Fixed Income Outlook

John Beaver, CFA | Jeffrey R. Porter, CFA

Second Quarter 2021

Optimism surrounding the potential end to the pandemic played out in the financial markets in the first quarter. Equities roared while fixed income markets sagged. The yield curve steepened as investors fretted over the potential for rapidly growing inflation. At the same time, credit markets have remained sanguine, reflecting the rosy prospects for corporate bond issuers even as they massage their balance sheets. Both of these bond market impacts stemmed from the expected state of a quickly growing, post-pandemic economy.

In response to the pandemic and forced closures of different parts of the economy, the Federal Reserve (the Fed) has maintained an enormous amount of monetary stimulus. This has been achieved by keeping short-term rates low, creating funding programs to boost liquidity in multiple market niches, as well as outright purchases of securities in the open market. The Fed's actions comprise the most sweeping and comprehensive of all monetary stimulus plans ever instituted by the central bank.

In tandem with this monetary policy, Congress has enacted yet another fiscal stimulus package. This $1.9 trillion stimulus package will be rolled out over time, spreading the payout across future years. It is the fifth such stimulus package, bringing the two-year total to $5.1 trillion in funds dedicated to sustaining the economy through the pandemic. This figure dwarfs past fiscal stimulus measures, including those enacted during the great financial crisis a decade ago.

Given the immense amount of monetary and fiscal stimulus, investors expect a fast economic bounce back from pandemic related slowdowns and lockdowns, which could then spur inflation if growth is rapid enough. Add in the Federal Reserve's pledge to keep monetary policy loose for the foreseeable future and investors can clearly see an open-ended set of policies in place.

Figure 1 **US Treasury Yield Curve at Year End 2020 & Q1 2021**

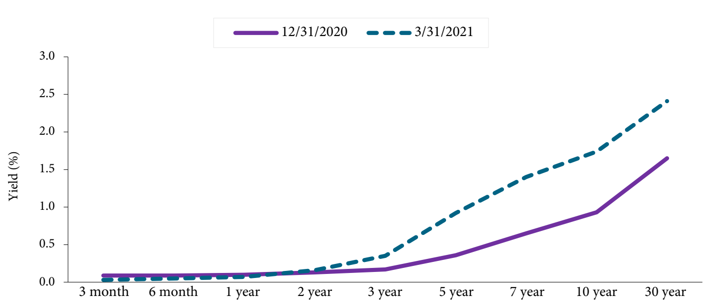

Figure 1 U.S. Treasury Yield Curve Source: FactSet

News of positive progress with COVID-19 vaccines plus the announcement of the most recent stimulus propelled action in the markets. The long end of the U.S. Treasury yield curve sold off, including a rise of over 80 basis points in the 10-year bond yield. This move pushed the 10-year yield to almost 1.75% in a curve move described as a "bear steepener" by market participants. As a knock-on, some areas of the stock market where valuations are tied to future growth were down as the higher rates negatively impacted the discounting of that growth.

We expect to see continued volatility in long term interest rates for some time to come. The Fed has anchored short-term rates for what will be an essentially indefinite period, leaving investors to speculate on the pace and amount of inflation that will creep into the economy. So far, inflation measures have been benign, albeit with some noise in food and fuel prices, which are notoriously volatile over short periods of time.

Figure 2 **Inflation measures PCE Deflator and Core PCS Deflator**

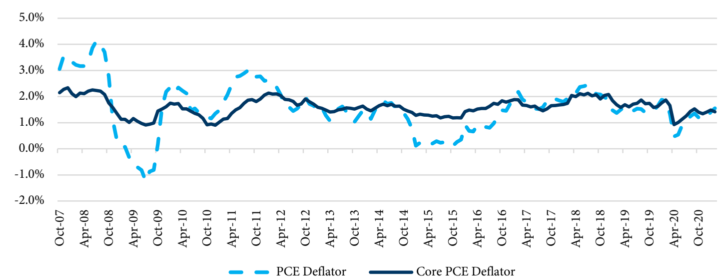

Figure 2 Inflation measures PCE Deflator and Core PCS Deflator Source: FactSet

Credit spreads, or the additional yield investors require to compensate for default risk, remain narrow and had little movement over the quarter. The Fed's liquidity support programs and monetary policy continue to abet these thin risk premiums. These supports have reduced default risk and the low interest rate environment has pushed investors into more risky assets. The narrow spreads are not lost on the chief financial officers who oversee company balance sheets. We have seen wave after wave of refinancing sprees and liability management, most notably in the investment grade markets.

Figure 3 **Intermediate Corporate Bond Spreads by Credit Quality**

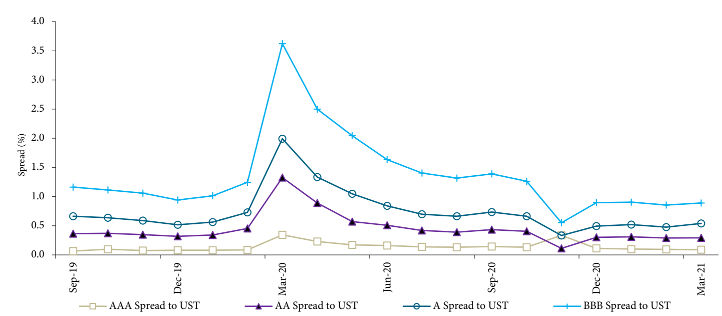

Figure 3 Intermediate Credit Spreads Broken Out by Quality Cohort Source: Bloomberg Barclays

Fixed income investors have shown a ravenous appetite for new issues. Verizon Communications recently brought a 9-part, upsized $25 billion bond deal that saw over $100 billion in orders, making the deal massively oversubscribed. This particular deal clearly highlights the immense investor desire for high quality paper. The great thirst shown by investors has allowed companies to issue new, cheap debt in order to add additional leverage or for replacing outstanding issues that are retired.

Performance for the quarter was impacted by stationary spread levels and rising interest rates. These two effects led to a modest down quarter for intermediate maturity fixed income issues, the first negative return quarter since the first quarter of 2018. Longer maturity issues were harder hit than short-term issues due to the disproportionate upward shift in longer rates. All of our intermediate index sector returns were negative with U.S. Treasuries slightly outperforming Corporate issues.

Looking ahead, we expect to see continued volatility for the long end of the curve. Corporate spreads will likely remain narrow as the thirst for yield will continue while interest rates are low. The speed of the economic recovery is much more of a wildcard given the uncertainty over the curtailment of the pandemic. Economic data appears promising so far, but there remain questions about the sustainability of the pace and breadth of the improvements. This uncertainty will permit the Fed to keep short-term rates low for quite some time.

We continue to invest our clients' portfolios in high quality, investment-grade bonds. Our commitment to maintaining these high standards should allow our clients to avoid disruptions should any of the positive trends reverse. Chasing higher yields in this market environment may be fraught with more risk than expected. We strongly advise investors to seek a stable, proven strategy such as the one we provide when it comes to their fixed income investments,

We hope that you all remain safe and healthy.

CONGRESS ASSET
MANAGEMENT COMPANY

Two Seaport Lane ▪ Boston, MA 02210 ▪ 800.234.4516 ▪ www.congressasset.com