# Fixed Income Market Update

*All amounts in $US unless otherwise stated.*

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## Fixed Income Overview

Fixed income securities are a major asset class in the global financial system. Broadly speaking, it refers to securities that pay investors a fixed amount of interest or dividend payments until its maturity. At maturity, investors are repaid the amount initially invested when the security was first issued. Examples include government bonds, corporate bonds, mortgage-back securities, fixed income exchange-traded funds, and fixed-income mutual funds.

Fixed income securities have a huge range of public and private applications that influence its markets. In the public sector, the central bank and government purchase, sell, and issue government bonds to influence interest rates, inflation, and stimulate the economy. In the private sector, fixed income securities are less risky than other types of assets such as equity and derivatives since they provide a predictable stream of cash flows to their investors. As such, they are used to manage portfolio risk and speculate on future interest rate changes. The diverse applications of fixed income make them the largest market by both market capitalization and trading volume.

## The Yield Curve

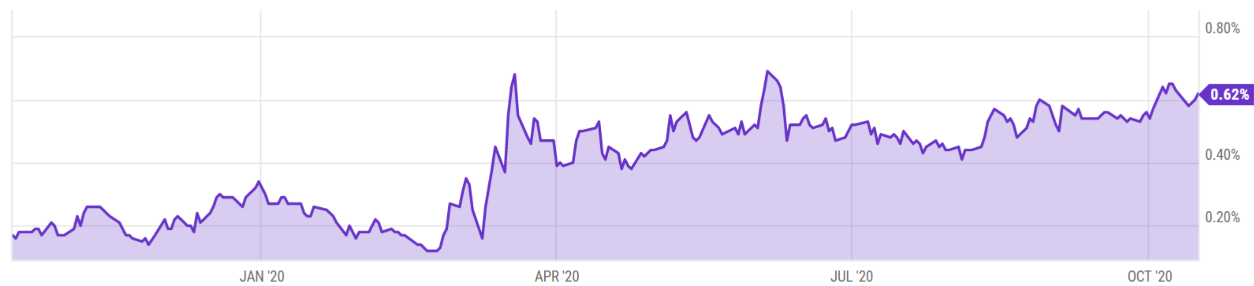
Fixed-income yields depend on numerous factors: interest rates, expected inflation, liquidity and maturity premiums, and default risk. A general indicator for the state of the fixed-income market are the yields on T-bills, T-notes, and T-bonds, which, graphed against time, form the yield curve. Since longer maturity bonds exposed investors to additional interest-rate risk, they usually sell at a premium compared to their shorter-maturity counterparts. Hence, the yield curve is usually upward-sloping. However, in periods of economic turmoil, investors will flock to longer-maturity bonds as a safe haven from increased short-term risk, resulting in higher long-term bond prices and lower yields. If the yields on longer maturity bonds dip below shorter ones, the yield curve is said to be inverted.

***Table 1: US Treasury Yields as of October 16, 2020.*** *The yield curve has normalized after a relatively volatile period in March.*

| Date | 1 Mo | 2 Mo | 3 Mo | 6 Mo | 1 Yr | 2 Yr | 3 Yr | 5 Yr | 7 Yr | 10 Yr | 20 Yr | 30 Yr |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Yield | 0.10 | 0.10 | 0.12 | 0.12 | 0.13 | 0.14 | 0.18 | 0.30 | 0.51 | 0.73 | 1.28 | 1.50 |

Such an inversion was seen in August 2019 with worries that the aging bull market was about to run out of steam. The yield curve remained relatively flat through early 2020 amid uncertainty about the economic impacts of COVID-19, with the 10-2 treasury yield spread remaining below 0.30% until March 2020. Since March, the 10-2 spread has rebounded slightly as worldwide government responses have quelled investor uncertainty and expectations have adjusted, and now sits at 0.60% (CNBC 2020). However, the impending election is likely to see another spread contraction as November approaches.

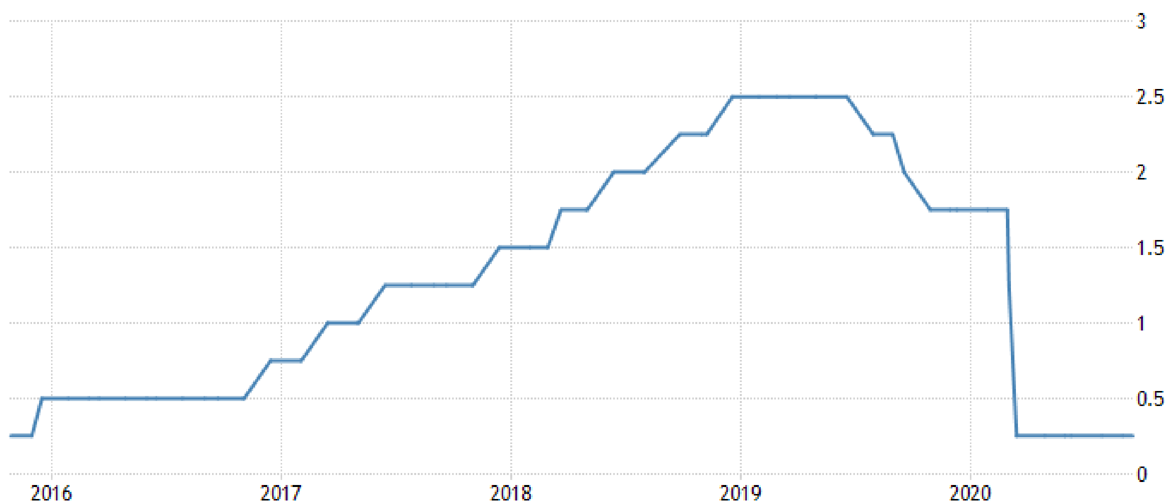
***Exhibit 1: Year-to-date 10-2 Year Treasury Spreads.*** *This metric represents the difference in yield between the 10-year T-bond and 2-year T-note and tracks the rough shape of the yield curve over time.*




## Monetary Policy Outlook

In addition to the lowest targets seen since the 07/08 financial crisis, banks have announced their commitment to continued quantitative easing, purchasing bonds and securities to inject money into the economy for further stimulation (National Bank of Canada, 2020). These actions have shifted the yield curve down, dramatically reducing treasury yields across the board and prompting many to look for more income in higher-risk corporate bonds. As BMO Global Asset Management puts it, “With global government yields as low as they are, demand for income is strong. At the same time, the March volatility is still fresh, making the more balanced profile of investment grade corporates appealing.” (BMO, 2020). At the same time, US corporate bond issuance is up again after a summer lull following a record-breaking spring (SIFMA, 2020). Corporate bonds could provide a higher-yield alternative, however, investors are warned to look out for increasing default rates, especially among speculative-grade bonds. S&P projects the corporate default rate for these bonds to rise from 3.5% in March 2020 to 12.5% in March 2021 (S&P Global Ratings, 2020).

***Exhibit 2: The Federal Funds Rate from 2016-present.*** *After steady increases pre-COVID over concerns of an aging bull market, interest rates were slashed to 0.25% in March and will remain at the zero-lower bound for the foreseeable future.*



### Continued Stimulation

With talks of a second wave resurfacing in many countries, central banks continue to plan further stimulation. In August, the Eurozone launched a €750 billion relief package involving unprecedented joint borrowing between EU nations (BMO, 2020). The US Federal Reserve has been considering Yield Curve Control, the continual purchase of long-term bonds to keep long-term interest rates below a target since July, a policy unheard of since World War 2 (Bloomberg, 2020). Although the Fed has remained reluctant to implement the policy thus far, a large sell-off threatening current yields could force their hand.

## The Upcoming Federal Election and the Fixed Income Market

While government response has diminished investor uncertainty, volatility is increasing as the upcoming US Federal Election approaches. According to Kevin Giddis, Head of Fixed Income at Raymond James, "Right now, while spreads have contracted quite a bit and continue to contract, volatility is starting to tick up which means investors are getting a little bit worried as we approach the election" (CNBC, 2020). But what are the implications for fixed-income strategies?

### Historical Impacts

It is important to note that in the past, elections have had limited impact on the fixed-income market, dwarfed in influence by the independent Federal Reserve. Although there will always be risk adjustments and pricing-in of uncertainty in markets, historically, the impact of elections has been short-lived. Even in surprise results such as the 2016 election, the increases in volatility and spreads normalized after the first few months (Lord Abbett, 2020). That being said, the decisions of the US Federal government do have consequences, and the fixed income market will not be completely immune to its effects.

### Polling and Projections Outlook

Nearly all advanced polling and projections sources, including Politico, CNN, and The Economist, predict a "blue wave": a Democratic sweep as the most likely outcome. Such an outcome could see taxes being raised and increased investment infrastructure which would make tax-exempt municipal bonds more attractive and increase their issuance. However, municipal bond markets have underperformed in the past month with small selloffs increasing yield in the lead-up to the election (Raymond James, 2020). Additionally, increases in taxes would decrease corporate profitability and have a negative impact on corporate bonds, however according to RBC Wealth management, "the actual appetite to raise taxes in the early years of a Biden administration given a weak economy may actually be quite low" (RBC Wealth Management, 2020). What is for certain is that both platforms have pledged large relief packages to further stimulate a weak economy in the wake of COVID-19. In summary, although a blue wave could result in a win for municipal bonds and a loss for corporates, yields will likely be kept low across the board under both platforms and the real focus should be on Fed changes this election cycle.

## Sovereign Debt Outlook

In today's yield-starved fixed income market, increasingly large amounts of investors have been turning to sovereign bonds to find more income. While many emerging bond markets such as India and Russia have had large selloffs in August, Chinese sovereign bonds have experienced an uptick in demand in recent months. Some investors believe that Chinese sovereign debt is a more stable and attractive place to find

higher returns as opposed to high-yield corporate bonds, with Chinese 10-year sovereign bonds at 3.25% compared to 10-year T-bonds at 0.76% (MarketWatch, 2020). "They're really the one asset out there that's both defensive and that's offering you some yield,'' said Evan Brown, head of multi-asset strategy at UBS Asset Management (Wall Street Journal, 2020). However, investors should be aware of the limitations and risks associated with Chinese debt: strict government regulations and local capital controls restrict transactions in the event of market shocks. In conjunction with additional regulation that encourage domestic banks to hold bonds until maturity, these regulations raise liquidity issues and trading costs in secondary markets.

## Appendix: Government Bonds

Government bonds are an important component of the fixed income market whose virtually risk-free returns serve as the basis for many metrics, trading concepts, and strategies. Although governments at all levels issue bonds (federal, provincial, municipal), the most common and widely traded government bonds are those issued by the federal government. Out of these, the most well-known are treasury bills (T-bills), treasury notes (T-notes) and treasury bonds (T-bonds), which are issued by the US Treasury Department with semiannual coupon payments and maturities ranging from 1 year or less (T-bills) to 2-10 years (T-notes) to 10+ years (T-bonds). At issuance, these are auctioned off by the Treasury Department and are subsequently traded on secondary over-the-counter (OTM) markets.