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Fixed Income 2021 Outlook

In the midst of a global pandemic, many traditional fixed income portfolios did not provide the expected diversification benefit. In March of 2020, bonds with government backing, like U.S. Treasuries, were some of the few sources of positive return in fixed income. High yield indices dropped by approximately 20% during the worst of the COVID-19 driven market rout. In late March, the Federal Reserve provided unprecedented liquidity into the fixed income markets. Between March and April, the Fed injected more than $3 trillion into the market, averting a painful experience for most fixed income investors. Investors that held longer duration fixed income strategies throughout 2020 enjoyed returns reaching north of 10%. Looking forward, we question the sustainability of these fixed income returns.

Barron's, The Financial Times, Kiplinger and others, have all written articles discussing the challenges surrounding the traditional 60/40 portfolio. The crux of most of these articles is that the "40" in 60/40 will no longer provide a sustainable, consistent yield, nor the steady values desired to offset volatility in equities. According to a research piece released by JPMorgan strategists in October, today's environment is "forcing adherents of the classic investing strategy of 60% stocks and 40% bonds to look further afield." They go on to state that U.S. fixed income investors are unlikely to earn much more than 3% per year over the next decade, appropriately phrasing it as a new "return crisis."

Why are so many pundits discussing the challenges around a traditional 60/40 portfolio? Essentially they are saying that fixed income's risk/return profile has changed, and it will no longer provide the traditional benefits to a balanced portfolio. Fixed income serves four key roles in a portfolio:

- Diversification
- Income
- Capital preservation
- Protection from deflation

Looking back over the last few decades, traditional fixed income has exceeded its goals. Inflation has trended lower since 1982 and as yields declined with it, investors have seen strong gains in long dated fixed income by following that trend. Additionally, with the exception of the 2008-2009 financial crisis, default rates have been directionally low, maintaining capital preservation as a key attribute. Finally, Treasuries in particular have provided fantastic diversification benefits in periods of chaos as yields had room to fall during "risk-off" periods.

Looking forward, we question the sustainability of these benefits.

We believe there are four key reasons that interest rates are set to rise, challenging the outlook for traditional fixed income in 2021.

- Yields are near historic lows providing inadequate income and the inability to provide enough cash flow to offset almost any potential decline in price
- U.S. Treasury yields are significantly below inflation
- The Federal Reserve's balance sheet has ballooned to unprecedented levels and any unwind of the balance sheet will challenge the market's ability to absorb the supply
- As the U.S. readies for a regime change, one must assume that fiscal policy will be more liberal

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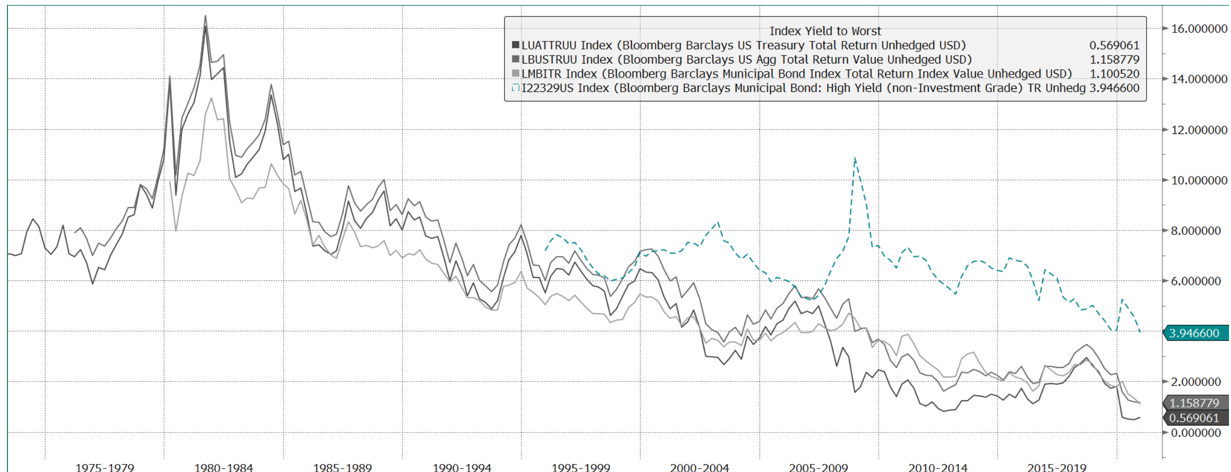
First, with interest rates near historic lows, yields in traditional fixed income sectors no longer provide investors with adequate levels of income. As we demonstrate later, this lack of income increases interest rate risk in 2021 as there will be little cushion to offset potential bond price declines.

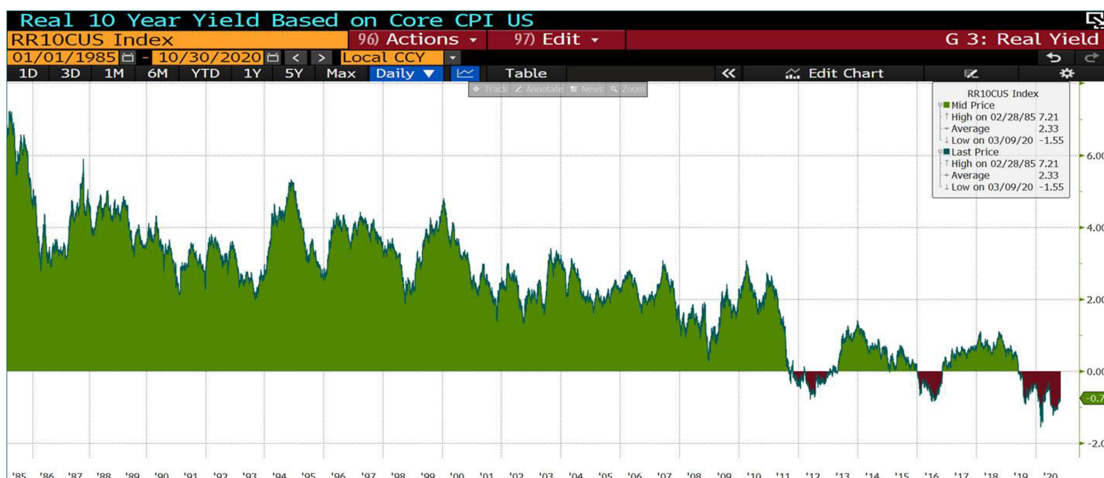
Fixed income yields trending lower



Source: Ecofin, Bloomberg as of 12/15/2020

Second, Treasury yields provide investors with negative "real yields" after accounting for inflation. The disconnect between Treasury yields and inflation has reached historic proportions with 10-year Treasury yields requiring an increase of 75 basis points just to breakeven with the Federal Reserve's preferred inflation gauge. While the Fed aims to maintain a low target rate, a "lower for longer" stance on the Fed Funds rate does not mean that yields on longer maturities will stay anchored. Thus, the yield curve is poised to steepen as rates on longer-dated Treasuries rise in order to match inflation.

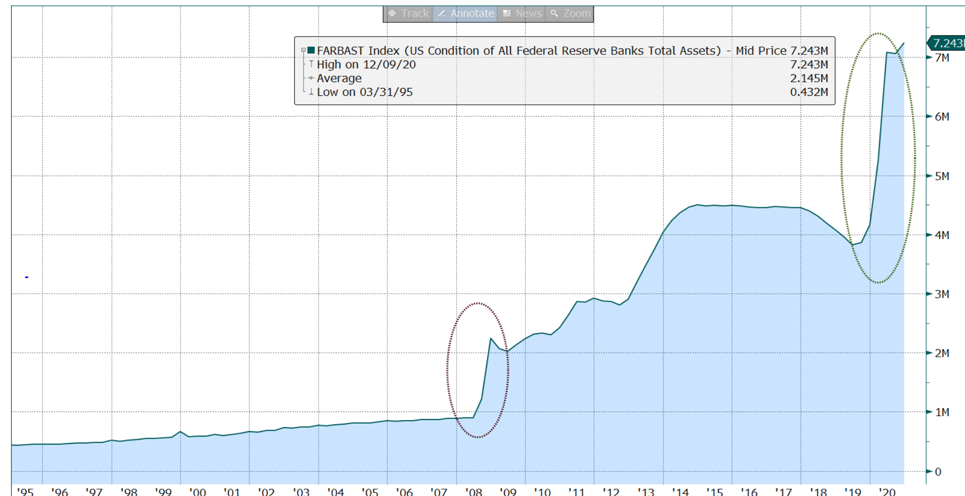
10-year Treasuries providing negative "real yields"



Source: Ecofin, Bloomberg as of 12/15/2020

Third, while the Federal Reserve injected unprecedented amounts of stimulus into the markets in 2020, its balance sheet has reached an all-time high of $7.2 trillion and dwarfs the size reached during the 2008-2009 financial crisis. It is logical to believe that the Fed is poised to scale back purchases in 2021 as the pandemic subsides and the vaccine is distributed. Additionally, the Fed was not alone in this action as bond buying programs were enacted broadly by central banks across the globe. As these purchases wane, the supply-demand dynamic will shift for bonds and yields are poised to rise as a result.

The Federal Reserve's total assets surge



Source: Ecofin, Bloomberg as of 12/15/2020

To put a rising interest rate environment in context, the below table illustrates the potential return for the included benchmarks over a 12-month horizon if interest rates rise by 50 or 100 basis points. Thus, interest rate sensitivity, measured by duration, is a key risk to investors in 2021.

				Yields up 50bps			Yields up 100bps		
Bloomberg ticker	**Index**	**Yield**	**Duration**	**Price**	**Income**	**Total**	**Price**	**Income**	**Total**
LUATTRUU	BBG Barc U.S. Treasury	0.6%	7.2	-3.6%	0.8%	-2.8%	-7.2%	1.1%	-6.1%
LBUSTRUU	BBG Barc U.S. Agg	1.1%	6.2	-3.1%	1.4%	-1.7%	-6.2%	1.6%	-4.6%
LMBITR	BBG Barc Municipal IG Bond	1.1%	5.2	-2.6%	1.3%	-1.3%	-5.2%	1.6%	-3.6%
I22329US	BBG Barc Municipal HY Bond	3.8%	7.2	-3.6%	4.1%	0.4%	-7.2%	4.3%	-2.9%

Source: Ecofin, Bloomberg as of 12/31/2020

The following table shows where these indices' yields would have to end to produce a 5% total return in 2021. Yields would have to reach all-time lows and in the case of Bloomberg Barclays U.S. Treasury Index, yields would have to go negative.

		Yield			Return		
Bloomberg ticker	**Index**	**12/31/2020**	**12/31/2021**	**Yield Δ**	**Price**	**Income**	**Total**
LUATTRUU	BBG Barc U.S. Treasury	0.6%	-0.1%	-66bps	4.8%	0.2%	5.0%
LBUSTRUU	BBG Barc U.S. Agg	1.1%	0.4%	-68bps	4.2%	0.8%	5.0%
LMBITR	BBG Barc Municipal IG Bond	1.1%	0.2%	-84bps	4.4%	0.6%	5.0%
I22329US	BBG Barc Municipal HY Bond	3.8%	3.6%	-18bps	1.3%	3.7%	5.0%

Source: Ecofin, Bloomberg as of 12/31/2020

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To offset the risks shown above, we are seeing large pension funds, endowments and foundations, as well as family offices increasing their allocation to private credit. Market participants have already highlighted the necessity of alternative income strategies in this environment, with 48% of investors slated to increase their allocations to private debt, up from 39% a year ago, according to a Preqin survey.

One may question if private credit is in a bubble? Our view is that traditional fixed income is in a duration bubble while private credit benefits a portfolio in non-traditional ways:

- Private credit strategies have provided investors with superior yields versus traditional fixed income sources with less interest rate sensitivity.
- Credit profiles can be idiosyncratic and present low correlations to broader markets.
- Private credit generally has strong covenant language in the loan documents which tends to mitigate downside risk, traditional fixed income does not have that language.
- Some private credit strategies are tax advantaged, adding additional benefits to private client portfolios.

Given the large amount of new investors and capital flowing into the space, it is important to search for differentiated strategies that are supported by fundamentals.

Previously it was difficult for the private client channel to access private credit. The resurgence of interval funds allows a broader array of investors to strategically allocate to private credit. At the end of 2010 there were 14 interval funds registered with the SEC and a total of $7 billion in assets amongst them. Over the decade, rising investor demand has grown the interval fund universe to over 60 funds and $34 billion in assets. We anticipate that this trend will continue as more investors search for alternative income strategies.

Interval funds have been around for more than two decades, but investors have recently started taking more notice as they seek out alternative strategies to meet income objectives. As registered investment vehicles with net asset value (NAV)-transparency, portfolio visibility and adherence to 1940-act rules, interval funds present significant appeal for both investors and investment managers. In the aftermath of the 2008 financial crisis, regulatory changes and a stronger desire for diversification have created opportunities in private credit which has driven demand in the space. By providing investors with institutional-quality investment opportunities, interval funds serve as a useful access point to diversify into private credit strategies that were only available to a select group in the past.

In summary, we believe it will be difficult for traditional fixed income to continue to provide the portfolio benefit that it has in the past. Additionally, we believe the risk characteristics of fixed income have changed. Investors have become complacent to duration risk as the persistent downward trend in yield has generally been in the long duration investor's favor. Historically, long duration risk mattered less when yields were much higher. Private credit offers an opportunity where the yield can offset the duration risk, while simultaneously providing loan covenants that help offset the credit risk. For the private client channel, an interval fund structure, with a shorter duration, can match the yield of longer duration open end mutual funds. We believe that allocators should consider taking more liquidity risk, relative to duration risk and consider the tradeoff between liquidity, duration, and yield in the current market environment.

At Ecofin, we strive to deliver strategies that provide a material return to your clients while also providing a material impact to society.

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