CONGRESS ASSET MANAGEMENT COMPANY

# Fixed Income Outlook

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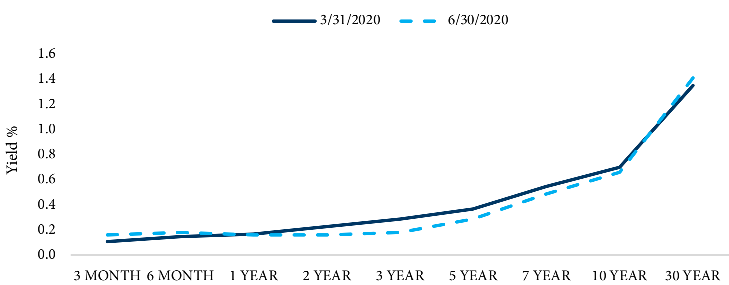
## Third Quarter 2020

As we view the fixed income landscape, it is apparent that the U.S. is fully engaged in its battle against the COVID-19 pandemic. Interest rates are near all-time lows and are expected to stay low for some time. Credit spreads continue to show heightened concerns over the health of corporations, most notably for lower quality issuers. Economic data points that we rely on to assess our country's overall fiscal and monetary health remain expectedly dour. All of these factors are requiring investors to maintain a long-term outlook and to embrace the optimism that a recovery will happen. We are certain of a recovery ahead, albeit with an open-ended time frame and an uneven adjustment period for us all.

After the Federal Reserve jumped into action in Q1, the short end of the yield curve has been essentially fixed in place. Short-term yields have hovered around 15 basis points of late, mirroring the very low effective federal funds rate that is controlled by the FOMC. Given the repeated rhetoric of the Federal Reserve as to its dogged intent to keep rates low for a long time, this situation should not be unsurprising. Movement further out on the maturity spectrum was muted over the quarter, as there were no meaningful changes to the shape of the yield curve.

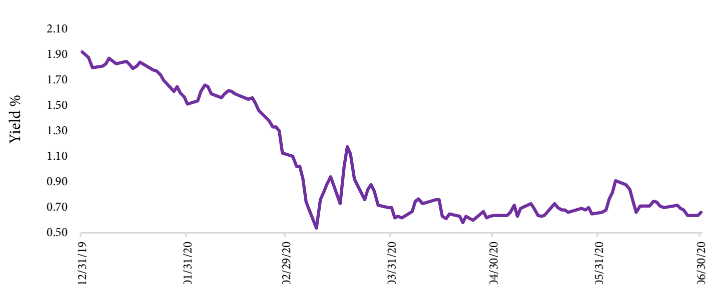
*Figure 1* **US Treasury Yield Curve** at 3/31/2020 & 6/30/2020




Source: FactSet

Looking more closely at longer term interest rates, all of the action happened in the first quarter of the year. Longer yields quickly came down as the pandemic spread to the U.S. and states began to close down their economies to combat its presence. Inflation was tame before the closures and now is even more subdued as our collective economic output has dwindled. With no risk of inflation, investors see less risk when purchasing long maturity paper, thereby pushing down yields.

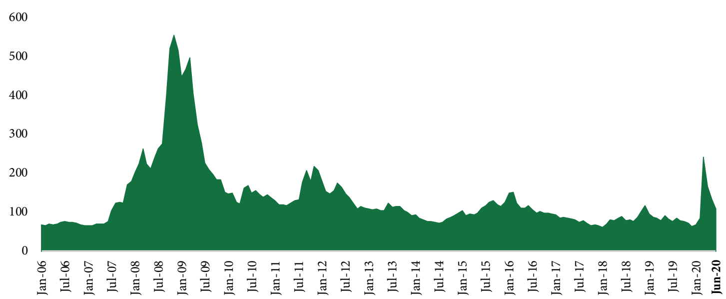
*Figure 2* **U.S. Treasury 10-Year Note Yield** 12/31/2019 - 6/30/2020




Source: FactSet

Corporate bonds have also been impacted by the FOMC. For the first time in history, the Fed purchased Corporate bonds outright in the marketplace as one component of its liquidity facilities. It has also been indirectly purchasing bonds by buying shares in ETFs that own corporate bonds. While the dollar amount spent pales in comparison to the overall size of the Corporate bond market, the program has undoubtedly impacted the psychology of the marketplace. Credit spreads, or the additional yield investors require to compensate for default risk, have shrunk since the announcement and subsequent initiation of the program. However, they remain well off of their best levels, highlighting increased default and liquidity fears.

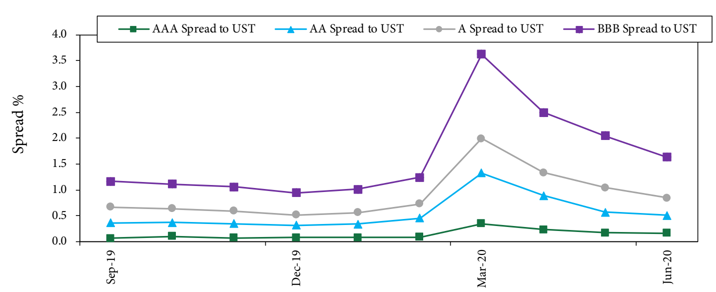
*Figure 3* **Intermediate Credit Spread** January 2006 - June 2020
**Monthly Obervations** *(in bps)*




Sources: FactSet, Bloomberg Barclays Intermediate Credit Index

Diving deeper into Corporate bonds, we have noted how credit spreads can vary widely across credit quality cohorts. Lower quality bonds typically underperform when the economy and the bond market come under stress and this year has been no exception. Investors were quick to sell bonds that had a higher risk of default as the economy slowed, pushing spreads upwards. The higher yields of these low-quality bonds do not come without risk and are typically the first securities sold in down markets. Elevated credit spreads persist despite the modest improvement over the quarter.

*Figure 4* **Intermediate Corporate Bond Spreads by Credit Quality** 2006-2020




Source: Bloomberg Barclays

Volatility ebbed in fixed income markets as the quarter progressed, buoyed by reports of a slowing spread of the COVID-19 virus. This was buttressed by several states moving to re-open their economies. One cannot blame investors for being optimistic, yet economic data points have not improved significantly. Unemployment remains very high and GDP continues to contract. We expect these figures to remain weak until a wider swath of the country can return to more normal working conditions.

The underlying domestic economy prior to the pandemic's arrival was quite robust. Current softness can be tied to precautionary actions taken by federal, state, and local governments as well as fallout from similar actions in foreign countries. This does suggest that a recovery, perhaps a partial one if not an encompassing one, is possible as these steps are unwound. Individual workers, small entrepreneurs, and large businesses alike are seeking to restart and return to business as usual. It is this very dogged commitment to work that provides our expectations of America's comeback.

Optimism was evident in the performance data for the second quarter of 2020 as Corporate bonds came out on top. Lower quality issues came back strongly after being the "last place finisher" in the first quarter. Investors shrugged off default fears and sought higher yields born from wide credit spreads. U.S. Treasuries showed positive returns but were heavy underdogs compared to the strength seen in Corporate issues. U.S. Government-backed and Corporate bonds had positive returns for the quarter as yields were relatively stationary.

We are not forgetful of the volatility seen in the first quarter of the year. Year-to-date performance metrics still show U.S. Treasury issues as unambiguous winners due to the flight to quality that began as the pandemic spread to North America. Corporate bonds have gained back some of their ground in the current quarter but have not fully bridged the gap to Treasury issues. As such, we have left our portfolio allocation between U.S. Treasuries and Corporate bonds unchanged with our clients' portfolios at roughly a 50%/50% mix.

We are pleased as we look backwards at performance and we look forward with regard to portfolio positioning. Investors who know us well appreciate our commitment to our long-term fixed income strategies. We continue to favor a well-diversified, liquid, and high-quality portfolio of bonds for our clients.

Please continue to be safe and healthy as we navigate through these times together.

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