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Investment Grade Fixed Income | Markets and Economy

U.S. fixed-income market: Optimism and pressure

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Boston - U.S. financial markets posted broad gains in the fourth quarter of 2020, adding to positive returns from the second and third quarters of the year. In many respects, and surprisingly, the markets ended the year much like they had begun, with U.S. equity markets trading at record highs, and credit spreads on investment-grade and high-yield U.S. corporate bonds narrow by historical standards.

Looking forward, potential fiscal support and the availability of COVID-19 vaccines pave the way for a sustained reopening of U.S. and global economies and, in turn, a broader and stronger cyclical recovery. As the U.S. recovery gains traction, we think unemployment will gradually fall, the consumer will recover further and the economy will begin to slowly wean itself off of policy support.

The first several months of 2021 could be challenging due to renewed virus restrictions in many parts of the world and the logistical challenges of inoculating a large percentage of the population. But overall, we believe 2021 will be a much better year than 2020 from a macroeconomic standpoint.

"Although we are seeing improvement in global economies, we also believe the U.S. fixed-income market could face some total return headwinds in 2021, so security selection will be key."

Fed support fuels issuance

The Fed's support of the bond markets fueled record levels of investment-grade and high-yield issuance in 2020. Gross leverage increased as result; however, net leverage did not rise at the same rate due to the record amount of cash sitting on balance sheets. Coupon rates fell and durations extended during the year, not only because companies issued longer-term debt but because they tendered for their front-end debt. The Bloomberg Barclays U.S. Corporate Investment Grade Index started 2020 with a 4.01% coupon and 7.9-year duration. It ended the year with a coupon and duration of 3.76% and 8.8 years. We see this trend continuing in early 2021, with downward pressure on coupon rates and extended durations, until rates likely rise on the long end of the curve in response to economic recovery.

Market pressure points

Although we are seeing improvement in global economies, we also believe the U.S. fixed-income market could face some headwinds in 2021, mainly because of the starting point for credit spreads and interest rates. Spreads on higher-quality credits appear to have already priced in a considerable amount of economic optimism, especially considering that the easiest part of the recovery — the fast, initial rebound — is behind us. Interest rates are also compressed.

On the political front, the size and makeup of future fiscal stimulus is uncertain given Democrats' narrow margins in Congress and the possibility for centrist Democrats to break party ranks. Nonetheless, we believe faster economic growth and U.S. dollar weakness will drive inflation expectations higher, putting upward pressure on longer-term rates.

With this in mind, we are making some adjustment to our strategies with shortened interest-rate duration and a move away from consumer-loan exposure toward clean energy asset-backed securities. We also continue to broadly favor U.S. agency commercial-mortgage-backed securities (CMBS), which offer beneficial environmental impact and attractive spreads relative to high-quality corporates, as well as select opportunities in non-agency CMBS.

Our positioning reflects our view that the U.S. recovery will strengthen in 2021, but that opportunities in the U.S. fixed-income markets may be harder to come by given the big move in markets since March. However, while broad beta moves may be over, opportunities still exist. The recovery has been uneven and there are sectors and issuers that we believe represent overlooked value. We are confident that our active investment process and focus on security selection will help us identify them for the portfolios we manage.

Bottom line: On the whole, we expect to see ongoing, cyclical recovery in the global financial markets. In view of narrow spreads and compressed interest rates, fixed-income investment opportunities may be harder to come by, but we are confident our active investment process will help us identify them for the strategies we manage.

Index definition: Bloomberg Barclays U.S. Corporate Investment Grade Index is an unmanaged index of domestic investment-grade corporate bonds.

About risk: Investing involves risk including the risk of loss. An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to decline.