Breakeven, have started moving lower. As the 5-year Treasury converged with inflation expectations, the Treasury curve started moving lower as well (see chart below left). Together, these suggest the market has begun to give the Fed's hiking cycle some credit for addressing inflation.



Source: Bloomberg

Lower Treasury Curve: After moving sharply higher though April, The Treasury curve moved lower in May, with the largest moves in the 2- to 10-year segment and more moderate moves on the short and long ends. The move lower in the Treasury curve drove positive returns across the majority of Fixed Income Indexes.



Source: Bloomberg

Credit Spreads: Corporate spreads were volatile in May, as they initially moved back to and then through the wides seen in March due to a higher-than-expected inflation reading and hawkish commentary from the Fed, only to then tighten at the end of the month with lower-than-expected inflation reading.

All investing involves risk, including potential loss of principal.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. Bonds and bond funds will decrease in value as interest rates rise and vice versa. Credit risk refers to the possibility that debt issuers may not be able to make principal and interest payments or may have their debt downgraded by ratings agencies. High yield securities may be more volatile, be subject to greater levels of credit or default risk and may be less liquid and more difficult to sell at an advantageous time or price than higher-rated securities of similar maturity. Municipal securities are more vulnerable to unfavorable economic, political and regulatory changes affecting specific municipalities. Some income from municipal securities and muni bond funds may be subject to local tax and could declared taxable and/or subject to the federal alternative minimum tax if federal or state laws change.

The opinions are as of the date noted and are subject to change at any time due to changes in market or economic conditions.

Credit spread is the difference in yield between a U.S. Treasury bond and another debt security of the same maturity but different credit quality.

Credit spreads are the additional compensation that investors require to hold securities that are not as safe and liquid as those issued by the US Treasury.

The Treasury Yield Curve shows the relationship between the US bond yield and the time to maturity. Yield and price have an inverse relationship. As the yield curve lowers, the price of bond increases.

The Five-Year Breakeven Inflation Rate represents a measure of expected inflation derived from 5-Year Treasury Constant Maturity Securities and 5-Year Treasury Inflation-Indexed Constant Maturity Securities. The latest value implies what market participants expect inflation to be in the next 5 years, on average.

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