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Fourth quarter 2020

Bond markets finished the year with a strong tone

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Rates plummeted early in the year due to massive monetary stimulus associated with the coronavirus crisis, and spreads widened dramatically. However, as the economy gained steam in the second half of 2020, credit spreads narrowed to end the year only slightly higher than January levels. Investors who held their positions throughout this tumultuous time were rewarded for their patience, illustrating the importance of a long-term time horizon. Going forward, we believe active management will become even more critical.

KEY TAKEAWAYS:

- Credit fundamentals are sound, though valuations are becoming rich and the risk of a duration-driven selloff remains salient.
- Despite the narrowing of credit spreads, we believe credit fundamentals will continue to improve in 2021.
- As spread and valuation levels have tightened over the last year, we believe active management will become even more critical.

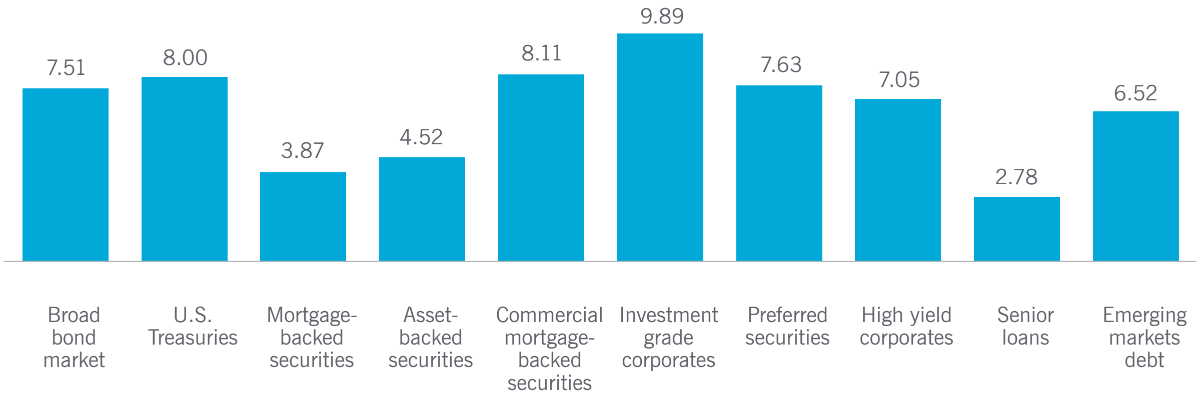
FIXED INCOME ASSET CLASSES OFFERED STRONG RETURNS

On the surface, 2020 looked like another solid year for bonds. The broad bond market returned 7.51%, outpacing 8 of the last 10 years. Investment grade corporates finished up 9.89%, U.S. Treasuries followed close behind at 8.00% and all major sectors were positive.

"Investors who held their positions throughout this tumultuous time were rewarded.

Figure 1: Most bond sectors posted solid returns in 2020

Total returns (%)

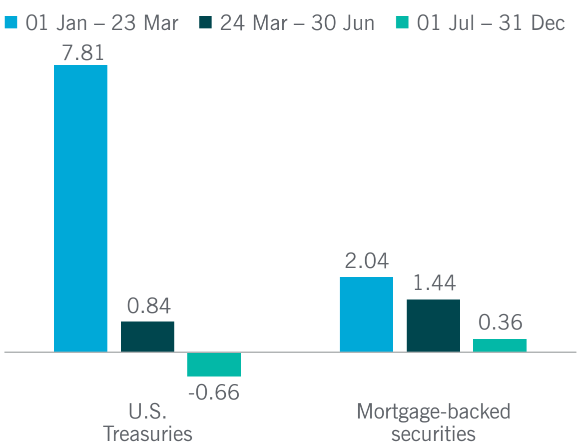


Data source: Morningstar Direct, 01 Jan 2020 – 31 Dec 2020. **Past performance is no guarantee of future results. Representative indexes:** broad bond market: Bloomberg Barclays Aggregate Index; **U.S. Treasuries:** Bloomberg Barclays U.S. Treasury Index; **mortgage-backed securities:** Bloomberg Barclays U.S. MBS Index; **asset-backed securities:** Bloomberg Barclays ABS Index; **commercial mortgage-backed securities:** Bloomberg Barclays CMBS Index; **investment grade corporates:** Bloomberg Barclays U.S. Investment Grade Corporate Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield corporates:** Bloomberg Barclays U.S. HY 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index; **emerging markets debt:** Bloomberg Barclays EM USD Aggregate Index.

However, the strong annual returns obscure a series of dramatic ups and downs. From the equity market low on March 23, higher-quality bond sectors rebounded in the second quarter, as rate cuts and direct Fed support programs stabilized returns. Lower-quality credit sectors, such as high yield corporates and preferred securities, had their strongest returns in the second half of the year.

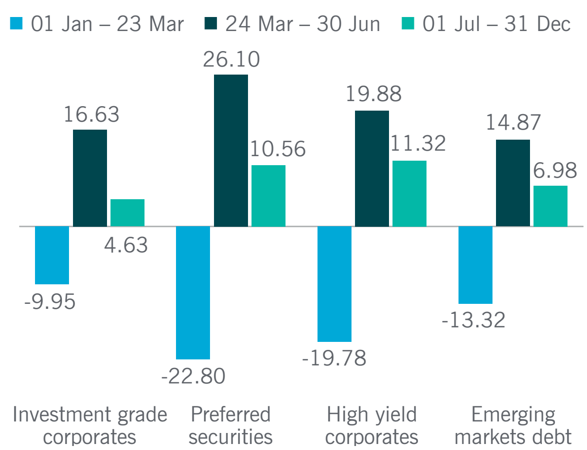
Figure 2: The highest quality sectors benefited immediately from Fed support…

Total returns (%)



…but credit sector recovery took longer

Total returns (%)



Data source: Morningstar Direct. **Past performance is no guarantee of future results. Representative indexes: U.S. Treasuries:** Bloomberg Barclays U.S. Treasury Index; **mortgage-backed securities:** Bloomberg Barclays U.S. MBS Index; **investment grade corporates:** Bloomberg Barclays U.S. Investment Grade Corporate Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **high yield corporates:** Bloomberg Barclays U.S. HY 2% Issuer Capped Index; **emerging markets debt:** Bloomberg Barclays EM USD Aggregate Index.

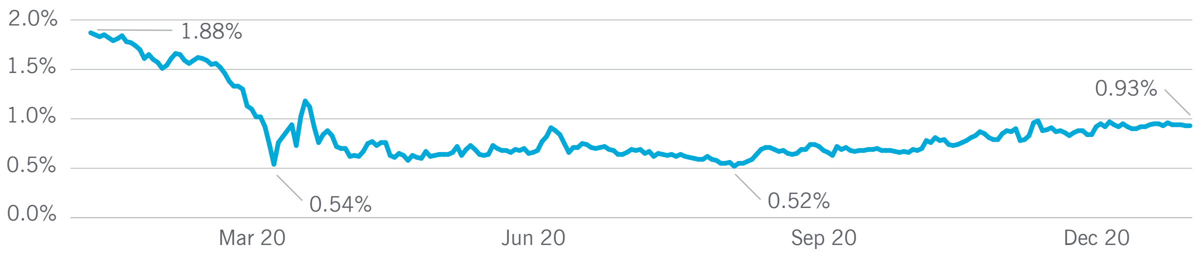
Investors who held their positions throughout the entire period were rewarded, underscoring the importance of staying invested despite market volatility. Going forward, we think allocations to credit sectors may continue to add income, and therefore total return potential to portfolios.

INTEREST RATES WERE VOLATILE, BUT REMAINED HISTORICALLY LOW

The 10-Year Treasury yield began the year at 1.88%, but plummeted following the Federal Reserve's two emergency rate cuts in March. Rates remained low throughout the summer, as economic activity slowed and inflation remained muted, touching a low of 0.52% on August 4. As the lockdowns ended, economic activity began to firm, and rates began to optimistically rise again once the efficacy of the vaccines was announced.

Figure 3: 10-year Treasury yield plummets in March

Yield (%)



Data source: treasury.gov, 01 Jan 2020 – 31 Dec 2020. **Past performance is no guarantee of future results.**

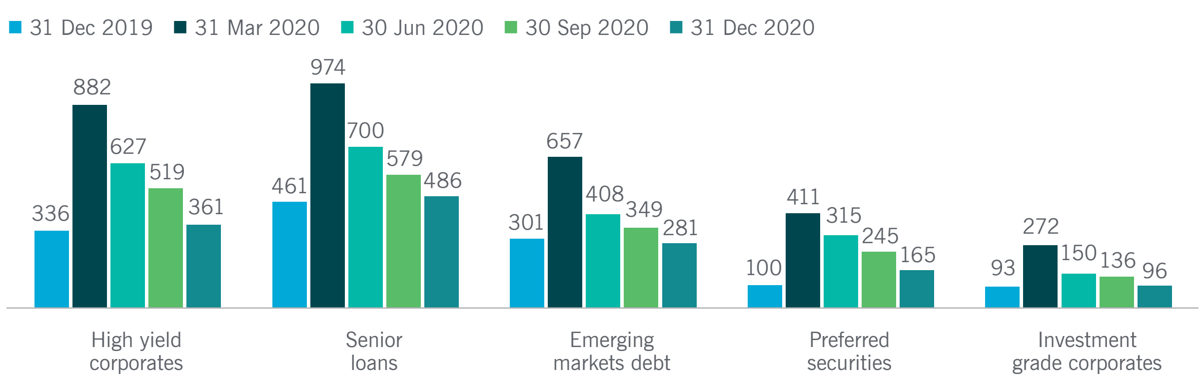
Falling yields most benefited longer duration, higher-quality asset classes, like U.S. Treasuries and investment grade corporates. Looking forward, we believe monetary policy will remain extremely accommodative. Rates may rise modestly, but we don't expect the kind of sharp increases that may impair bond returns. Rather, we think low rates will help keep the economy moving forward as it continues to recover from the recession.

SPREADS WIDENED DRAMATICALLY, BUT HAVE RECOVERED

Credit spreads widened substantially in March due to heightened risk associated with the coronavirus pandemic. Spreads narrowed again through the summer and fall, as financial market liquidity improved and the economy gained traction. Below investment grade high yield bonds, senior loans and preferred securities moved the most. By year-end, spreads of higher-quality sectors, such as investment grade credit and emerging markets debt, returned to levels similar to the beginning of the year.

Figure 4: Credit spreads proved to be volatile

Spread (bps)



Data sources: Bloomberg, L.P. Credit Suisse. **Past performance is no guarantee of future results. Representative indexes: high yield corporates:** Bloomberg Barclays U.S. HY 2% Issuer Capped Index; **senior loans:** Credit Suisse Leveraged Loan Index; **emerging markets debt:** Bloomberg Barclays EM USD Aggregate Index; **preferred securities:** ICE BofA U.S. All Capital Securities Index; **investment grade corporates:** Bloomberg Barclays U.S. Investment Grade Corporate Index.

Despite the narrowing of credit spreads, we believe credit fundamentals will continue to improve in 2021. We continue to find credit sectors attractive, especially high yield, emerging markets debt and preferred securities. However, going forward, we think income will create the majority of their total returns. Because no sector looks especially cheap, we believe security selection will become increasingly important. Bottom-up fundamental research can uncover opportunities among industries and in individual issues.

ACTIVE MANAGEMENT CAN HELP MANAGE THROUGH THE NEXT YEAR

While we believe the worst of the coronavirus crisis is behind us, the low absolute rates and narrow credit spreads can make it more difficult to find value in fixed income assets. Investors have been rewarded for broad market participation over the past decade, as risk assets have generally rallied.

As spread and valuation levels have tightened over the last year, we believe active management will become even more critical. Investment professionals can take advantage of opportunities across a wide range of sectors and employ fundamental research to seek undervalued individual positions. This can help build income into portfolios, even in a low rate environment.

We suggest considering these types of strategies:

Core plus. Combine a larger portion of higher-quality sectors – like U.S. Treasuries, mortgage-backed securities and investment grade corporates – with smaller (typically up to 30%) allocations to lower-quality sectors, such as high yield corporates and emerging markets debt. The ability to actively adjust allocations to lower-quality segments can increase yield while balancing overall risk.

Multisector bond. Augment a base of diversified higher-quality sectors with larger allocations (typically up to 50%) to below investment grade securities. Offer more yield potential than core plus, in return for greater potential volatility.

Core/core impact with limited plus sector exposure. Focus more on higher-quality sectors to maintain return profiles similar to the broad bond market and a low correlation to equities. Core strategies with the flexibility to add small amounts (0% to 10%) of lower-quality sectors can be particularly attractive in this low yield environment. Core strategies with an impact investing mandate add the additional diversification of responsible investing themes.

OUTLOOK

Continued U.S. growth supports credit sectors

We expect U.S. growth to continue at an above-trend pace through 2021. The recently-enacted batch of fiscal stimulus, which includes another round of stimulus checks, small business support and expanded unemployment benefits, will support personal disposable income and ultimately consumption over the next several quarters. As populations receive COVID-19 vaccinations, virus-driven disruptions should decline. Consumer and corporate balance sheets are healthy, providing a solid backdrop for growth.

Credit fundamentals are sound, though valuations are becoming rich and the risk of a duration-driven selloff remains salient. U.S. Treasuries will likely struggle to replicate their strong 2020 performance, which will feed through to pressure higher-quality sectors. Nevertheless, steeper curves should benefit financials and preferreds, and continued strong growth will likely drive flows further down the credit risk spectrum. The firmly dovish Fed, with low policy rates and a commitment to a slow normalization of policy, will support emerging markets debt and foreign currency.

We continue to favor a moderately risk-on portfolio, preferring credit risk to duration risk. We think credit sectors should benefit from improving economic data, progress on vaccine distribution, strong investor inflows, a slowdown in supply and expectations for continued policy support. Given somewhat stretched valuations and the still-uncertain pandemic outlook, credit selection will be key.

Overall returns will likely be in the low single digits, with spread sectors providing both higher income and better odds for further capital appreciation. We remain focused on credits with durable free cash flow and solid balance sheets across a wide range of sectors, including high yield corporates, emerging markets debt, leveraged loans, investment grade credit, non-agency mortgage-backed securities, off-the-run asset-backed securities and preferred securities. We continue to find the mid-quality rating segments (BBB, BB and B rated) most attractive.

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Endnotes

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