Annual Fixed Income Outlook

Executive Summary

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Brian M. Erickson, CFA
VP – Fixed Income Research

Jon Kyle Cartwright
Senior Director – Fixed Income Research

Stephen Tufo
Director – Fixed Income Research

Douglas D. Noah, CFA
Senior Analyst – Municipal Research
Key Themes

A no-win: Accepting lower yields or taking more risk

We believe the U.S. Federal Reserve and other developed market central banks likely expand stimulus and liquidity through 2021, fueling the pace of recovery. We expect rates, both short-term and long-term, to remain compressed in 2021, resulting in muted total return prospects for fixed income and most asset categories. Low yields tempt investors to reach for income and returns or to accept lower yield that comes from traditional investments, a no-win situation.

The relationship between risk and reward may be a casualty of sustained central bank liquidity. Whereas High Yield Bonds yield less than 4.5% today, 10-year Treasuries offered a similar yield in 2007 albeit with a moderately higher inflation backdrop (2.8% CPI in September 2007 vs. 1.2% end of October this year). Even three-month Treasury bill yields offered a greater yield in 2007 than High Yield Bonds do today. The rigorous use of Monetary policy since the financial crisis compacted real 10-year Treasury yields from +2.5% to -0.7% over the comparable period. We do not see central bank intervention as a permanent, long-term condition. We believe the Fed and its peers seek to spur inflation and then return to a less distorted bond market. While it is tempting to reach for yield today, we believe excessive risk-taking may turn costly when the Fed begins withdrawing stimulus.

Credit cycle turns, picking up momentum through 2021

Credit Overweights: We expect consumer spending to remain strong throughout 2021, with discretionary purchases picking-up cadence in 2Q21 as a growing percentage of the global population becomes vaccinated for COVID-19. We believe consumer sentiment should continue to improve throughout 2021, driving increased consumption of durable and non-durable goods. Our outlook for technology in 2021 is positive. We believe that the pandemic has forever changed the way people work, shop and play. We expect the bonds issued by health care companies that add real economic value in the context of reduced hospital stays, improved clinical outcomes and enhanced quality of life to outperform. We expect industrials to outperform as the early-cycle recovery gains strength over the next several years and could continue to perform well until the economy reaches a cyclical peak.

Credit Underweights: Energy tends to be a peak-cycle industry, and unfortunately, we believe the global economy is beginning an early cycle recovery. In aggregate, we recommend investors underweight energy. However, in our opinion, bond investors could still benefit from limited exposures to defensive sectors like exploration & production (E&P), refining & marketing (R&M), energy services, renewable energy, and electric utility companies. We believe investors should underweight financial sector bonds until economic, interest rate, and FinTech risk moderate. We are content waiting for the financial industry to benefit from the early-cycle recovery before moving to an overweight posture.

Core bond’s nemesis – inflation, and how to plan for it

The taper tantrum of 2013 reminded us that the Fed's willingness to provide ever more support has a hidden weakness. Like kryptonite for Superman, the Fed's resolve diminishes when inflation picks up. We believe bond markets remain prone to a surprise inflation cameo. Looking into 2021, we do not anticipate break-away inflation. Several quarters ahead, the Fed may contemplate ending government bond purchases, leading to a potential rise in long-term Treasury yields and a commensurate drop in price. To bolster the resiliency of core bond allocations, we recommend shifting a quarter of U.S. Treasury exposure to short-term TIPs, which may see positive performance should CPI inflation rise. When that time comes, TIPs likely prove a crucial diversifier in our view.
Rates steady in 2021– Fed Funds near zero, 10-year forecast 1.00%

We forecast that the Fed Funds target range ends 2021 at 0.00 - 0.25%, where rates have been since March 2020. A rise in Fed policy rates likely follows the return to full employment (unemployment less than 5%) and sustained inflation. While the Fed likely ends its monthly $120 billion bond purchases ahead of the first rate hike, we expect that a low rate target probably persists through 2023 or beyond as the Fed looks to achieve its 2% average inflation objective.

We set our 10-year Treasury yield forecast at 1.00% for the end of 2021. A steepener trade would traditionally be appropriate heading into the recovery we expect next year. Our belief that the Fed could buy long-term Treasuries as a stimulus offsets modest inflation forces for higher 10-year yields in our base case. This leaves 10-year yields little changed from the end of 2020 to 2021. In our optimistic case, we contemplate a short-lived twist and firmer inflation leading 10-year Treasury yields higher to 1.50% at the end of 2021. Our adverse scenario would see tepid inflation, further Fed efforts to compress long-term rates, and a 0.50% 10-year Treasury yield at year-end. We recommend a 5.5-year duration target for long-term, total return portfolios just short of the 6-year duration of the Bloomberg Barclays U.S. Universal Index.

Corporate defaults peak in the first half

We forecast corporate defaults to peak in the first half of 2021 as early energy-related failures evolve into leisure and business services sector defaults. The multistage recovery should benefit cyclical sectors through 2021 but likely leaves leisure-related segments and the business services sector at risk through the year.

We forecast global speculative-grade defaults rise to 8-10% on a trailing 12-month basis in our base case scenario. Domestically we expect U.S. defaults to top 10%. Defaults likely peak in the first half as companies capitulate after the year-end demand surge. We continue to see the lower rating quality of leveraged loans as an indication the sector may be as vulnerable. We expect high yield bonds to experience higher potential default rates and potentially lower recoveries than seen historically for the asset class.

Municipals – risk lags, recommend a selective approach

We believe investors should approach the municipal sector with tempered expectations, as continued credit challenges and compressed spreads will likely leave little room for upside in 2021. We see an opportunity for value in select sectors of the market, as we expect issuers with balance sheet strength and long-term viability to weather the near-term impact from Covid-19.

Through past recessions, credit deterioration in the municipal market has typically lagged the corporate bond market. We expect this trend to hold through our current crisis. State budgets are likely to remain under pressure through 2021 and into the following two years, which we expect to have knock-on effects for other issuers. Impacted revenue sectors will likely benefit from a continued economic recovery, but many may face a slower recovery and a more difficult financial position to address challenges that existed pre-COVID-19. These issues could take a while to unwind, and we expect defaults among investment-grade issuers to continue to be rare in 2021. However, the troubled areas in investment-grade will become more apparent through the year, resulting in further credit dispersion and an uptick in downgrades.
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Research and due diligence leader
Lyle B. Schonberger
Vice President

Business Unit Compliance Liaison
Jeff Carlson, CLU, ChFC
Sr Manager

Kimberly K. Shores
Investment Research Coordinator

Jillian Willis
Sr Administrative Assistant

Strategists

Chief Market Strategist
David M. Joy
Vice President

Global Market Strategist
Anthony M. Saglimbene
Vice President

Thomas Crandall, CFA, CMT, CAIA
Sr Director – Asset allocation

Cedric Buermann Jr., CFA
Analyst – Quantitative, Asset allocation

Gaurav Sawhney
Research Analyst

Amit Tiwari
Sr Research Associate

Chief Economist
Russell T. Price, CFA
Vice President

Manager research

Michael V. Jastrow, CFA
Vice President

Mark Phelps, CFA
Director – Multi-asset solutions

ETFs, CEFs, UIPs
Jeffrey R. Lindell, CFA
Director

James P. Johnson, CFA, CFP®
Sr Analyst

Alternatives
Justin E. Bell, CFA
Vice President – Quantitative research and alternatives

Kay S. Nachampassak
Director

Quantitative research
Kurt J. Merkle, CFA, CFP®, CAIA
Sr Director

Peter W. LaFontaine
Sr Analyst

David Hauge, CFA
Analyst

Blake Hockert
Sr Associate

Bishnu Dhar
Sr Research Analyst

Parveen Vedi
Sr Research Associate

Darakshan Ali
Research Process Trainee

Equities
Christine A. Pederson, CAIA, CIMA
Sr Director – Growth equity, infrastructure and REIT

Benjamin L. Becker, CFA
Director – International and global equity

Cynthia Tupy, CFA
Director – Value equity and equity income

Alex Zachman, CFA
Analyst – Core equity

Fixed income
Steven T. Pope, CFA, CFP®
Sr Director – Non-core fixed income

Douglas D. Noah, CFA
Sr Analyst – Core taxable and tax-exempt fixed income

Fixed income research and strategy
Brian M. Erickson, CFA
Vice President

Jon Kyle Cartwright
Sr Director – High yield and investment grade credit

Stephen Tufo
Director – High yield and investment grade credit

Retirement research
Jay C. Untiedt, CFA, CAIA, RICP
Vice President

Nidhi Khandelwal
Director

Matt Morgan
Sr Manager
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There are risks associated with fixed-income investments, including bond funds, such as credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer-term securities.

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Mortgage- and asset-backed securities are affected by interest rates, financial health of issuers/originators, creditworthiness of entities providing credit enhancements and the value of underlying assets.

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Cash Investments generally refer to assets, securities and/or products which are low in risk and highly liquid. These instruments can include Treasury bills, certificates of deposit, money market funds as well as high quality bonds whose maturities are less than 12 months. Cash investments can also include illiquid cash held in a mutual fund or pledged as collateral for derivatives. You can only access this cash by redeeming the fund using it, subject to fees or time constraints associated with redemptions.

Discount Margin is a yield-spread calculation designed to estimate the average expected return of a variable-rate security, usually a bond.

Market risk may affect a single issuer, sector of the economy, industry or the market as a whole.

Current Yield: Represents the current annual dividend divided by the current share price.

Yield to Call (YTC) is the yield of a bond or note if you were to buy and hold the security until the call date, but this yield is valid only if the security is called prior to maturity. The calculation of yield to call is based on the coupon rate, the length of time to the call date and the market price.

Yield to Maturity (YTM) is the total return anticipated on a bond if the bond is held until the end of its lifetime. Yield to maturity is expressed as an annual rate.

Yield to Worst (YTW) is the lowest potential yield that can be received on a bond without the issuer actually defaulting. The YTW is calculated by making worst-case scenario assumptions on the issue by calculating the return that would be received if the issuer uses provisions, including prepayments, calls or sinking funds.

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