FIXED INCOME REVIEW AND OUTLOOK

Third Quarter 2020

Brown ADVISORY
Thoughtful Investing.

The third quarter of 2020 can only properly be described as boring for those of us in fixed income markets. No part of the Treasury yield curve finished more than 4 basis points higher or lower for the quarter, with the 10-year Treasury trading between 0.65% and 0.75% for most of the period. Municipals were not much different, with yields falling a bit in July before rebounding in August and ending only mildly lower. Even credit spreads, which had been wildly volatile for most of the year, finished the quarter almost unchanged. Yet despite this placid appearance, we argue that the third quarter of 2020 was a historic one for the bond market, and the consequences could be felt for years to come.

In early 2019, we wrote in our quarterly letter that the U.S. Federal Reserve had made a historic shift in strategy. By stopping rate hikes (and later by outright cutting), the Fed had ended a decadeslong prioritization of inflation over unemployment. In August 2020, Chair Jerome Powell officially codified that shift. In a speech at the Fed's annual Jackson Hole conference, the chair said that the Fed would adopt an "average inflation targeting" regime, or AIT. Under an AIT approach, the Fed would tolerate inflation rising above its 2% target to "make up" for periods where inflation ran below. Effectively, this means that the Fed is now willing to forgo strict control of inflation in an attempt to keep unemployment low.

Powell's announcement was met by wide skepticism from the market. In the days and weeks that followed the Jackson Hole speech, indicators of inflation expectations, including the value of the dollar, the shape of the yield curve or the break-even level on TIPS, all suggested inflation would recede. In other words, the Fed announced it wanted inflation to rise, and markets responded by assuming inflation would fall.

To be sure, the pandemic-induced recession and commensurate high unemployment almost certainly mean that inflation may not be a threat in the short term. However, to blithely dismiss the possibility of higher inflation would be a mistake. We only need to go back to 2018 to find when core personal consumption expenditures, the Fed's favored inflation measure, ran between 2.0% and 2.1% on a year-over-year basis from March through December.

INDEX PERFORMANCE AS OF 09/30/2020	QTR (%)	PAST 12 MONTHS (%)
Bloomberg Barclays U.S. Aggregate Bond Index	0.62	6.98
Bloomberg Barclays Int. Aggregate Bond Index	0.48	5.66
Bloomberg Barclays U.S. Treasury Index	0.17	8.04
Bloomberg Barclays Long U.S. Treasury Index	0.12	16.34
Bloomberg Barclays Mortgage-Backed Sec. Index	0.11	4..36
Bloomberg Barclays U.S. Corporate Index	1.54	7.90
Bloomberg Barclays U.S. Corporate High-Yield Index	4.60	3.25
Bloomberg Barclays U.S. Municipal Bond Index	1.23	4.09

Source: Bloomberg

It seems reasonable to assume that if at some point in the future, the labor market got as tight as it was in 2018, we could once again see inflation rise above 2%. Indeed, at that time, the Fed had been hiking rates since 2015 and was widely expected to keep hiking rates. If we imagine a scenario where employment conditions were similar to 2018 but the Fed stayed on the sidelines, it seems quite plausible that inflation could run even higher than it did in 2018.

The Fixed Income team's job is not to second-guess the Fed's policy strategy, nor do we think we have any edge in forecasting what happens next for inflation. Rather, our approach is to consider possible paths for the bond market and compare these paths to what may be already priced into securities. Hence, we would be loath to guess at what the odds are of inflation rising to 2018 levels sometime in the next few years, but it is something we consider for managing risks.

For now, we are trying to protect portfolios by underweighting bonds 10 years and longer. Should the market change its tune and begin pricing in higher inflation in future years, the first place it would happen would be in longer-term bonds. Not only would markets demand direct compensation for higher inflation, but it would also likely increase the risk premium markets demand for longer-term bonds. Right now, that risk premium is unusually low due to low inflation volatility. If inflation volatility rises, so

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should the extra yield investors demand for long-term bond risk.

We are also considering how a more hands-off approach from the Fed could influence corporate bond yields. Over the course of the quarter, we reduced our corporate bond overweight by about 2%, which leaves us about 10% less overweight than we were at the end of April. However, we still remain overweight and still find this sector quite attractive. Historically, spreads on corporate bonds generally tighten until such time as a recession is threatened. Often the reason why a recession occurs is that the Fed tightens policy too much. It could be that the Fed's AIT approach elongates expansions. In addition, credit spreads remain solidly wider than pre-recession levels, so it should be true that credit outperforms even in a status-quo environment.

It is worth noting that our overweight of corporate bonds has not resulted in the portfolio having a "risk-on" bent. We looked at our strategy performance in the post-COVID-19 period on days when stock prices fell. We found that our core-style strategies produced positive returns on approximately 80% of such days and outperformed the Bloomberg Barclays Aggregate Index on 65% of days. This is a testament to our downside focus in individual bond analysis, but also how we are approaching this recession specifically. We feel this is a highly uncertain economic environment and therefore want to own securities for which the gyrations of the business cycle are of minor importance.

In a similar vein, our taxable strategies outperformed meaningfully for the quarter, but we would especially like to highlight August and September. In July, credit spreads fell meaningfully, so like April–June, our portfolios benefited from being overweight credit generally. However, in August–September, credit spreads were unchanged, meaning that our outperformance during this period was about individual bond selection. This is our bread and butter. We are much more comfortable trying to outperform on picking good bonds than on top-down factors.

Our municipal bond strategies also outperformed during the quarter as "middle-quality" rated credits led municipal market returns. This was in stark contrast to the underperformance experienced by A- and BBB-rated municipal bonds as credit spreads blew out during the second quarter. The BBB-rated municipal universe outperformed AAAs by 230 basis points in the third quarter but continue to lag by more than 300 basis points for the full year. We continue to find attractive relative value in A- and BBB-rated bonds, but individual credit selection (and diligence) is key. Municipal credit is largely an idiosyncratic market. While a top-down, macroeconomic-driven shock like the COVID-19 crisis certainly weighs on most credits, it is important to separate headline risk and price dislocation from actual impairment risk. We are constantly re-underwriting all of our holdings as new information becomes available and have exited several credits as the level of risk or uncertainty outweighed the relative opportunity set for that specific holding.

As active as we have been assessing pockets of vulnerability in our municipal portfolios, we have been even more active finding value and adding strong essential service credits at very attractive valuations. Municipal new issue supply has been robust, and many deals are coming at very attractive concessions to secondary market levels. The third quarter was one of our busiest quarters in memory participating in municipal new issue deals. We have leveraged our relationships across the street and have been able to uncover meaningful value for our investors, especially around ESG-focused credits.

In the short term, the Fed's policy maneuvering may become less important for fixed income portfolios. With the March liquidity crisis fading from memory and the Fed set on keeping short-term rates near zero for a long time, monetary policy is becoming more of a constant than a variable. As we said above, the next time the Fed really becomes relevant will be once unemployment has fallen back into 2018-type levels. At that point, we may see whether inflation starts to pick up and how the Fed reacts. Until then, it is refreshing that we will get to focus on selecting individual bonds with strong fundamentals and attractive yields.

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