

IN BRIEF: The U.S. Fixed Income Markets, Performance, and Strategy

Through quantitative easing, the Fed continues to expand its balance sheet in efforts to stave off the struggling economy. The massive size and abrupt nature of the monetary injections during 2020 has sparked concerns of inflation. Personal consumption expenditures, a measure the Fed uses to gauge inflation, is at 1.3% as of December, over 1% below that of its latest peak back in 2006. Even with all the excess liquidity provided by the Fed, inflation remains subdued at 1.4%. Last year the Fed shifted its target inflation from 2% to an average of 2% which will allow the bank to keep rates lower for longer. The expansive monetary policy coupled with the anticipated additional fiscal aid set the table for inflationary pressure in the future. Fixed income portfolios positioned with short duration securities are best suited to take advantage of higher yields when they become available in the future.

According to a recent study done by Goldman Sachs, U.S. equities have seen outflows for six consecutive years, in contrast to massive inflows preceding the tech bubble in 2000. They indicate that there has been a \$3.2 trillion difference between global equity outflows and cash/bond inflows since 2019. With that as a backdrop, improving macroeconomic and corporate profits appear to be the more important ultimate driver of market returns.

Year to date, bonds advanced 5.6%, as denoted by the Merrill Lynch Domestic Master 1–10-year index. Stocks continued to outperform as low bond yields fueled the risk-on trade. Corporate bonds soared in tandem narrowing spreads against the U.S. treasury. Municipals, pinched by tightened state and local governments, had only modest returns, while higher yielding issues enjoyed heftier returns.

EXHIBIT I

Fixed Income Sector Performance – Q4 2020

	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing 12m TR
Treasury (Intermediate)	Aaa/AAA	3.99	3.8	0.31%	N/A	\$105.29	5.65%
Agency	Aaa/AA+	3.89	3.03	0.40%	0.09%	\$106.12	4.22%
MBS	Aaa/AAA	3.32	3.19	0.84%	0.53%	\$106.94	4.09%
Municipal	Aa3/A+	4.75	3.47	0.46%	0.15%	\$115.26	3.82%
Corporate (Intermediate)	A2/A-	5.35	5.83	0.88%	0.57%	\$110.24	9.28%
High Yield	B1/B	6.43	3.26	4.21%	3.90%	\$104.61	6.17%

Source: Altman Investment Management Research and Bloomberg

The lower interest rate environment limits the near-term upside potential for bonds, as the risk-on trade is anticipated to continue alongside the economic recovery. Consequently, the best opportunities lie within select high quality corporate bonds as opposed to treasuries. Based on the expectation that interest rates will rise accordingly, portfolios positioned with a very low duration and in some cases cash reserves, provides the opportunity to buy bonds at higher rates in the future providing a hedge against frothy equity markets at some point.

We also believe an overweight cash buffer is warranted, both to add stability to portfolios and to allow for re-positioning down the road as the global growth upturn solidifies. The sharp rise in bond yields with additional upside down the road underscores that the investment climate will become more challenging following the reflation-fueled rebound of the past year.

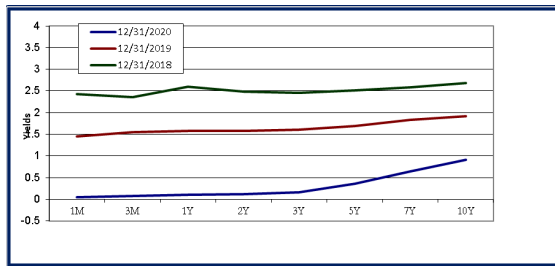
Sector Close up:

➤ **Government Bonds**

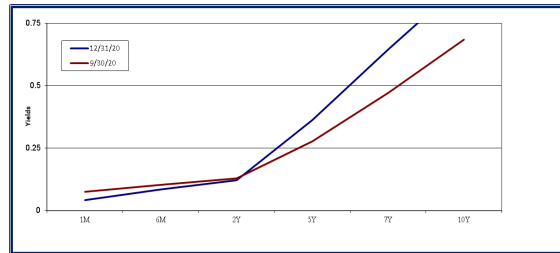
As the economy recovers with the backing of Fed policy, forward sentiment should improve. As it does, the optimism should push yields higher. The liquidity injection of \$2.4 trillion into treasury and agency securities by the Fed throughout 2020 pressured yields at the shorter end of the curve lower. The 3-month treasury bill yield fell by 2 basis points last quarter while the longer end rose 20, steepening the curve. As the Fed committed to keeping rates lower for longer, we anticipate this trend to continue for some time into the future. We expect that yields will rise in an economic recovery scenario, albeit likely in waves than in an extension of the recent surge. We continue to underweight government bonds within fixed-income and balanced portfolios.

EXHIBIT II-III-IV

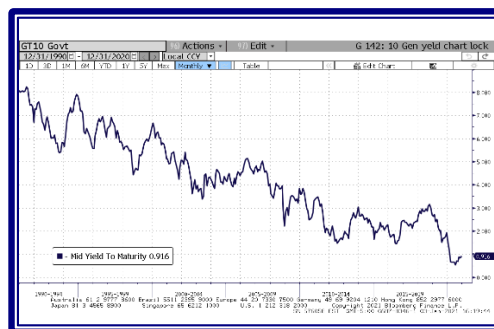
Long Term U.S. Treasury Yield Curve



The Short Term U.S. Treasury Yield Curve Has Steepened Since the End of Q3



The 10-Year Treasury Yield



Source: Bloomberg and Altman Investment Management Research

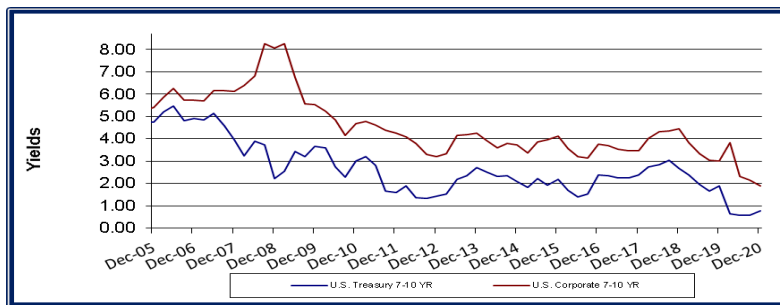
➤ Investment-Grade Corporate Bonds

Corporate bond yields have declined to 1.9%, further narrowing the spread over U.S. treasuries. In turn, over the past 12 months they have enjoyed total return of 9.3%. The spread does have some room to tighten from current levels, as investors' appetite for risk continues into 2021. However, yields of this level may encapsulate corporate bonds within a trading range offering little upside over the next few months. Higher quality corporates are our preference, as lower quality are more susceptible to the risks of additional debt issuance during a period of earnings weakness.

Corporate credit (and spread product more generally) continues to outperform similar-duration government bonds - and we continue to emphasize an overweight stance against a backdrop of improving corporate finances, as the economic recovery solidifies. However, relative valuations for both U.S. investment-grade (IG) and high-yield (HY) debt appear elevated, with spreads on each well below the average of the past 10 years and near the cycle lows of past expansions. Already very tight spreads and an expected further rise in U.S. treasury yields will most likely generate moderate losses for IG bonds and meager returns for HY bonds in absolute terms.

EXHIBIT V

Corporate Credit Spreads



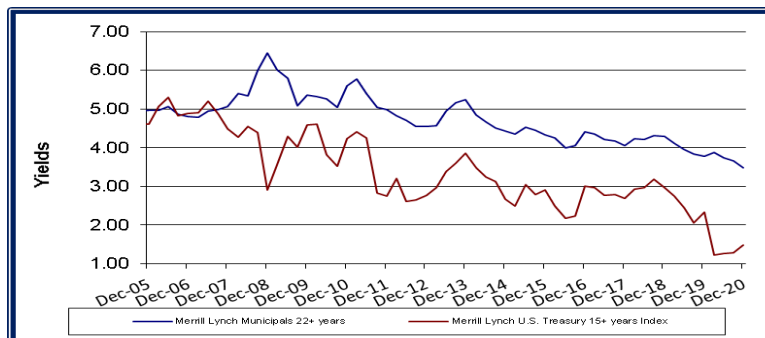
Source: Bloomberg and Altman Investment Management Research

➤ Municipal Bonds

Stabilizing municipal yields against falling treasury yields provide an opportunity for yield pick-up and long-term total return, as spreads revert to historical norms. Focusing on high quality in this area eliminates some expected volatility as states navigate the pandemic that is extending into 2021. Therefore, in municipals, we continue to emphasize high quality debt as the spread over treasuries remains elevated.

EXHIBIT VI

10-Year AAA Municipal Bond Spread Over 10-Year Treasury



Source: Bloomberg and Altman Investment Management Research

Recent Thoughts on the U.S. Bond Market Rout - March

It is important to emphasize that we believe interest rates will rise across the yield curve if the economic recovery is sustained. The Fed and other central banks will try to suppress interest rates via bond purchases and forward guidance for some time. However, deeply negative real interest rates, especially at the long end of yield curve, will eventually increase as the global economy improves, and rising demand for capital runs up against diminishing excess supply.

The threat of rising interest rates to risk assets depends on the former's speed, magnitude and timing. Yields have risen very rapidly so far this year, despite no change in central bank policy or rhetoric. This underscores the impact that momentum trading and extrapolation can have - even in a market dominated by the central banks, particularly when starting yields are so low.

Rapid changes in rates can be very troublesome to markets in the short run. However, we continue to believe that a U.S. 10-year treasury yielding 1.6% doesn't pose a threat to the health of the U.S. or global economy. Similarly, the recent rise in bond yields across Europe does not jeopardize the regional economy in any way.

The timing of the recent rise in yields is also not a particularly worrisome problem either. Economic growth is accelerating, as is corporate earnings growth, which are tailwinds for stocks, corporate bonds, and other growth-sensitive assets. Corporate bonds and equities generally run into trouble when interest rates are rising, and economic growth is slowing. The anomaly in the current environment is that while the economic and earnings cycles are in the early stages of an upswing, today's equity and corporate credit valuations are more consistent with the late stages of an economic expansion phase.

Upside for Bond Yields - and Threat to the Economic Recovery

Bond yields will rise materially further as the economic recovery progresses. There is no meaningful threat to the economic recovery at least until real bond yields are positive, although bouts of rising yields will cause "indigestion"/corrections in select risk asset prices.

At the outset, it is important to note that the rise in the U.S. 10-year treasury is signaling limited near-term upside for yields and/or increasing the probability of at least a modest decline. The latter is mitigated by the still very low level of current yields. The upside for treasury yields depends on the strength and durability of the economic recovery, investor demand for inflation compensation and Fed policy.

The real 10-year treasury yield is approximately -0.9%, not far above the lows of the past decade. The real rate rose sharply during the 2013 Taper Tantrum when the Fed signaled it would scale back its purchases of treasuries. Real yields subsequently moved into positive territory and peaked along with U.S. growth momentum in mid-2018. The Fed remains committed to purchasing \$80 billion per month of treasuries and \$40 billion of mortgage-backed securities which will continue to suppress treasury yields in the year ahead.

The debate about inflation will take center stage in the coming years - high unemployment and ongoing technology-related productivity gains will serve as anchors against the uncertain long-term impacts of the hyper-accommodative monetary and fiscal policies to combat the pandemic. It will also take time to assess any permanent damage of the pandemic to the supply-side capacity and thus reliably quantify the output gap that economists use to gauge inflation risks.

In the meantime, however, we expect investors to demand greater compensation for longer-term inflation uncertainty given the policy backdrop and monetary and fiscal starting points. As noted earlier, the economic recovery will not be threatened if real bond yields rise gradually toward zero in the year ahead. Our base-case scenario is that U.S. nominal GDP will rise on the order of 5-5.5% year over year in the fourth quarter of 2022. Such growth would significantly outpace that following the Great Recession and throughout the last expansion, when the 10-year treasury yield was materially higher than the current level. However, we believe that the 10-year yield will eventually settle at a level broadly consistent with expectations of potential GDP growth, which would still be markedly above the current level. We expect global bonds should exhibit similar trends, rising as the global economic recovery gains traction, albeit to varying degrees depending upon national/regional conditions.

IN SUMMARY:

In this environment, there is little appeal at the short end with historically low interest rates exposing risks to the long end. Looking ahead, we anticipate the challenging environment for bonds to continue. The lack of yield availability amongst government issues, leads us to recommend an investment portfolio with an emphasis on select U.S. investment grade credit with maturities less than 10 years.

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