DUCENTA SQUARED
ASSET MANAGEMENT

# Monthly Fixed Income Insight

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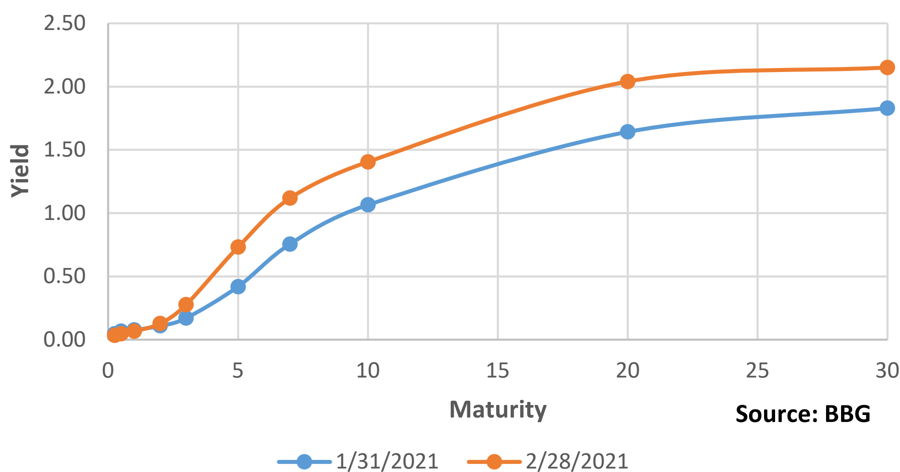
Interest rates took center stage in the fixed income markets in February. Long dormant bond vigilantes ignored the adage of "don't fight the Fed" and tested the Federal Reserve's resolve to maintain easy monetary policy in the face of reflationary fears and a global upswing in economic activity. In extremely volatile and illiquid trading, the 10-year U.S. Treasury briefly breached 1.60% before ending the month up 33 basis points at a yield of 1.41%. Given the rise in rates, returns across most fixed income markets were negative, with the Bloomberg Barclays Aggregate Index returning -1.44% for the month.




With Covid cases falling and vaccines rolling out, economic data showed the beginnings of a transition from weaker activity to the robust growth we expect by mid-year. Consumer spending rebounded in January with the infusion of government transfers from December's $900 billion stimulus package. Personal incomes climbed 10% and the savings rate exceeded 20%, providing ample fuel for spending as the economy reopens. Improvements in the labor market, however, have stalled and employment remains approximately ten million jobs below pre-Covid levels.

Inflation fears, predicated on easy monetary policy, additional fiscal stimulus, and an eventual economic reopening, dominated the start of the year. Inflation expectations from the breakeven inflation rate in the TIPS market continue to climb and ended the month at 2.16%. Actual inflation, however, remained modest with the Core CPI and Core PCE for January at 1.4% and 1.5% respectively.

The House passed the $1.9 trillion "American Rescue Plan" which now goes to the Senate for debate and amendments. The Biden administration's "go big" approach potentially brings the combined stimulus since the start of the pandemic to $5.4 trillion or a staggering 25% of GDP.

The Federal Reserve faces a difficult communication challenge. Chairman Powell pushed back against the rise in rates and reiterated that changes to current policy are tied to "substantial

further progress" towards the committee's goals of stable 2% inflation and maximum employment. For now, the rise in rates is viewed by the Fed as a "healthy" confirmation of the market's confidence in the economic recovery. The recent rise in rates differs from the taper tantrum in 2013 where the markets reacted negatively to a potential change of Fed policy. Instead, the Fed is trying to reassure the markets that policy will continue to remain accommodative while investors are reacting to an adjustment to the outlook for inflation and the economy.

In our fixed income strategies, we continue to believe the fundamentals for the credit and securitized sectors should improve with the economic recovery. The sectors are also supported by positive supply and demand technicals. Supply should decline after the robust issuance in 2020, and the demand for yield is extremely strong. Valuations are the biggest challenge for the markets. Most sectors have returned to pre-Covid levels and leave little upside potential. Yield or carry -- rather than price appreciation -- should drive returns in 2021. We are currently positioned with overweights in high yield and asset-backed securities, neutral investment grade credit and underweight agency MBS. We expect U.S. interest rates to consolidate in the near-term but have raised our year-end target for the 10-year Treasury to 1.75%.

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