FEG INSIGHT

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2020 FIXED INCOME MARKET OUTLOOK

Where Do We Go from Here?

FEG investment advisors

Many fixed income conversations at FEG begin with trying to answer the question: "What is the role of fixed income in the client's portfolio?"

There are two acceptable answers to this question:

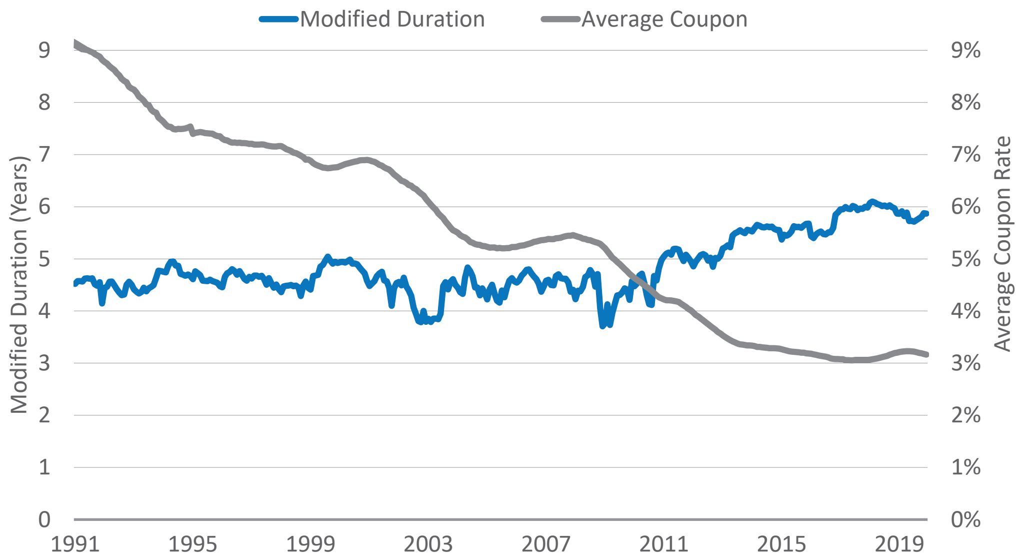
- *The first is intuitive. The focus is equity risk mitigation and deflation protection, both of which are crucial to asset allocators.*
- *The second is a nuanced version of the first, as fixed income investors' baseline expectation—whether explicit or not—is for this part of their portfolio to act as a store of capital for opportunistic allocations when risky assets decline in value. In other words, investors do not expect to lose money with this allocation. Instead they expect the capital to be available when needed.*

Risky and risk-mitigating assets do not often appreciate in tandem, but that is what happened in 2019. As the calendar rolls forward, investors face a particularly challenging environment in 2020.

2019 RECAP

In FEG's 2019 Fixed Income Market Outlook, we highlighted that as interest rates on U.S. Treasuries continued their approximately 40-year descent, the coupon rates declined while the risk associated with interest rate increases intensified. Modified duration—a measure of a bond's price sensitivity to interest rates—steadily increased. As a result, for every increase in rates, bond values fell more substantially than they had in the past.

BBAGG MODIFIED DURATION AND AVERAGE COUPON SINCE 1991



Data source: Bloomberg, L.P.

Despite the multi-decade-long decline in interest rates that commenced in the early 1980s, and changes to the Bloomberg Barclays Aggregate Bond Index's (AGG) composition over the last decade, FEG noted that a more pronounced bout of turmoil for risk assets during 2019 had the potential to lead to an outsized return for core fixed income investors. That potential outcome became real in mid-2019, as investors bid up the price of U.S. Treasuries. The inversion of the 2-year/10-year Treasury curve in August implied that the U.S. economy may have been weakening further than anticipated by the Federal Reserve.

On July 31, the Federal Reserve ultimately succumbed to market pressures and began the first of three rate cuts of 25 basis points (bps) each for the year. Risk assets generally stalled further into the third quarter, as the yield curve ultimately began to re-steepen. As the fourth quarter arrived, the short-term future of the economy was looking more positive and risk assets rallied strongly through the remainder of the year. The long-presumed negative turn in the markets appears to have been pushed back, for now.

WHERE DO WE GO FROM HERE?

1. Reduce Duration

While the 2019 fixed income experience for investors using "core" strategies as their primary fixed income allocation proved exceptional—the AGG returned 8.7%—the asymmetry of U.S. Treasuries is now decidedly negative. Treasuries illustrate how low rates in intermediate bonds limit long-term returns even if rates decline further, and any rate increases bring near-term downside risk.

	LIMITED UPSIDE INTEREST RATE DECREASE			DOWNSIDE RISK INTEREST RATE INCREASE						
	25bp	50bp	100bp	25bp	50bp	100bp	200bp	300bp	400bp	500bp
5 YEAR NOTE										
1 Year Horizon	1.7%	2.4%	3.9%	0.2%	-0.5%	-1.9%	-4.7%	-7.3%	-9.9%	-12.5%
3 Year Horizon	1.1%	1.2%	1.4%	0.8%	0.7%	0.5%	0.0%	-0.4%	-0.9%	-1.3%
4 Year Horizon	1.0%	1.0%	1.1%	0.9%	0.9%	0.8%	0.6%	0.4%	0.3%	0.1%
10 YEAR NOTE										
1 Year Horizon	2.6%	4.2%	7.4%	-0.4%	-1.9%	-4.9%	-10.5%	-15.8%	-20.8%	-25.5%
3 Year Horizon	1.5%	1.9%	2.7%	0.7%	0.3%	-0.5%	-2.0%	-3.4%	-4.8%	-6.2%
5 Year Horizon	1.3%	1.4%	1.8%	0.9%	0.8%	0.4%	-0.2%	-0.9%	-1.5%	-2.1%
30 YEAR NOTE										
1 Year Horizon	5.4%	9.6%	18.6%	-2.5%	-6.2%	-13.1%	-25.1%	-35.0%	-43.3%	-50.2%
3 Year Horizon	2.6%	3.8%	6.5%	0.1%	-1.0%	-3.2%	-7.2%	-10.7%	-13.8%	-16.4%
5 Year Horizon	2.0%	2.7%	4.2%	0.7%	0.0%	-1.2%	-3.5%	-5.5%	-7.2%	-8.8%
10 Year Horizon	1.6%	1.9%	2.5%	1.1%	0.8%	0.3%	-0.6%	-1.4%	-2.2%	-2.9%

Data sources: Bloomberg, L.P., FEG, Data as of January 20, 2020
For illustrative purposes only. Returns presented gross of fees, assuming reinvestment at 1.56%, income tax of 40.8%, and capital gain tax at 23.8%.

Aside from U.S. Treasuries, asset allocators who rely on core fixed income as their primary fixed income strategy find an opportunity set where the other two key sectors of the AGG, investment grade credit and agency residential mortgages, are not particularly attractive. Investment grade corporate bonds ended the year with an option-adjusted spread of only 92 bps, well below the historical average of 144 bps. Yield-hungry investors seem to be ignoring the fact that only 50% of the overall corporate bond market was rated A or better at the end of 2019, representing an all-time low in credit quality. Meanwhile, the residential mortgage market presents little opportunity following a year of increased mortgage refinancing and improvement in consumer credit quality and housing prices.

The higher degree of duration in the AGG, coupled with the knowledge that most active core fixed income managers do not make material duration "bets," leads to one potential solution for investors. Those seeking a more stable fixed income experience could shift assets away from core strategies to an intermediate duration version. The Bloomberg Barclays U.S. Intermediate Aggregate Bond Index (intermediate AGG) offers a 3% coupon, versus 3.2% for the AGG, and only 62% of the duration—3.7 years for intermediate AGG versus 5.9 years for the AGG at the time of this publication's release.

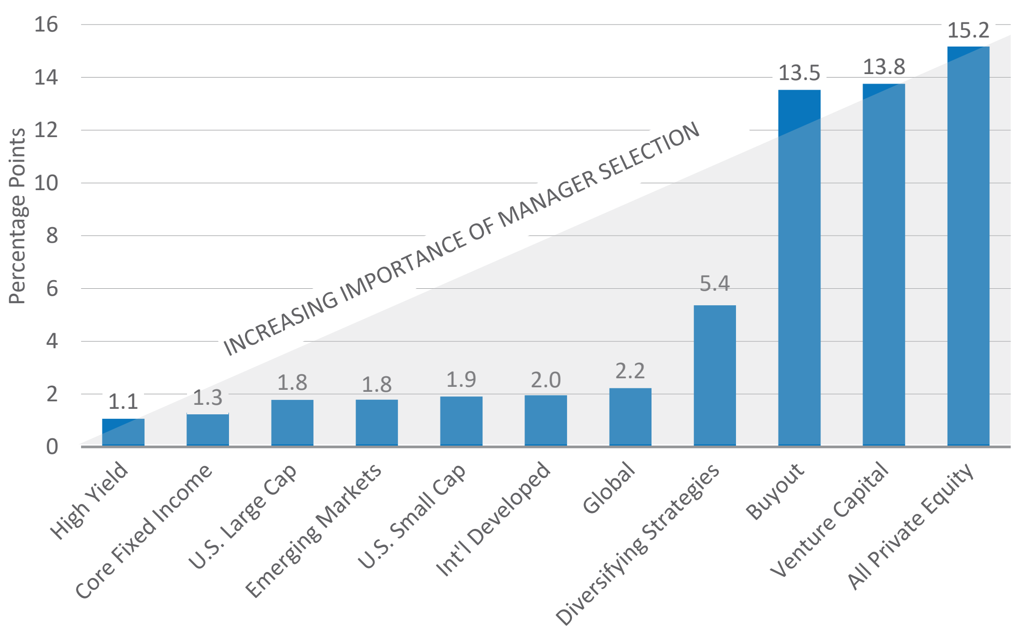
With compound coupons, there was little sacrificed in terms of yield by shifting to an intermediate duration strategy, as the intermediate aggregate index yielded 91% of the AGG at the end of 2019—2.1% versus 2.3%. The potential downside to making this shift is lagging performance of internediate bonds if rates fall further, but the upside is less volatility as rates ebb and flow.

2. Seek Lower Fees and Consider Passive Options

Given the generally unattractive yield environment facing fixed income investors today, FEG suggests investors seek to reduce the fees they are paying for active fixed income management. To put this into context, and once again using core fixed income as an example, the performance difference between top and bottom quartile managers over the past decade was only 1.3 percentage points.[1] This marks the second lowest differential among other asset classes measured and suggests a "beta-like" experience for actively managed core fixed income. The average expense ratio for actively managed core fixed income institutional mutual funds with a minimum track record of 10 years was 43 bps.[2]

The first lesson fixed income analysts learn is "basis points matter," and when the starting yield of an asset class is only 2.3%, paying 43 bps can lower return potential by almost 20%.[3] In conjunction with lower fees, investors may consider passive fixed income strategies to replicate the exposures they seek in traditional fixed income markets, as these vehicles typically have lower fees.

PERFORMANCE DIFFERENCE BETWEEN TOP AND BOTTOM QUARTILE
10 Years Ending December 2019



Data sources: Lipper, HFRI, Thomson One Vintage Year 2009, private capital performance is lagged and available through September 30, 2019 as of December 2019.

3. Consider Alternatives

FEG has advocated for semi-liquid fixed income strategies, particularly in structured products, for many years following the credit crisis, with a general preference for consumer credit versus corporate credit risk. The length of the economic recovery and improvement in underlying asset quality in many of these areas has led to tighter spreads in these portfolios. Like core fixed income, fees for these strategies should be reviewed as well.

The amount of leverage being used in these strategies is an important consideration, as semi-liquid credit strategies are notoriously challenging for managers to hedge. Given the positive fundamentals that led to strength in returns in structured products in recent years, managers may be inclined to increase the risk in their portfolios by investing lower in the capital structure (implicit leverage) or by the use of financing methods (explicit leverage) in order to justify the fees charged to investors.

Beyond semi-liquid fixed income strategies, FEG has also advocated illiquid draw-down strategies in private debt for nearly two decades. These strategies can be broadly defined as defensively oriented, such as direct lending (i.e., senior, uni-tranche, and mezzanine) or opportunistic (i.e., special situations and distressed). While this definition is not all-encompassing, these strategies generally define the private debt options that are available to investors.

Direct lending strategies have benefited from considerable inflows over the past four-to-five years. Uni-tranche strategies have modestly gained traction over the past few years as well, while mezzanine debt flows have been generally stable.

The key purpose of each of these defensively oriented strategies is to generate returns primarily through coupons—preferably cash—as coupons are the key driver of long-term fixed income returns. Low yields in the traditional fixed income markets have pushed investors into these illiquid strategies.

These loans are illiquid, which means they do not trade and are not securities; therefore, they offer higher coupons than can be generated by their publicly traded fixed income peers at comparable points in the corporate capital structure. Despite an increase in inflows in recent years and some spread compression in coupons, FEG continues to advocate these strategies as part of a fixed income portfolio. As always, and particularly in the case of these strategies, manager selection is paramount. To help mitigate default risk, FEG favors experienced lenders who have exhibited success across multiple cycles.

Opportunistic private debt strategies such as special situations and distressed debt sound like fixed income options at first blush, due primarily to the entry point of investment, typically through the debt instruments of the company. The risk profile of these strategies can be quite different from a stable fixed income experience, however, as these investments often behave more like private equity than investors' other fixed income allocations. In private equity parlance, the J-curve of a distressed debt drawdown fund is much deeper in the early years than defensively oriented private debt funds.

FEG believes opportunistic private debt strategies can provide beneficial risk-adjusted returns. Because of the J-curve situation, however, these strategies may be better situated outside of a fixed income portfolio. Regardless of where these strategies may fall in an investor's portfolio, FEG's fixed income team leads the analysis of these strategies due primarily to the initial entry point of the investment and the nature of the investment firm sponsoring the strategy—i.e., typically credit-oriented asset managers.

CONCLUSION

When considering the current environment facing traditional fixed income investors and asset allocators in the fixed income space, FEG advises investors to consider the following:

- Shorten the duration of the traditional fixed income portfolio from core to intermediate
- Focus on fees being paid for active management in the overall fixed income portfolio, particularly in the traditional and semi-liquid segments
- Monitor leverage being used in semi-liquid fixed income strategies; gauge if leverage is required to justify the higher fees being paid to the manager
- Continue allocating to defensively oriented private debt strategies as appropriate
- Evaluate where opportunistic private debt strategies should reside in a portfolio

[1] Lipper, HFRI, Thomson One Vintage Year 2009, performance available through September 30, 2019.
[2] eVestment Alliance – spreadsheet available upon request.
[3] Calculation: (2.30% - 1.87%)/2.3%= 18.7%.

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