Fixed Income – Short-Term Drawdown, Long-Term Opportunity

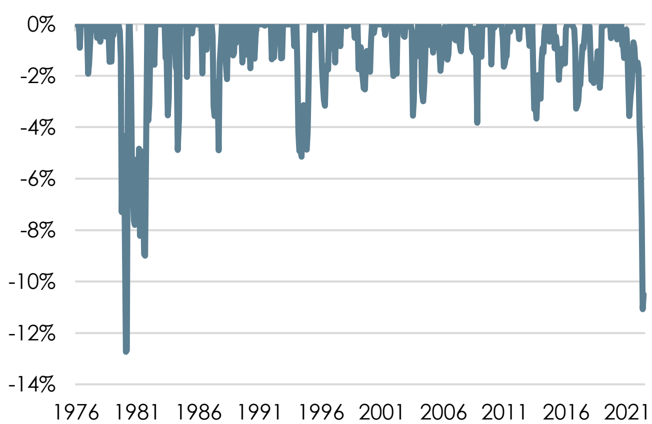
June 2022

- **Until recently, equity and fixed income markets have benefitted from a secular decline in interest rates over the last 40 years**
- **While a traditional ballast to diversified portfolios, fixed income investments have experienced historical drawdowns in 2022**
- **Going forward, diversified fixed income portfolios can benefit from the rise in interest rates and wider credit spreads**

Recent Events

An extended period of low inflation and accommodative monetary policy that followed the 2008 global financial crisis reduced yields for fixed income investors while fueling returns for equity investors. Market forces shifted dramatically following the onset of the COVID pandemic in 2020. Massive amounts of monetary and fiscal support were met with supply chain disruptions and a spike in inflation. Pricing pressures were amplified by the Russia-Ukraine conflict in 2022. As the Fed signaled tighter monetary policy to slow consumer demand, market yields increased and credit spreads widened in the first few months of 2022. These actions negatively impacted bond prices due to the inverse relationship with rates and spreads. The US Aggregate Bond Index was down -8.9% through the end of May, the worst start to a year in its history (which dates back to 1976). The current drawdown is the worst since 1980.

Bloomberg US Aggregate Bond Index Drawdowns



Source: ACG Research, Bloomberg

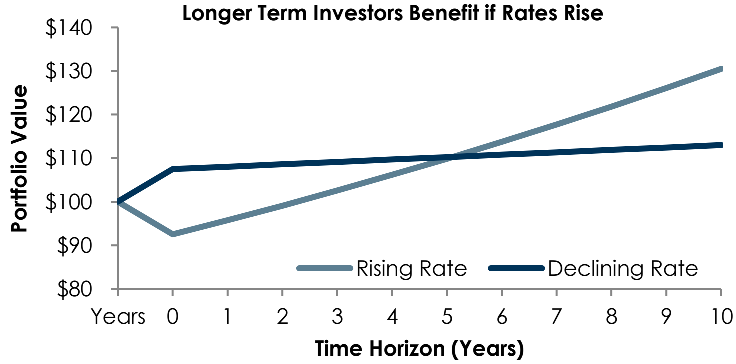
Longer-Term Historical Perspective

To combat rampant inflation in the 1980s, Federal Reserve Chairman Paul Volcker raised interest rates to such an extent that the 10-yr Treasury peaked at ~16% on September 1981. This triggered a recession and began a 40-year secular decline in interest rates to the point where the 10-year bellwether rate has averaged a meager 2.4% since the beginning of 2008, encompassing the global financial crisis. Then, in March 2020, as equity markets plunged, investors rotated into risk-free treasuries and the 10-yr bottomed at 0.52% that summer. After over a year of near-zero interest rates, investors were expecting a gradual rise in rates. By September 2021, futures market prices implied one rate hike of 25 bps by the end of 2022. As labor markets stabilized after the COVID-driven layoffs and inflationary pressures rose, the Fed began removing policy accommodation to slow demand. The first rate hike of 25 bps occurred in March and was followed by an uncommon 50 bps rate hike in May. Futures markets recently have priced in additional rate hikes, including a few in 50 bps increments. As a result, the 10-yr Treasury yield moved higher and a bear flattening of the yield curve began in 2022 with front-end rates rising even more quickly. The swift rise in rates negatively impacted duration-sensitive Treasury bonds (typically a safe haven) early in the year. Credit spread widening followed suit and negatively affected corporate bond returns as the market digested recent economic data showing some signs of uncertainty.

The Forward-Looking Opportunity

In general, corporate balance sheets have been strengthened through refinancing of existing debt at lower rates in recent years. This process has helped to keep investor concerns over default risk in check amid this year's market volatility. Even with higher rates, debt financing typically remains cheaper than equity financing for companies needing to access the capital markets. This dynamic should support continuing bond issuance, particularly for those with investment grade credit ratings. For long-term investors, the rapid increase in interest rates and credit spread widening this year leads to a higher reinvestment starting point for both coupon income and returns of principal at maturity which should benefit investors with a longer time horizon. For taxable investors, this short-term decline also presents a unique opportunity for tax-loss harvesting within the fixed income portfolio. With corporate credit spreads now sitting near their 15-year median levels, the entry point for taxable investors also appears more attractive than in recent periods.

Longer Term Investors Benefit if Rates Rise



Assumptions: 5-yr portfolio duration, 2% starting yield, 1.5% instantaneous parallel shift in both directions
Source: ACG Research, Income Research + Management

ACG's Position

Many of the challenges the fixed income market has experienced year-to-date are part of the natural long-term economic cycle. While volatility is likely to remain in 2022, diversified, actively-managed fixed income portfolios with long-term horizons are in a better position to navigate income opportunities as they arise and serve as a ballast to portfolios.

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