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Investment Institute

Market Commentary

Weekly perspective on current market sentiment **March 24, 2021**

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Last Week's S&P 500 Index: -0.8%

Playing fixed income defense

Key takeaways

- Although we expect interest rates to rise only modestly, fixed income exposure is recommended but suggest being more defensive.
- A number of different fixed income segments offer less sensitivity to higher interest rates.

When interest rates rise, all else being equal, bond prices generally fall. In fixed income land, bond prices and rates are negatively correlated. But all else is not always equal. Of course, until recently, our game plan involved overweighting high-yield (HY) and investment-grade (IG) corporate bonds in portfolios because we believed the yield spread between those instruments and a risk-free government bond would narrow as the economy climbed out of a deep but short-lived pandemic-induced recession. In other words, we believed those prices would rise and their yields would fall relative to risk-free government bonds. U.S. Treasury rates have risen for the right reasons, a recovering economy. Note that early in a new cycle, as investors become more comfortable with the forward growth outlook, they are typically more willing to take on risk. It is at this part of the economic cycle when fixed income spreads tend to narrow even as Treasury rates rise.

And that is indeed what has happened over the course of the last year. HY and IG corporate spreads are back at or very near prepandemic lows after surging in March of last year as uncertainty reigned supreme and the economy was being locked down as the coronavirus began to quickly spread. We view further opportunities in HY and IG corporates as limited due to this meaningful spread compression and recently downgraded both to neutral from favorable. Overall, we see rates trending only modestly higher over the balance of the year. As a result, we now recommend that investors move some funds from fixed income toward equities. However, in our view, well allocated portfolios should not be eliminating exposure to fixed income. We suggest taking on a more defensive tone in this portion of one's portfolio.

So how is this done? While we currently rate most of the fixed income complex as neutral, we do continue to favor both municipal bonds (munis) and preferred stock. In terms of munis, credit profiles appear to be in good shape and the massive stimulus package just passed by Congress and signed by the president is expected to benefit states. In addition, higher tax rates will likely benefit the municipal sector. From the preferred stock angle, we think the prospects of higher yields than most fixed income securities can offer and pricing that tends to benefit from heightened investor appetite for risk make this fixed income segment a good place to invest now.

Other fixed income suggestions include neutral-rated intermediate bonds. Longer-term bonds are more sensitive to rising rates while instruments with intermediate maturities offer less sensitivity. Bank loans, emerging market debt, and the HY segment round out our defensive recommendations. Bank loan interest rate risk is typically low, and they offer yield pickup versus short-term securities. We see emerging market debt offering higher yields and better performance as the global recovery advances. HY securities usually have shorter maturities, and we recommend a full allocation.

Even though we prefer equities at this time, we believe a well allocated portfolio should still include fixed income exposure despite a modestly rising interest rate environment.

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