

# Interim Update: Fixed Income Outlook

We have received many questions recently on our outlook for interest rates, inflation, and fixed income. We see near-term risks to fixed income returns and weigh those risks against the role fixed income plays in balanced portfolios and our active positioning of fixed income allocations.

## EXECUTIVE SUMMARY

- We anticipate intermediate and longer-term interest rates could continue to rise moderately this year due to both rising real rates and increased inflation expectations.
- Inflation readings may rise in the short-term, but we believe slack in the economy limits the risk of high sustained inflation.
- For balanced portfolios, we are underweight fixed income and are emphasizing short-duration and corporate securities, but fixed income continues to play a key role in risk management.

## OUTLOOK

Our outlook for fixed income is muted, with the potential for flat or negative returns for the asset class in 2021. We expect that the ongoing economic recovery will put upward pressure on real interest rates, which is typical early in an economic cycle. We also anticipate that inflation *expectations* will increase, particularly as investors contemplate the impact of fiscal and monetary stimulus amid the recovery. However, we do not expect actual broad inflation to rise substantially in a sustained fashion. The labor market still has significant slack, in our view, despite a robust recovery. The February unemployment rate remained elevated at 6.2%, and that doesn't include people who have stopped looking for work. We believe this should limit wage cost inflation pressures. Capacity utilization also remains at the low end of its range during the pre-COVID-19 expansion. While there are some pockets of higher inflation in the economy, for example in oil and other commodities, rising costs for such economic inputs are generally diluted as they work their way through the production chain.

We have confidence in our outlook for equities versus fixed income, but we also recognize risks to that outlook, including a continuation of elevated equity volatility driven by uncertainty on the timing and magnitude of the economic recovery, among other factors.

Our balanced strategies contain fixed income primarily to help mute the volatility of returns. Fixed income returns tend to have low or negative correlation to equity returns, especially in periods of negative equity market volatility. Some investors have questioned holding fixed income given current low yields and fixed income volatility early in the pandemic. Some have also suggested holding cash in lieu of fixed income. Cash, however, currently offers a negative real yield and merely dilutes volatility, while fixed income can potentially offset equity volatility through negative correlation. We see no indication that this complementary relationship between equities and fixed income has fundamentally changed.

## PORTFOLIO POSITIONING

### Allocation To Fixed Income

In our balanced strategies, we are **underweight fixed income**, given our positive economic outlook and the risk of rising interest rates. Nonetheless, with likely equity volatility in the early stages of this recovery—given the potential for rising interest rates, tax changes, and ongoing pandemic uncertainty—we do not see a compelling reason to maximize equity exposure at this time. While we believe fixed income is likely to underperform equities this year, maintaining the diversification of a material fixed income allocation in balanced strategies helps mitigate risk of equity exposure.

### Positioning Within Fixed Income

With our view that the Treasury yield curve is likely to steepen, our fixed income exposure is positioned with a materially **shorter duration** than the benchmark to reduce interest rate risk. The yield reduction of having a shorter average maturity is largely offset by a material **overweight of investment-grade corporate securities**, which offer higher yield and lower duration than Treasury securities for a given maturity. While corporate yield spreads have narrowed materially in recent months, we believe that spreads should remain stable or could narrow further as the economic recovery continues, which, combined with their higher absolute yields, should support corporate bond outperformance versus Treasury securities.

**WestEnd Advisors Investment Team | March 15, 2021**

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