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THE FUTURE OF FIXED INCOME

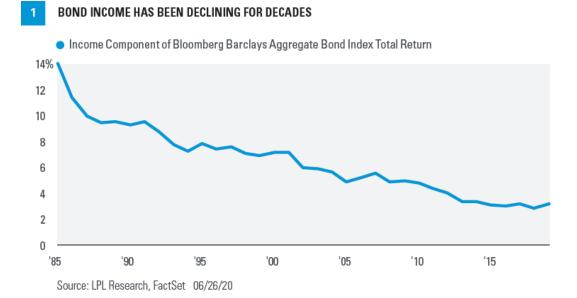
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Although the US economic recovery has picked up and we expect yields to rise in the second half of 2020, structural forces may help limit the size of the move. The pandemic-driven demand shock, the Federal Reserve, and disinflationary pressures may likely keep yields low for quite some time.

DOWNWARD PRESSURES ON YIELDS REMAIN

The US economic outlook has improved quite a bit since March, as more evidence of economic recovery has emerged in timelier economic data. The record hiring evident in the May US Bureau of Labor Statistics jobs report and the record surge in retail sales last month per the US Census Bureau are two examples of how the economic recovery since the peak of the lockdowns in April has surprised many economists. However, the improving growth outlook that the stock market has been pricing in has not translated into much of a move on the bond side. Further, inflation pressures remain well contained—and are likely to stay that way for some time—and the Federal Reserve's (Fed) stance hasn't changed.

As a result, we have reduced our base case year-end 2020 forecast for the 10-year US Treasury yield from 1.25–1.75% to 1–1.5%. While still an increase from current levels, if realized, this would be the lowest level to end a year on record.





THE FED IS KEEPING RATES WELL ANCHORED

The Fed is unlikely to hike (or cut) rates in 2020, and may not do so in 2021 either—even if the economic recovery becomes a little better than we expect. Persistently low inflation during the last expansion may minimize any Fed concerns that it needs to raise rates preemptively to keep inflation under control. Consistent with its messaging, we expect the Fed to remain accommodative for some time, and raising rates probably won't be on the table until after it ends its bond purchases.

The Fed may even consider instituting some form of yield curve control by setting a target cap for rates at maturities possibly as far out as five years. In that scenario, the central bank would buy enough Treasuries to keep rates below that threshold, which would further help anchor rates for longer-maturity bonds. For now, even the possibility of such a program has helped keep rates lower at the shorter end of the curve.

CHALLENGE FOR INCOME INVESTORS

These historically low rates have continued to hurt savers while introducing interest-rate risk for bond investors looking for more yield at longer maturities. Investors seeking income are in a tough spot. Rising Treasury yields can weigh on bond prices, eating away at interest income and gains from tighter credit spreads relative to Treasuries. With the credit spread for the Bloomberg Barclays Aggregate Bond Index already near the average for the last economic cycle, and interest income at historically low levels, we expect the index's returns to be near flat for the rest of 2020, with some risk of losses [Figure 1]. However, it would take a move above our new target yield range forecast to erase gains from the first half of the year.

DOWNSIDE RISK TO YIELDS

Core bonds, particularly Treasuries, may benefit if a downside scenario emerges, such as a second wave of COVID-19 cases accompanied by renewed stock market volatility. In that case, the 10-year Treasury yield could potentially fall back to 0.5% or lower and boost broad bond market returns, based on the Bloomberg Barclays Aggregate Bond Index. Although this is not our base-case scenario, it does highlight why suitable investors may consider the potential diversifying benefit of bonds.

The subject of negative rates has also been a hot-button issue, as investors are concerned that experimental policy rates implemented internationally will make their way to the United States. We think that is an unlikely scenario, even if a second wave of COVID-19 leads to more lockdowns, based on recent comments by Fed officials and the lack of evidence that the policy has been effective in other countries.

CURRENT RECOMMENDATIONS: INVESTING FOR RECOVERY

We would recommend that suitable investors consider positioning portfolios with below-benchmark interestrate sensitivity and near-benchmark credit quality. We favor mortgage-backed securities (MBS) for their combination of interest income and limited rate sensitivity. We are neutral on investment-grade corporate bonds with valuations no longer attractive and leverage increasing, but we still see incremental value for corporate bonds over Treasuries.

Suitable investors may want to consider increasing exposure to dividend-paying equities for income rather than over-emphasizing the credit-sensitive bond sectors, although these bond sectors can play a role in well-diversified portfolios. Among those sectors, we would favor a mix of dollar-denominated emerging market debt

and high-yield bonds. We believe emerging market debt may likely benefit from the broadly supportive monetary policy environment, and valuations for high yield are still attractive.

Municipal bond yields still look attractive relative to Treasuries for tax-sensitive investors. We maintain a bias toward high-quality municipals and are more cautious on their high-yield counterparts. While federal aid and the Fed's Municipal Liquidity Facility have helped the market stabilize, the pandemic has delivered a big blow to municipal tax receipts, and municipal default risk historically has tended to lag the corporate market.

Thank you to Nick Pergakis for his contribution to this week's Weekly Market Commentary.





IMPORTANT DISCLOSURES

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The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

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International debt securities involve special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

All index data from FactSet.

Please read the full Outlook 2020: Bringing Markets into Focus publication for additional description and disclosure.

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