Fixed Income Outlook

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CONGRESS ASSET MANAGEMENT COMPANY

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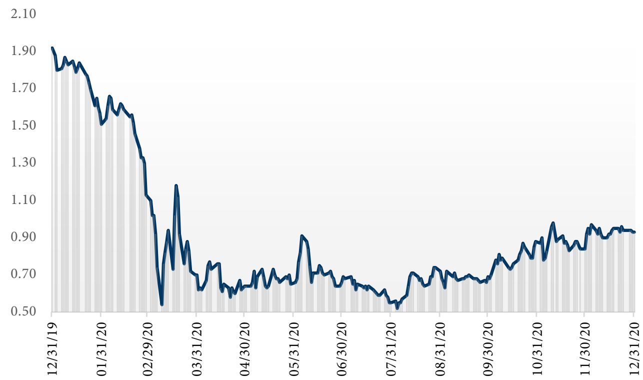
This past year was not one any of us could have imagined. The global pandemic has upturned life as we know it, forcing everyone to change their lifestyle and daily outlook. At this time last year, we were worried about tariffs and counter tariffs on international goods, slack economies in Europe and Japan, and low single digit GDP growth domestically. Now we are focused on vaccine rollouts, a change in domestic leadership, and markets that seem disconnected from the day-to-day realities of our COVID-19 impacted economy.

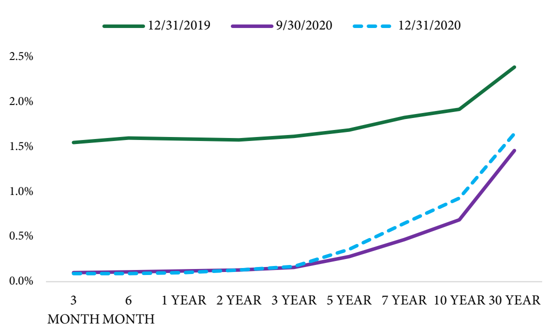
Figure 1. **US Treasury 10 Year Note Yield 2020**



Source: FactSet

Interest rates have remained historically low, anchored by the Federal Reserve's (the Fed) steadfast commitment to maintain maximum liquidity and access to capital. The very low federal funds rate, set by the central bank, has been at essentially zero since March and will remain there for some time to come. Longer-term interest rates, set by the market, are also low and have been largely unchanged as we progressed through the year. Changes from quarter to quarter have been minimal, reflecting the expectations of no changes to the short end of the curve and little inflation in the future.

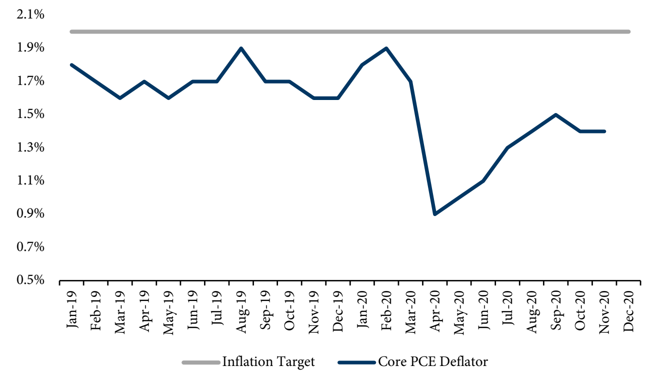
Figure 2. **US Treasury Yield Curve** at 12/31//2019, 9/30/2020 & 12/31/2020



Source: FactSet

Domestic growth has slowly recovered from the shocks administered by regional officials as they moved their states and communities into and out of various forms of lockdown, such as stay at home or shelter in place orders. Over the year, GDP growth has been uneven as COVID-19 hot spots have flared up in different areas, causing rolling restrictions and closures. Thankfully, we now have a better grasp of how the virus is transmitted and this knowledge has allowed some states to enact milder restrictions than seen earlier in the year. These less intensive measures have a smaller dampening effect, supporting better growth in the broader economy.

Figure 3 **Core PCE Deflator** Monthly figures



Source: FactSet

Inflation measures were quite tame before the pandemic and, with slower domestic growth, they are highly unlikely to grow in the coming months or quarters. The slow recovery combined with the Fed's assurances that rates will remain low for quite some time has bolstered the opinion that inflation will be minimal going forward. As a consequence, this has translated into a very flat U.S. Treasury yield curve.

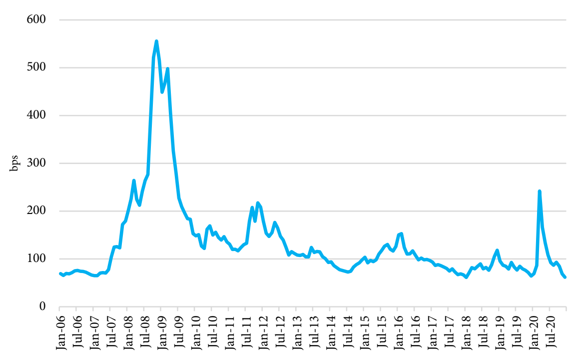
The Fed has been a force in the marketplace in 2020. First came the immediate support via monetary policy in the form of interest rate cuts. Then came a slate of programs designed to assist with access to capital that targeted a wide array of borrowers, from individuals to corporations to municipalities. The final assist was a change to their method of inflation targeting. The previous target had been a static 2% bogey, which was altered to an average of 2% over time, ultimately giving the Fed more flexibility as to future interest rate moves. These three pillars of support provided the fixed income markets with confidence and the equity markets the optimism that a future recovery could be achieved.

The upside to the Fed's combined actions was an immediate stop to the market backslides in March. Investors viewed these measures as not just calming but constituting a "rescue" of heavily indebted, over-leveraged borrowers. Indeed, the Fed's new policies supported the most troubled industries and companies, short circuiting the normal relationship between risk and return. We have been, and still are, critical of these bailouts and are concerned that they may lead to unintended consequences in the future.

The cumulative effects of these efforts can be felt beyond the markets. Low interest rates have further spurred an already healthy housing market by enticing new home buyers with cheap financing, prodding the sector into even stronger territory. The same can be said for other durable goods such as automobiles, recreational vehicles, and boats. Further, the Fed's efforts are assisting an array of corporations to adjust to the new environment, offering opportunities to refinance existing debt or to borrow anew.

A more direct, knock-on effect has been the resurgence of risky assets in the marketplace. Initially shunned in March, low quality assets across multiple marketplaces staged a remarkable recovery as the year moved along. For example, High Yield bonds have seen a rally from their March lows as the year progressed. High beta, low-quality stocks, too, have recovered. This support has so influenced investors that they are more willing today to take on more risk knowing that the Fed is there to support, and perhaps even enrich, floundering businesses and industries.

Figure 4. **Intermediate Investment Grade Credit Spreads 2006-2020**



Source: Bloomberg Barclays

Credit spreads, or the additional yield investors require to compensate for default risk, have recovered steadily since hitting their March highs. In fact, they eclipsed their lows and are now smaller than where they ended in 2019, which we attribute to three factors. First, the low yields on U.S. Treasuries have sent investors looking for better yields in Corporate bonds. Second, the Fed's assurances have lessened the possibility of default, thereby compressing spreads. Third, the negative interest rate environment abroad has clearly propelled investors to the U.S. markets as they offer positive yields with excellent credit quality.

Turning to performance over the fourth quarter, we note that Corporate bonds saw a resurgence and outperformed U.S. Government-guaranteed issues handily. This should not be a surprise as spreads shrank and the yield curve was relatively unchanged. The late surge by Corporate bonds also pushed them to the top of the leaderboard for calendar year performance, just edging out U.S. Treasuries for best performing market segment within our primary benchmark. A rally in low-rated issues were the main driver in Corporate performance for both the quarter and the full year.

When attempting to look ahead we cannot forget the unexpected year behind us. In some ways making predictions seems foolish after the year 2020, but we do have some sincere forecasts. We expect the Fed to remain in full accommodative mode for the upcoming year, meaning rates will remain low and its support programs will continue as they are today. This extrapolates into a continued environment of low rates and a relatively flat yield curve. If there is any movement along the curve, we would expect some volatility at the long end but, even then, this should be mild given low inflation expectations.

One thing that remains a constant for us is the unwavering belief that high quality, investment-grade bonds should be an integral part of every investor's asset allocation. These bonds provide the income, stability, and security that allow for more risky investments (e.g., equities, high yield, international, etc.) to be made with the assurance that not every penny is on the line in one basket. Investors must make certain that there is a level of comfort and a margin of safety in their aggregate portfolios. In short, all investors need bonds in their portfolios, but they need the right kinds. Low quality and high-risk issues are not appropriate venues in which one should seek haven, a truth that should have been made evident back in the first quarter of the year. We most strongly advise investors to seek out high quality bonds utilized within a stable, proven strategy such as those we provide to our clients.

We hope that you all remain safe and healthy.

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