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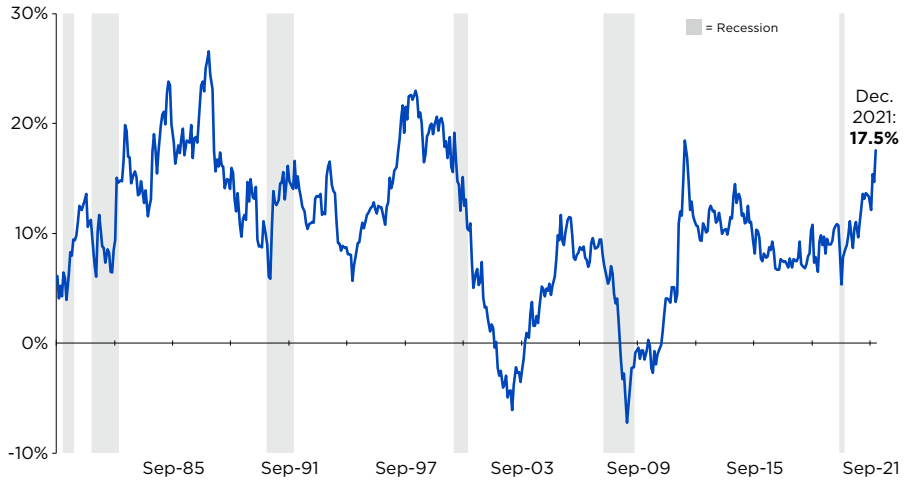
Fixed Income at an Inflection Point

INTRODUCTION

The post-financial crisis period has been both strong and consistent for investors, despite the sudden spell of uncertainty and volatility during the COVID-related downturn and recovery. Thanks to recent strong rallies in both stock and bond markets, even investors with moderate portfolio allocations have enjoyed robust returns. For example, the traditional balanced portfolio of 60% equities/40% bonds has delivered an annualized return of 17.5% over the last three years and 11.1% over the last 10 years (using the S&P 500 Index and the Bloomberg U.S. Aggregate Bond Index as proxies for the respective portfolio allocations.)

3-year Average Annual Return for 60/40 Portfolio
(60% S&P 500® Index/40% U.S. Aggregate Bond Index)



Source: FactSet Research Systems.

After a stretch of strong performance, a period of more modest returns would not be unexpected or unhealthy for the markets. It could, however, challenge many investors who have grown accustomed to double-digit returns from their 60/40 balanced or moderate growth portfolios. While equity markets have several significant risk factors to contend with, this paper examines the current dynamics in fixed income markets and how potential outcomes for bonds could impact investors with diversified portfolios.

Mark Hackett
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KEY TAKEAWAYS

- Inflation has spiked due to supply chain disruptions and temporary input shortages, though it remains uncertain how long these inflationary pressures may persist.
- Federal Reserve monetary policy remains a primary driver of the market and the economy, though the tapering of asset purchases isn't expected to produce disruptions like the "taper tantrum" in 2013.
- The supply/demand dynamics of fixed income assets could be at an inflection point, with both Treasury and corporate issuance potentially slowing in 2022 and uncertainty about continued strong demand from investors.
- Forecasting interest rates has historically shown to be unreliable, with central bankers, economists and bond investors all demonstrating inaccuracy in predicting the future direction of interest rates.

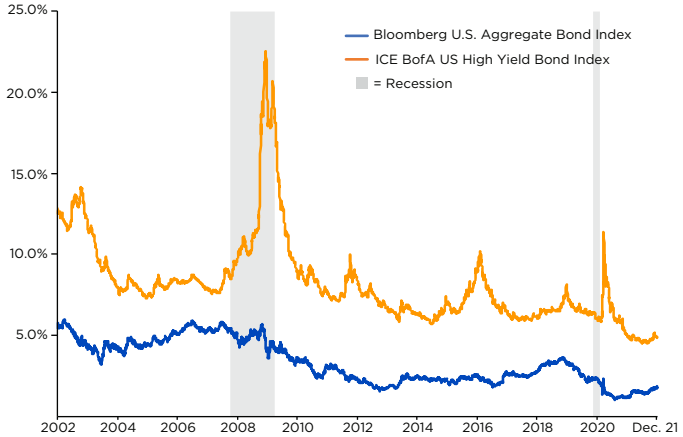
HEADING INTO UNCERTAIN WATERS

Since hitting all-time lows in August 2020, interest rates rebounded into 2021 but didn't really break out to higher levels. The benchmark 10-year Treasury rate hit a calendar-year high of 1.72% in March, then met resistance that lasted through the remainder of the year. Not that there hasn't been enough impetus to push rates higher; inflation spiked to levels not seen in 40 years and the Federal Reserve moved to taper their asset purchase programs starting in November, setting the stage for rate hikes in 2022. Fears of higher interest rates are justified, even if they haven't fully materialized yet, because from current levels any move higher for interest rates would shrink bond market return and may potentially reduce the total return of the traditional 60/40 portfolio to single digits.

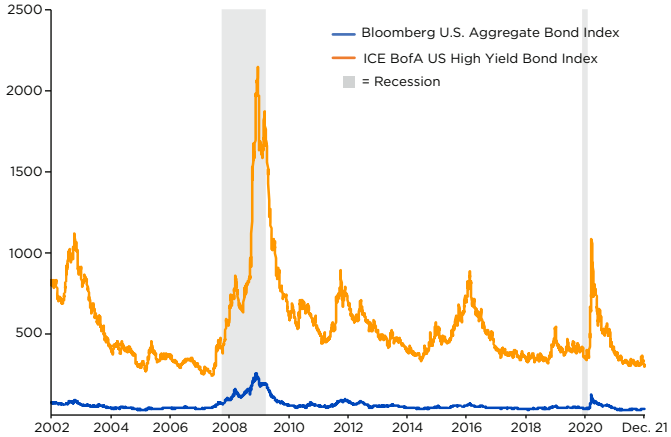
Given the near-unidirectional move in interest rates since the global financial crisis (and arguably back to the early 1980s), an extended period of capital losses for bonds would test the majority of investors. Low-duration bonds may offer some protection in a rising rate environment, as they are quicker to benefit from higher yields, but these securities have largely been dismissed by investors due to their low absolute yields and the stronger relative returns in longer-duration assets.

Meanwhile, exposure to credit-sensitive assets could mitigate the low-yield environment, as the improving economy, accelerating earnings and higher commodity costs act as a tailwind. Active management can exploit areas of opportunity within industries and companies. A short-duration, credit-sensitive allocation could balance a traditional longer-duration exposure to protect against capital losses in an uncertain rate environment.

U.S. Bond Yields



U.S. Bond Spreads



Source: FactSet Research Systems

SUPPLY & DEMAND CONSIDERATIONS

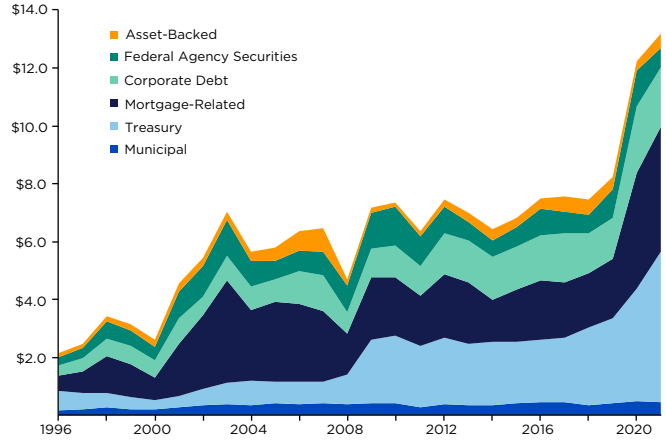
Since the global financial crisis, both companies and governments in advanced countries have aggressively issued debt to take advantage of low interest rates and the accommodative environment. The U.S. saw its debt-to-GDP skyrocket from 46% in 2007 to 122% at the end of Q3 2021.[1] This trend is expected to increase through 2025 without factoring in any additional fiscal spending initiatives. Corporate bond issuance has exploded higher as well, with domestic investment-grade and high-yield issuance jumping from roughly $800 billion in 2019 to nearly $1.5 trillion in 2020.

Heading into 2022, there were some signs of tempering in bond market supply. Treasury bond issuance had begun to slow late in 2021. Moreover, we saw evidence in 2021 of corporate issuers front-loading their borrowing needs for the next several years. This raises the possibility that corporate bond issuance may ease from recent record levels in the coming year.

Behind the historic pace of bond issuance is the persistent demand for yield and safety from investors, especially as the population has aged. If investor appetite and/or confidence fades, issuers will be forced to either slow the growth of debt or pay more to borrow in the form of higher interest rates. Fixed income flows were sluggish during the previous "taper tantrum" in 2013. That could foreshadow how investor demand may cool during a period of sustained higher interest rates.

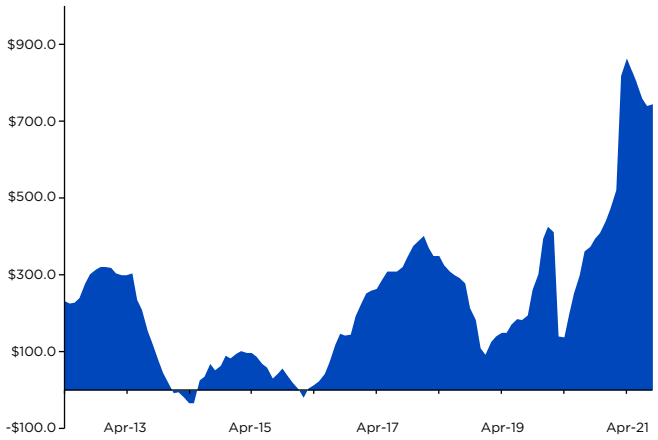
[1] Federal Debt: Total Public Debt as Percent of Gross Domestic Product, (GFDEGDQ188S). Federal Reserve Bank of St. Louis (FRED data)

Bond Issuance per Year



Source: Bloomberg, Dealogic, Refinitiv, U.S. agencies, U.S. Treasury

Fixed Income Flows (Funds & ETFs)



Source: FactSet Research Systems

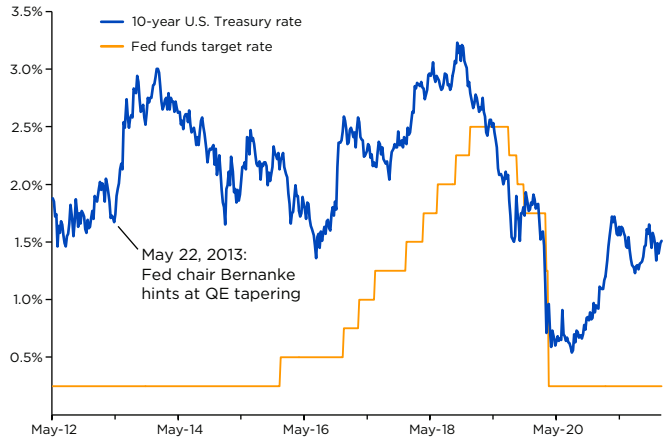
TAPERING WITHOUT THE TANTRUM

Since the advent of zero-rate policy and quantitative easing in the global financial crisis, bond market dynamics have been inextricably linked to the outlook for Federal Reserve policy. The central bank's reaction to the COVID-19 pandemic injected trillions of dollars of support into bond markets, which along with the lowering the Fed funds target rate to near-zero helped the economy make it through the initial shock of the pandemic.

As the economic recovery continued in 2021, the Fed did a reasonably good job in telegraphing their intention to back away from accommodative monetary policies, including the "tapering" bond purchases beginning in November. This approach was markedly different from the previous period of Fed tapering in 2013, when interest rates rose on the Fed's announcement of tapering bond purchases (the infamous "taper tantrum") but moderated once the actual tapering began. In retrospect, the "taper tantrum" of 2013 was mostly a case of investors reacting to uncertainty by "selling the rumor, buying the news."

In 2021, bond investors have more confidence in the way the Fed is managing the current tapering process. That helps explain why we didn't see much disruption in the bond market last year, including no break-out of rising interest rates.

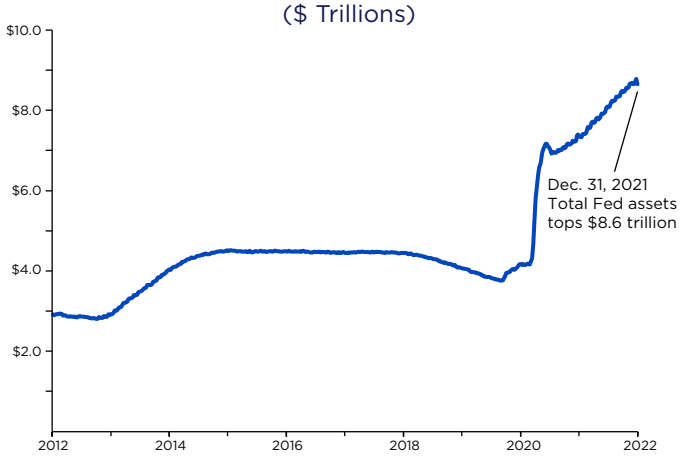
10-Year Treasury Rate vs. Fed Funds Rate



Source: FactSet Research Systems

Federal Reserve Assets

($ Trillions)

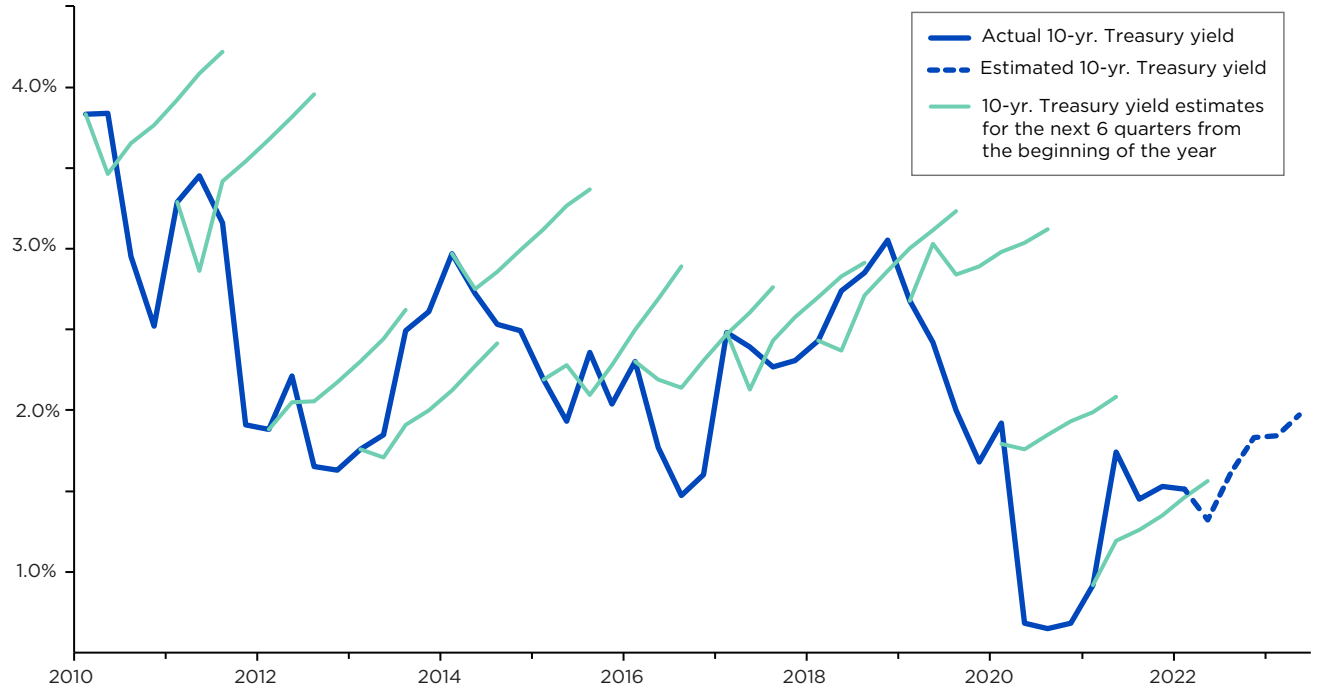


RATES ARE DIFFICULT TO FORECAST

Any discussion of the outlook for the bond market should also include a caveat about forecasting interest rates. Both economists and bond market analysts have collectively been lousy at predicting the future direction of interest rates. Since the end of the financial crisis, the consensus of annual estimates from economists on where the 10-year U.S. Treasury rate was headed in the coming year were wrong in 10 out of 11 circumstances. The one year that economists got their predictions mostly right was 2017. (See chart below.) In particular, predictions for the 10-year Treasury yield were worst in the two most recent years, 2020 and 2021. Moreover, the bias was almost exclusively to the upside, assuming a reversion to the mean. But what is the mean of the 10-year yield over the past 40 years?

If economists have a difficult time predicting rates, perhaps we should take our signals from the market. However, a similar chart showing Fed Funds futures rates (market-based) versus actual Fed funds rate shows a similar degree of inaccuracy. These discrepancies serve as further evidence that taking large swings in a portfolio based on the direction of interest rates is risky proposition. A more prudent approach would include a diverse range of bond maturities across the yield curve.

10-year U.S. Treasury Yield
(Actual vs. Six-Quarter Estimates)



Source: Factset Research Systems, Philadelphia Federal Reserve.

Conclusion

An inflection point for interest rates may be on the horizon as the economic cycle matures and issuance remains robust. There's a good probability that the 40-year bull market in bonds is likely over, with the historic low for 10-year Treasury established in August 2020. Increasing interest rates would pressure returns for many fixed income strategies, along with the patience of investors. Continued strength in the economy is likely to help credit-sensitive issuers, potentially offsetting the rate headwinds. In an uncertain rate environment, short-duration and credit-sensitive allocations could help balance a traditional longer duration exposure to protect against capital losses.

ABOUT THE AUTHOR

Mark Hackett serves as Chief of Investment Research. As a leader for Nationwide's capital markets analysis, Mark develops content to educate financial advisors and their clients on financial markets and implications for investors. In this role he is responsible for asset class research, market commentary, white papers and topical market pieces.

Mark brings more than 20 years of experience in the asset management industry, including roles in research for both Nuveen and Vanguard Group and as a portfolio manager for Nuveen. He began his investment career at the Vanguard Group as a research associate in the fixed income group.

Mark has been interviewed by and quoted in numerous media outlets, including The Wall Street Journal, CNBC.com, CNN Money, The Associated Press Money and several others. He also contributes weekly market commentary to the Nationwide Advisor Advocate Blog.

He earned his Bachelor of Science in Business Administration with concentrations in Finance and Economics at the University of Richmond, holds Chartered Financial Analyst (CFA) and Chartered Market Technician (CMT) designations and is a member of the CFA Institute.

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Bloomberg US Aggregate Bond Index: An unmanaged, market value-weighted index of U.S. dollar-denominated, investment-grade, fixed-rate, taxable debt issues, which includes Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities and commercial mortgage-backed securities (agency and non-agency).

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