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Where to Find Yield While Limiting Risk in the 2021 Bond Market.

Fixed income strategists offer their outlooks and recommendations.

The performance of the U.S. fixed income market in 2021, like most financial markets, will depend largely on the extent of the economic recovery, which in turn, depends on the trajectory of the coronavirus pandemic and the distribution and uptake of vaccines that can stem its spread.

The Federal Reserve said as much in its latest policy statement: "The path of the economy will depend significantly on the course of the virus. The ongoing public health crisis will continue to weigh on economic activity, employment, and inflation in the near term, and poses considerable risks to the economic outlook over the medium term."
In the meantime, long-term rates have been rising almost steadily higher since Pfizer first announced on on Nov. 9 that its COVID-19 vaccine was 90% effective — a number it soon raised to 95% — followed by the first vaccinations on Dec. 8 in the U.K. and Dec. 14 in the U.S.

The 10-year Treasury note was yielding 0.92% as of Dec. 25, and U.S. bond strategists expect even higher rates by year-end 2021, at or slightly above 1.5% if the recovery gathers steam.
"It will be a big move if we get to 1.6%," but not much of a surprise if the economy is growing and inflation is rising, said Kathy Jones, chief fixed income strategist at the Schwab Center for Financial Research, in an outlook webinar. Most economists expect growth will pick up in the second half of the year but not return to pre-pandemic levels for at least a year.

Short-term rates are another story. The Fed has indicated it won't raise them from their current 0-0.25% range before 2023 and has pledged to maintain that range until the economy has achieved maximum employment with inflation averaging 2% and inflation expectations "well anchored at 2%." Inflation, based on the Personal Consumption Expenditure Deflator, the Fed's favorite indicator, was up only 1.5% in November compared with a year ago.

"Finding long-term returns will be more difficult now than it was in the last decade," said David Kelly, chief global strategist at J.P. Morgan Asset Management.

Given this backdrop of potentially moderately higher long-term yields, unchanged short-term rates and an economic recovery that's vulnerable to flare-ups of the virus, more contagious strains and vaccine distribution issues, bond strategists caution investors to expect middling returns for fixed income assets in 2021.

For example, John Flahive, head of fixed income investments for BNY Mellon Wealth Management, expects the AGG — the aggregate index of investment-grade government securities, mortgage and asset-backed and corporate bonds — will return less than 3%, compared with 7% this year.

For those investors searching for yield, many strategists are recommending moving down the credit rating scale but not below B and being selective about individual issues.

“Avoid the lowest credit quality in the corporate sector,” Jones said, noting that even though a lot of companies managed to refinance their debt, they don’t see a strong future for earnings or cash flow. And CCC-rated bonds “don’t have a lot of upside.”

“The BB-rated index has a yield around 5%, and we expect default rates have already peaked,” wrote BlackRock’s chief investment officer of global fixed income, Rick Rieder, in his 2021 outlook.

Elaine Stokes, portfolio manager at Loomis, Sayles & Co. expects the spread between high-yield bonds and Treasurys of comparable maturities to narrow to about 300-325 basis points from their current level, which is slightly above 400 basis points, according to the St. Louis Fed.

Despite expectations for narrower spreads in 2021, many strategists advise investors to be selective in their bond choices.

“Know what you’re buying,” cautioned John Queen, a fixed income portfolio manager at Capital Group. Referring to the corporate, mortgage-backed and municipal bond market, he said, “There are still opportunities, but they need to be assessed security by security, issuer by issuer and active management will play an important role.”

For muni bonds, Queen stressed the importance of knowing which states will continue to do well despite the pandemic and which will experience credit deterioration. More federal aid for state and local governments would help, but that possibility remains unfulfilled.

Emerging market bonds is another fixed income asset category that strategists like for 2021 because of expectations for global economic recovery and a weakening U.S. dollar. “Emerging markets, especially Asia, have proven surprisingly resilient during the COVID crisis and could do especially well in a world of ample U.S. dollar liquidity, rebounding global growth, a weaker U.S. dollar and compressing yield/risk premiums,” Rieder wrote.

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