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Fixed Income Strategy Bulletin

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Bond Investors Confront Inflation Risk With Valuations Still High

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- Further fiscal stimulus combined with “easy” Fed policy will likely turbocharge the U.S. economy as it reopens post Covid-19. With this massive expected infusion of stimulus (more than 10% of GDP in 2020 and 2021) comes the risk of higher inflation. Indeed, long-term forward inflation measures are spiking and now indicate future inflation enduring at over 2% **(see Figures 1-2)**.
- Shorter-term inflation proxies are also corroborating this view, including increasing US home prices and commodity prices. That said, recent home price increases appear to reflect a temporary shift in consumer housing preferences combined with restraints on building during the pandemic. Similarly, commodity price increases are most frequently transitory. The recent spike in prices is a rebound from depressed pandemic levels, at least for a start **(Figure 3)**.
- Regardless of the future sustainability of the inflation impulse, financial markets are incorporating these data points and quickly shifting to a theme of “reflation” (see CIO Strategy Bulletin, Big Fiscal Guns Are Still Blazing in Washington. Is Inflation Next?). The selloff in Treasuries this week is particularly pronounced, as the 10y yield has now moved above 1.25% and the 30y yield above 2.05%.
- Including the move this week, longer-dated US Treasury rates have been moving higher for months now, resulting in the worst YTD start for bond markets since 2013, with 10y Treasury prices down almost 3% YTD and 30y Treasuries dropping almost 10%. While the Fed’s recent statements suggesting a ”lower for longer” Federal Funds rate is anchoring the shortest end of the Treasury curve near zero, the yield curve has been steepening **(see Figure 4)**. In our view, 10-year US Treasury rates are likely to continue moving higher, settling in around 1.50%-2.0% as further stimulus is injected into the economy over the course of 2021.

Figure 1: US Government Debt as % of GDP and Inflation

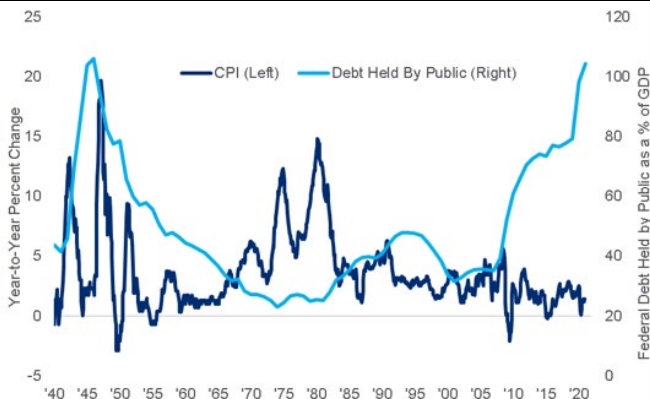
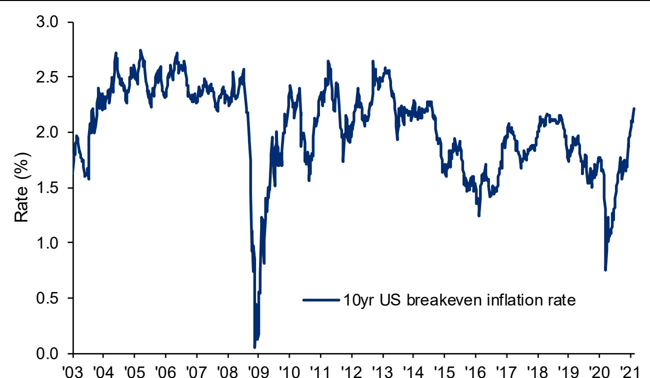


Figure 2: US Treasury 10-year average expected inflation



Source: Haver Analytics as of February 17, 2021.

Figure 3: Rising home and commodity prices

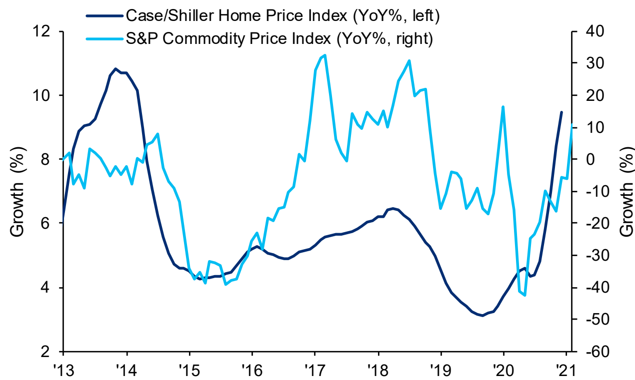


Figure 4: 2s10s US Treasury Yield curve has steepened

Source: Haver Analytics as of February 17, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

- Rising rates have important implications for fixed income portfolio construction. First, longer-dated fixed income instruments will likely track Treasury prices moving lower and incur a mark-to-market hit. Second, while corporate bonds provide some protection to inflation on a yield basis, spreads overall are historically low and therefore offer less room to cushion the price drop.

- Investment grade (IG) bond yields of less than 2% generally offer negative real rates when measured vs inflation expectations of higher than 2%. Nevertheless, they should provide better inflation protection than cash, albeit with some credit risk. High yield (HY) bonds offer positive real yields and many are geared to the positive economic news driving inflation expectations higher. However, given their higher leverage, rising rates may negatively impact the credit risk of some of the issuers. Within HY, we prefer variable-rate bank loans, which offer higher yields than bonds **(Figure 5)** and are higher on the capital structure, as well as may provide protection if short term rates do rise given their embedded short-term floating rate component.

- In addition to variable-rate loans, we favor fixed income instruments and strategies which might provide some mitigation to both rising yields and widening spreads. These include:

  - Treasury Inflation-Protected Securities (TIPs), which pay higher yields as inflation increases.
  - Emerging market dollar bonds, which offer near-HY yields in companies with lower leverage and whose earnings should benefit on average from higher commodity prices **(Figure 6)**.
  - Financial institution preferred bonds, which also offer near-HY yields in companies whose earnings should benefit from a steeper yield curve.
  - Various types of structured strategies and fund solutions, which can provide income even if rates rise by providing more "duration neutral" fixed income exposure.

Figure 5: HY loan yields are higher than unsecured bonds

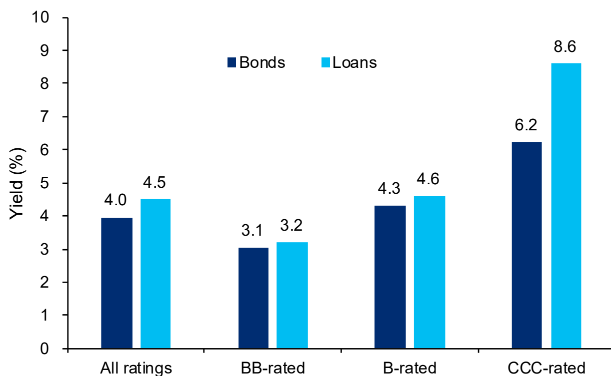
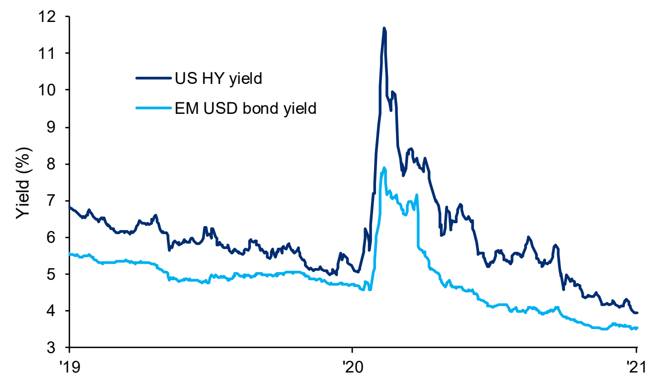


Figure 6: EM bonds also comparable to US HY level yields



Source: Bloomberg Barclays Indices, S&P as of February 17, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

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