# Logan Fixed Income



## LOGAN FIXED INCOME MARKET COMMENTARY
## Q4 | 2020 REVIEW

### MARKET ENVIRONMENT

Throughout the year, the economic downturn meant that bond yields fell and remained depressed as the pandemic gripped the economy. They have remained exceedingly low in response to exceptionally accommodative monetary conditions, the change in fiscal policy throughout the year, a surge in savings, and deeply negative output gaps.

Policymakers around the world are fearful of the consequences of removing accommodation too early but neither can they ease monetary policy much from here. Traders expect the Federal Reserve to quickly clamp down on any large and sustained increase in long-dated Treasury yields, which influence everything from mortgages to auto loans to borrowing costs for heavily indebted corporations. Some investors suggest the central bank will extend the weighted average maturity of the $80 billion in Treasuries it purchases each month. That's not quite yield-curve control in its purest form, but it effectively sends the same message: We won't tolerate a selloff.

Many economists caution against expectations of a longer-lasting acceleration in inflation, in large part because unemployment is expected to remain elevated throughout the next year. Shelter costs, which include rents and make up about a third of the CPI, are also expected to remain subdued. Measures of rents and owners' equivalent rent were unchanged for the first time since 2010.

Tame inflation has been a hallmark of the pandemic, as the coronavirus has curbed demand for services, which make up about 60% of the overall CPI and 75% of the core measure. Although market participants are increasingly projecting prices to pick up next year as demand increases for those industries most impacted by the coronavirus, we think any run-up in this measure will be temporary, as the softness seen during the spring of 2020 had eventually moderated by summer.

Inflation has been consistently running below the Federal Reserve's 2% goal, which is measured by the Commerce Department's Personal Consumption Expenditures Price index and is currently 1.4% on an annual basis (source: Bloomberg). The softness helps explain ultra-easy monetary policy from the Fed, which has signaled it plans to keep interest rates near zero through 2023.

The stronghold the Federal Reserve has over the domestic bond market is the latest example of how the Fed's outsized presence in markets, which began with the 2008 financial crisis and shows no signs of ending, is distorting traditional trading strategies. It's squelching volatility, adding fuel to a record-setting advance in stocks, leaving credit markets priced to perfection (more on this below), and curbing Treasury yields at levels that no longer fully reflect market sentiment or investors' belief in the economy.

Were it not for Fed policy makers frequently affirming that they'll do whatever it takes to bolster the economy – comments that accentuate the commitment they made this summer to tolerate higher inflation than they did in the past -- the 10-year Treasury yield would likely already have bounced back above 1%. Instead, the 10-year yield edged lower every time it's come close to that level since March, dragged down by traders worried the Fed could adjust its bond purchases in the near future. Policy makers have also said a hard cap on yields remains in their toolbox too.

## PORTFOLIO REVIEW

The combination of historically low bond yields over the spring and summer before gradually ascending during the final period of the year combined to produce returns hovering around zero. Within this environment, spread sectors outperformed government bonds on optimism over vaccines and the prospects for stronger economic growth in 2021. A majority of investors are looking ahead to more "normal" times, despite the current record surge in cases and hospitalizations due to COVID-19.

The 10-year U.S. Treasury rose 23 basis points during the quarter, from 0.684% to 0.913% (Bloomberg). The Federal Reserve's 0% interest rate policy should continue to hold short-term rates in check and lead to a further gradual steepening of the Treasury yield curve over the first half of 2021.

Credit spreads compressed further throughout the period, as they grind tighter toward pre-pandemic levels. Both technical as well as fundamental pressures have been observed as investors search for any security appearing "yieldy" aligns with the expected robust recovery in the year ahead.

We have gradually increased the corporate allocations from 2018 through most of 2020 where we could, to take advantage of spreads that had come off tight levels at the end of 2017. Technical pressures have caused spreads to compress this year to a current level we feel does not currently compensate investors adequately for the sector's risk and volatility. This key metric will be carefully assessed over the coming months, likely resulting in a lowering of the corporate bond allocation within client's portfolios.

The $3.9 trillion U.S. municipal bond market is on track to finish 2020 with strong returns marking the seventh straight year of gains and recording a tremendous rebound from a record selloff in March as fears about the pandemic's fiscal impact rattled investors.

The relative resilience of state & local government tax revenues during the pandemic means that the overall budget shortfalls facing those governments are likely to be smaller than many had feared. That reduces the downside risk of future state & local spending cuts weighing on the economy and supports our view that GDP growth will rebound markedly next year as coronavirus vaccines are rolled out.

We have observed that state & local governments were very quick to clamp down on spending and cut employment. Coming out of the last recession, Muni/Treasury yield ratio had almost fully recovered by the time that state & local government austerity began. A similar path was observed this year. Also, state budgets were in good shape heading into the COVID downturn, with all-time high Rainy Day fund balances.

## PORTFOLIO OUTLOOK

We would not be surprised if the Fed kept the funds rate at its current level for upwards of 3 years. Since the 2008 financial crisis, it kept its key rate at zero for approximately 7 years.

In 2020, the 10-yr yield averaged about 0.90%, and fluctuated between 1.88% (max) and 0.51% (min) (source: Bloomberg). We expect a small amount on upward pressure on rates due to progress on the vaccine, passage on additional fiscal stimulus, as well as potentially more QE from the Federal Reserve.

After record breaking issuance during 2020, we expect weaker gross issuance within the corporate sector. The technical impact will continue to contain spreads during the first half of 2021. Soon after, high debt levels, particularly among credits further down the quality spectrum, may pressure spreads wider towards long-term average levels.

Demand for both tax-free as well as taxable municipal bonds should continue to be strong in the coming year as yields for this sector slightly exceed comparable quality corporates. Also, with tax rates not expected to decrease in the intermediate time horizon, tax free income will be prized by investors.

This material represents an assessment of the market and economic environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. Forward-looking statements are subject to certain risks and uncertainties. Actual results, performance, or achievements may differ materially from those expressed or implied. Information is based on data gathered from what we believe are reliable sources. It is not guaranteed as to accuracy, does not purport to be complete and is not intended to be used as a primary basis for investment decisions. It should also not be construed as advice meeting the particular investment needs of any investor. Past performance does not guarantee future results.

| U.S. TREASURY YIELDS | 12/31/2019 | 3/31/2020 | 6/30/2020 | 9/30/2020 | 12/31/2020 | YTD Change |
|---|---|---|---|---|---|---|
| 2 YR | 1.569% | 0.246% | 0.149% | 0.127% | 0.121% | -1.448% |
| 3 YR | 1.609% | 0.293% | 0.173% | 0.157% | 0.165% | -1.444% |
| 5 YR | 1.691% | 0.380% | 0.288% | 0.277% | 0.361% | -1.330% |
| 7 YR | 1.831% | 0.541% | 0.491% | 0.470% | 0.643% | -1.188% |
| 10 YR | 1.917% | 0.669% | 0.656% | 0.684% | 0.913% | -1.004% |
| 20 YR | n/a | n/a | 1.174% | 1.224% | 1.440% | n/a |
| 30 YR | 2.390% | 1.321% | 1.411% | 1.455% | 1.645% | -0.745% |
| | | | | | | |
| 10S MINUS 2S | 34.8 bps | 42.3 bps | 50.7 bps | 55.7 bps | 79.2 bps | |

Source: Bloomberg

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