CONGRESS ASSET MANAGEMENT COMPANY

Fixed Income Outlook

John Beaver, CFA | Jeffrey R. Porter, CFA

Fourth Quarter 2020

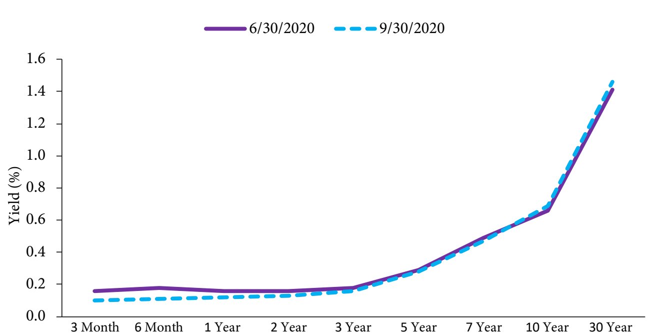
While stocks have frantically rallied since March, bond yields have remained stationary and steadfastly low. Economic data has slowly and unevenly improved as the U.S. economy continues to seek firm footing. The outlook for the economy is as uncertain as the timetable for resolution to the global pandemic, as we have seen some COVID-19 clusters appear domestically and internationally. This uncertainty is heightened by what has been a contentious and divisive run up to the presidential election in November. Given all of this, we expect interest rates to remain low for some time.

This past quarter the Federal Reserve reinforced their desire to keep interest rates low with new measures to assist them in shaping monetary policy. The most critical of these is a shift in the method of inflation targeting. The previous target had been a static 2% target, which has now been altered to an average of 2% over time. A subtle change, but the shift will allow the Fed to keep rates low long after inflation rises above 2%, removing an impediment to maintaining monetary stimulus as the economy recovers.

The Federal Reserve remains active in the capital markets by purchasing securities and ETFs in the open market. Examples of these purchases include U.S. Treasuries, mortgage bonds, corporate bonds, and ETFs that hold corporate bonds. While the absolute dollar amount of purchases is large, the size of these purchases relative to the size of their markets has been small. Nevertheless, the Fed's efforts have had a stabilizing effect on these various corners of the bond market.

Reviewing the impacts of the Fed's collective actions on the markets reveals a status quo environment. Interest rates across the U.S. Treasury yield curve were essentially unchanged over the quarter. Rates remain low, anchored by a federal funds rate that hovers around 10 basis points. There have been few developments that would cause a shift either upwards or downwards in yields and none are expected given the current economic environment.

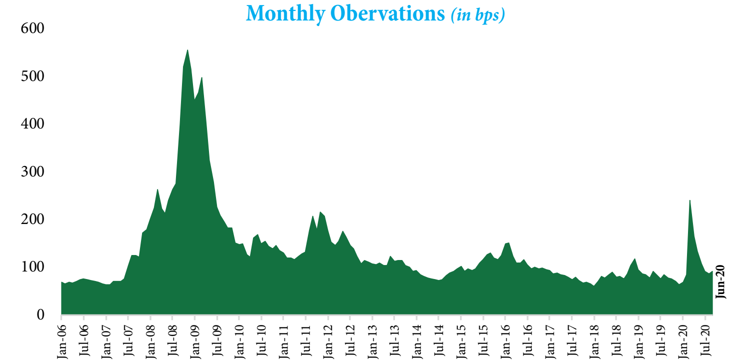
Figure 1 **US Treasury Yield Curve** at 6/30/2020 & 9/30/2020



Source: FactSet

Turning to the economy, inflation remains quite tame and will remain so until the economy recovers fully. GDP and unemployment continue to show signs of recovery but are clearly off of their pre-2020 levels. A bright spot remains housing, with both new and existing home sales showing repeated strength over time. Demand has been notably strong. Buoyed by low mortgage rates and a flight out of cities, housing inventories are low, helping to push up prices.

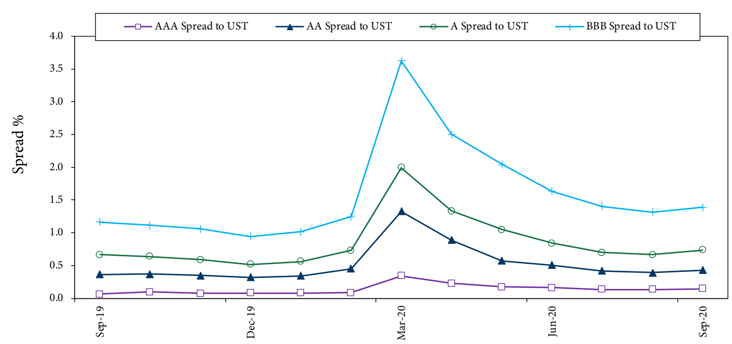
Figure 2 **Intermediate Credit Spread** January 2006 - September 2020
Monthly Obervations *(in bps)*



Sources: FactSet, Bloomberg Barclays Intermediate Credit Index

Corporate bonds have been very strong since March. Credit spreads, or the additional yield investors require to compensate for default risk, initially widened in March then narrowed. Lower quality issues saw the most volatility as spreads gyrated out and back. They remain wider than their pre-pandemic lows but are still historically narrow. There are some residual fears of default and liquidity problems in that lower quality cohort.

Figure 3 **Intermediate Corporate Bond Spreads by Credit Quality** 2006-2020



Source: Bloomberg Barclays

Smaller credit spreads have seen an accompanying rush by corporations to the new issue market. Many are seeking to refinance existing high coupon debt to lock in savings on their interest expenses. Others are looking to term out shorter maturity debt taken on during early stages of the pandemic when they were seeking immediate liquidity as business came to a halt. Year to date investment grade corporate bond issuance through the end of the third quarter was over an astounding $1.5 trillion. The market's seemingly unending thirst for new issues has been remarkable.

With interest rates holding steady and credit spreads narrowing, it should not be a surprise that Corporate bonds were the top performer for the quarter. Yet again, lower quality issues were far ahead of higher quality issues. This same dynamic applied to both investment grade and high yield issues, showing that investors are exhibiting a diminishing fear of default risk. Returns remain positive but if the yield curve were to shift upwards, then performance could turn negative.

In general, the bond market appears to be on stable footing with little impetus for change. Economic data continues to evolve as the U.S. grapples with the COVID-19 pandemic, cautiously emerging from lockdown conditions in many parts of the country. The Federal Reserve's policies are highly unlikely to change until the economic picture becomes more robust. Interest rates will remain low and credit spreads will remain narrow into 2021 barring some unforeseen circumstance. We continue to purchase liquid and high-quality bonds for our clients' portfolios. In these unprecedented days we remain committed to our long-term fixed income strategies.

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