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2021: The Year in Bond Funds

Credit risk prevails in a rocky year for bond markets.

Bond markets had to contend with a rocky 2021 characterized by rising inflation, a bumpier economic recovery, and the start of tighter monetary policy. The threat of inflation gathered pace over the year, unnerving government-bond markets in the process and culminating in the Federal Reserve's hawkish pivot in the fourth quarter. Meanwhile, the stretch for yield that began in 2020 continued, with lower-quality credit surging for much of the year.

As a result, performance across fixed-income Morningstar Categories was mixed as more-credi--sensitive strategies outpaced most of the pack, while interest-rate-sensitive and non-U.S. dollar-denominated bond funds posted losses. High-yield municipal funds led the way, with an average return of 5.7%, while emerging-markets local-currency bond funds plunged 7.3% on average. The Morningstar U.S. Core Bond Index, a proxy for typical U.S. bond exposure, fell 1.6% for the year, posting its worst calendar-year return since the taper tantrum roiled fixed-income markets in 2013.

Fed Tightens Policy Amid Rising Inflation
Driven by a first-quarter spike, interest rates rose in 2021, causing notable volatility at times as investors got to grips with rising inflation, a changing economic outlook, and new coronavirus variants. The year began with a significant steepening of the yield curve as the market reacted to the potential for both higher economic growth and inflation. The 10-year U.S. Treasury yield spiked 81 basis points over the first quarter to end the period at 1.74%. However, as the economic recovery became bumpier and inflation continued to rise, the yield curve partly retraced the first quarter's steepening over the remainder of the year. Short-term yields modestly rose, while the 10-year yield declined to 1.52% by the end of 2021.

The Fed characterized inflation as transitory for much of the year but abandoned that tag in November as core price inflation prints continued to rise. At the most recent reading, CPI rose 6.8% over the trailing 12 months through November 2021. In response to the growing threat of inflation and an improved job market, the Fed pivoted to a more hawkish stance in the fourth quarter. The Fed began tapering asset purchases in November, aiming to complete the wind-down by mid-2022. However, in December, the Fed doubled the pace of the tapering, speeding up the timeline to an expected finish in March 2022. Fed officials also increased their expectations for rate hikes in recent meetings, with the latest projections now indicating three rake hikes in 2022.

As inflation expectations rose, U.S. Treasury Inflation-Protected Securities outperformed nominal Treasuries; the Morningstar U.S. TIPS Index returned 5.7% for 2021, while the Morningstar U.S. Treasury Bond Index posted a 2.3% loss. Within the inflation-protected bond category, strategies that added credit exposure alongside TIPS led the way. One such offering was Lord Abbett Inflation Focused (LIFIX), which rallied 10.4% and bested all but one of its peers. Meanwhile, short-term Treasuries fared better than longer-term issues given the first-quarter yield-curve steepening. Tracking one- to three-year maturity issues resulted in a modest 0.7% fall for Vanguard Short-Term Treasury Index (VSBSX).

Within the intermediate core and core-plus bond categories, strategies that held elevated allocations to securitized sectors and/or high-yield debt, both of which have less interest-rate sensitivity than Treasuries and investment-grade corporates, were among the top performers, though gains were modest. Pioneer Bond (PICYX) posted a 0.7% return, which outpaced its typical core-plus category peer by 140 basis points thanks to its elevated allocations to securitized and junk-rated credits.

Credit Investors Hunt for Yield
Alongside rising inflation, credit-sensitive assets continued to outperform. Within corporate credit, junk-rated bonds outperformed investment-grade issues over 2021 as investors stretched for yield, though there was a brief period of risk-off sentiment in the fourth quarter driven by the emergence of the omicron coronavirus variant and the Fed's more hawkish stance. The Morningstar U.S. High Yield Bond Index rose 5.2%, while the Morningstar U.S Corporate Bond Index (which tracks investment-grade issues) posted a 1.1% loss. Energy credits gained a significant boost from a surge in the price of oil due to robust demand. Crude Oil (WTI) began the year just under $50 dollars a barrel and ended it at $75, having pared back some of its substantial gains in the fourth quarter.

The U.S. high-yield default rate fell below 1% in 2021, and positive credit trends helped the lowest-rated credits outperform. The Bloomberg index for credits rated CC to D rocketed 12.5%, with the highest returns at the lower end of the credit-quality spectrum. The best performers in the high-yield category were typically funds that tilted toward lower-quality bonds and/or had a hefty allocation to equities. Fidelity Capital & Income (FAGIX) held roughly one fifth of assets in equities for most of the year and profited from the continued rally in stocks to return 11.7% for the year, besting nearly all comers in the category.

Convertible bonds, hybrid securities that combine debt and equity characteristics, also benefited from the continued upswing in equities. MainStay MacKay Convertible (MCNVX) returned 10.1% and landed in the convertibles category's best decile over the period. Meanwhile, bank loans were back in vogue. The S&P/LSTA Leveraged Loan Index added 5.2% for the year as investors eyed the sector's floating-rate coupons, which increase as interest rates rise. Similar to the theme across corporate bonds, lower-rated loans outperformed. Invesco Senior Floating Rate (OOSYX) gained 9.1% and beat all bank-loan category peers thanks to its sizable stake in loans rated below B.

Strong Dollar Weighs Down Global Returns
Alongside the Fed, central banks across the globe began to tighten monetary policy in late 2021, though they did so to varying degrees. The Bank of England unexpectedly hiked rates to 0.25% in December 2021, becoming the first G7 central bank to raise rates since the onset of the coronavirus pandemic. The European Central Bank took a more gradual approach, electing to taper its bond purchases but to continue them for at least the first 10 months of 2022. Meanwhile, the Bank of Japan remained among the most dovish central banks by dialing back some emergency funding while pledging to keep monetary policy ultra-loose.

The U.S. dollar enjoyed a strong 2021, gaining 6.7% for the year against a basket of developed-markets currencies, driven by the American economy's relative strength and the Fed's tighter policy outlook. That backdrop helped the U.S.-dollar-hedged version of the Morningstar Global Core Bond Index limit its slide to 1.7%, while the unhedged version dropped 5.7%. Across world bond funds, those that ventured further outside of sovereign debt into corporate and securitized credit fared better in 2021. AB Global Bond (ANAIX) did just that, which helped limit its slide to 0.8% and placed it among the world bond USD hedged category's top performers.

Emerging markets were also weighed down by the strength of the U.S. dollar along with a weaker outlook for growth. Local-currency-denominated emerging-markets debt materially lagged hard-currency fare, with the J.P. Morgan Index for the former plunging 8.8%, while the latter slid 1.8% for the year. Here, too, corporates outperformed; the J.P. Morgan CEMBI Diversified Index gained 0.5%. Avoiding local-currency debt and adding a dose of corporate credit helped limit Fidelity New Markets Income's (FNMIX) fall to 1.8%, while its typical emerging-markets bond category peer declined 2.4%.

Demand for Munis Continues

Municipal debt continued to see robust demand in 2021 as further fiscal stimulus, particularly March 2021's $1.9 trillion American Rescue Plan, along with the potential for higher income taxes, helped fuel investor appetite. Long-term muni sales exceeded $450 billion in 2021, roughly in line with 2020's record-breaking numbers. That backdrop helped the Bloomberg Municipal Bond Index gain 1.5% for the year, outpacing U.S. Treasuries by over 3 percentage points in the process.

The general fixed-income theme of lower-quality credit outperforming over the year also extended to the muni market. The Bloomberg High Yield Municipal Bond Index surged 7.8% as the hunt for yield and munis' lower default rate compared with corporates helped drive demand. BlackRock High Yield Municipal (MAYHX) was one of the strongest performers over the year in the high-yield muni category, rocketing 9.2% in part because of its overweighting in lower-rated bonds.

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