FIXED INCOME COMMENTARY

January 5, 2021

“A Long December” - *Counting Crows*

Longer term bond yields crept higher in December as investors absorbed the favorable vaccine news which may mean a not-too-distant end to the pandemic. Still, many parts of the country struggled with spikes in hospitalizations and deaths, and many local officials placed tighter restrictions on various activities, all of which may have increased the pressure on Congress to pass another economic assistance package. Investors cheered this news and remain focused on the future. Yields on the front end of the Treasury curve (0-5yr) were lower by 1 to 3 basis points while yields further out (7yr+) were up by 7 to 8 basis points. In terms of performance, corporate, municipal, and mortgage-backed bonds performed better than Treasuries. Since Treasury bond yields are so low, many investors have clamored to invest in these sectors, and we expect more of the same in 2021.

Bond investors should also cheer the vaccine news since the improving prospects for the economy will be a welcome relief for all manner of bond issuers. The pandemic led to significant hits to cash flow generation for corporate and government entities. When cash flow is suddenly curtailed, the debt profile of borrowers becomes more risky. If the decline persists and proves significant, the rating agencies may take action such as assigning a negative outlook to bond ratings, placing the debt on review for downgrade, or foregoing these preliminary steps altogether and simply downgrading the bonds immediately.

In terms of our economic outlook for next year, we expect a materially higher growth rate for the broad economy assuming the vaccination effort continues unabated. The hardest-hit industries in 2020, most of which are in the service sector, will likely enjoy robust gains as consumers return to more normal patterns of behavior. We expect a gradual, though back-end loaded, return to “normal” will also allow the labor market to improve, although we do not expect the unemployment rate to reach the low of 3.5% set in 2019. We expect the residential construction market to register solid growth as well. Housing is an important industry with powerful trickle-down effects and is benefitting from rising demand, low mortgage rates, and tight supply.

Even though we start the new year with low prevailing yields, the US is fortunate that policymakers have not followed Japan and the EU by adopting negative official policy rates. As of December 14, a record $18.4 trillion in global debt is priced to yield less than zero, up from a five-year average of $10.3 trillion. Instead, the US fed funds rate is at the zero bound as it was from late 2008 to early 2016. The major difference between now and then is the Fed’s new average inflation targeting policy which will now tolerate higher inflation (to a point) in order to achieve the

KEY TAKEAWAYS

Yields on the back end of the curve saw a bump up in rates as investors absorbed favorable vaccine news. Looking into 2021, bond investors will continue to watch the pace of economic recovery. While there is light at the end of the pandemic tunnel, there are still a number of potential issues from the pandemic response, such as excess leverage, at the corporate and government levels, that must be watched.

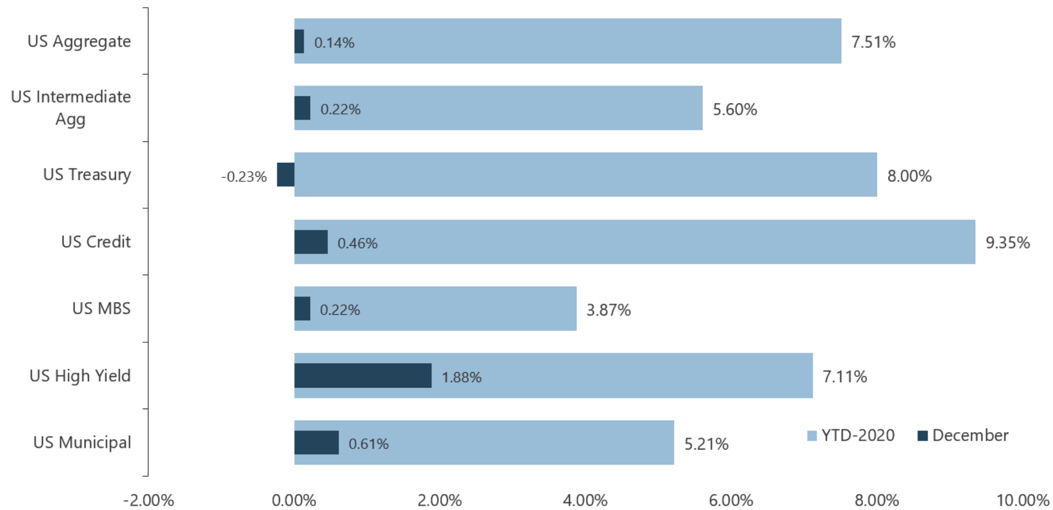
Key Rates (%)	Dec 31 2020	Nov 30 2020	Dec 31 2019
Treasury Yields			
2 Year	0.12	0.15	1.57
5 Year	0.36	0.36	1.69
10 Year	0.91	0.84	1.92
30 Year	1.64	1.57	2.39
Credit Yields			
BBB Industrial 10 Year	1.80	1.83	3.10
Muni Yields			
AAA 10 Year	0.69	0.71	1.48
Mortgage Backed Securities			
30 Year FNMA Current Coupon	1.34	1.33	2.71

DECEMBER IN REVIEW

- The 10- year Treasury yield finished the month with a yield of 0.91%, up 7bps on the month.
- Credit finished the month higher, +0.46%.
- Treasuries were weak on the month on the bump up in rates in the back end of the curve, -0.23% total return.

desired 2% average. This means the zero fed funds rate will likely be with us for longer since the Fed will not be raising rates at the first sign of inflation. By tolerating a higher rate of inflation, the Fed will effectively be letting the economy run "hot" for longer than it would have in the past, and this means short term bond yields will likely stay lower for longer too. This development will no doubt give rise to some inflation worries. Our view is that inflation measures will creep a bit higher in 2021 due to some transitory factors, but we do not expect runaway inflation to develop. The Fed would welcome higher inflation since they and all the other developed market central banks have been unsuccessful in this realm for some time, and deflationary trends remain solidly in place across most of the world. We would advise not to worry if the inflation bears start to get louder on TV and to change the channel to issues that do deserve some thought.

EXHIBIT 1: Fixed Income Market Total Returns



Source: Bloomberg Financial L.P. and Barclays Securities

When financial conditions become very loose and the cost to borrow is extremely low, the danger is that too much leverage will build up in the system and capital will be mis-allocated. If and when another economic downturn occurs, financial conditions can tighten quickly, and excess leverage can cause companies (or government entities) to find it difficult to meet their fixed obligations or roll over their debt on favorable terms. Many examples can be cited throughout history, but industries exposed to sudden technological change, commodity price changes, or foreign competition have often been the most impacted.

Also of concern is the vast amount of debt that's been issued by government and business alike, mostly to deal with the pandemic but also due to the recent federal tax cut as well as a very active pace of debt-financed mergers and acquisitions. Since the cash flow generation of many borrowers has been reduced, it is more important than ever for borrowers to get serious about reducing debt and improving their balance sheets. At the risk of repeating ourselves, we still believe this set of facts calls for caution and selectivity when investing in bonds.

These are our chief concerns at this time, and we remain of the belief that bonds can still provide an important risk-mitigating role while generating income and serving as a store of value or a source of liquidity if needed. If equity returns begin to falter, bonds should hold up reasonably well and provide the desired ballast to a diversified investment portfolio.

We wish you all a safe, healthy, and prosperous year in 2021 and we remain humbled and grateful to play a role in your financial strategies.

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