



# FIXED INCOME UPDATE THIRD QUARTER 2021

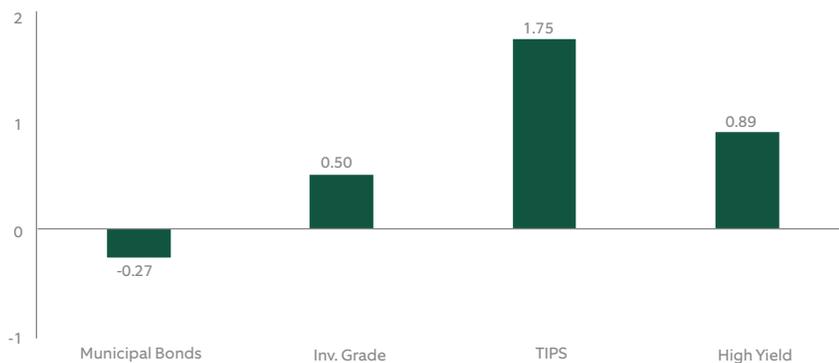
## KEY POINTS

- The economy improved, although more slowly than earlier this year.
- The Federal Reserve remains accommodative. However, recent financial developments are reshaping the extremely accommodative policies of monetary and fiscal authorities.

## EXHIBIT 1: TIPS DELIVER STRONGEST RETURNS

Treasury inflation-protected securities (TIPS) delivered the strongest fixed income returns during the quarter as investors worried that the U.S. faces sustained inflation. High yield and investment grade bonds also delivered positive returns, while municipal bonds declined.

### Third Quarter Bond Returns (%)



Source: Bloomberg, as of September 30, 2021

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## Long-Term Views

- Inflation, central bank policy and the yield curve are regaining their prominence in investors' minds as the economic and market impact of the pandemic fade.
- Global central bankers will remain accommodative as economic growth slows but doesn't stop, and inflation remains elevated for now.

ECONOMY

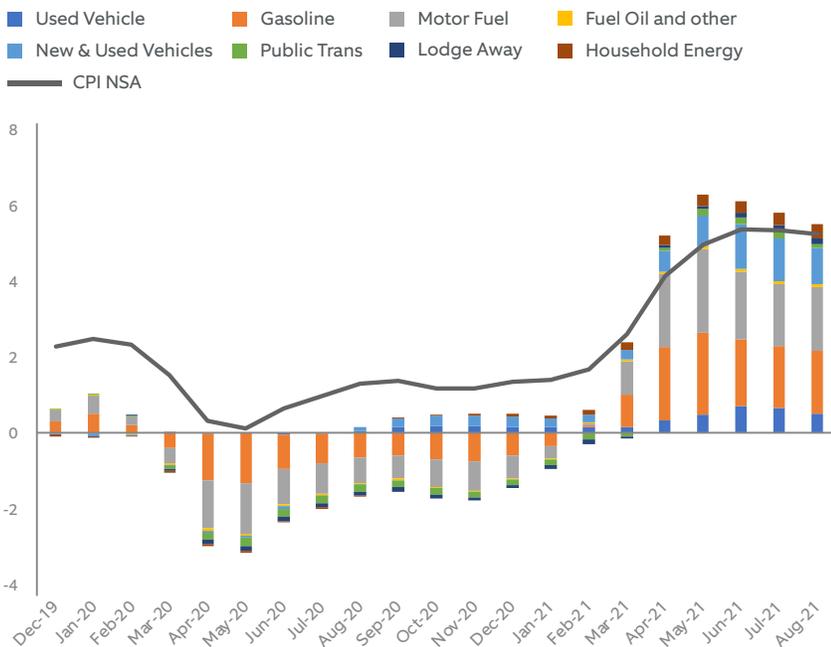
- Both initial and continuing jobless claims fell, suggesting that people are returning to work. The unemployment rate ended the quarter at 4.8%. Conversely, businesses across the country continued to report difficulties in hiring and keeping employees.
- The Core Personal Consumption Expenditures Index continued at highs comparable to the early 1990s. This was largely due to pricing in areas of the economy that were hit particularly hard by COVID-19 — such as airlines, hotels and transportation.

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EXHIBIT 2: UNSUSTAINABLE PRICE HIKES BOOST INFLATION

Inflation remains elevated. Because it's due to what we view as unsustainable highs in a few areas, we don't think it will persist.

U.S. Consumer Price Index Components' Contribution to Year-Over-Year Change (%)



\*NSA should be interpreted as, “not seasonally adjusted”  
 Source: Northern Trust Asset Management, Bloomberg. As of September 30, 2021

FEDERAL RESERVE

- The Fed remained accommodative throughout the quarter, keeping its asset buying at a constant pace of \$120 billion per month to keep interest rates low. However, Chairman Jerome Powell indicated the Fed is prepared to begin winding down asset purchases later this year. His statements caught investors off guard, causing them to think the Fed may raise rates sooner than they’d anticipated.
- Investors speculated about the potential near-term impacts on policy of Fed personnel changes. A personal trading scandal contributed to the early retirement of two nonvoting regional Fed presidents, Eric Rosengren and Robert Kaplan. Also, Chairman Powell’s renomination was called into question by Senator Elizabeth Warren.

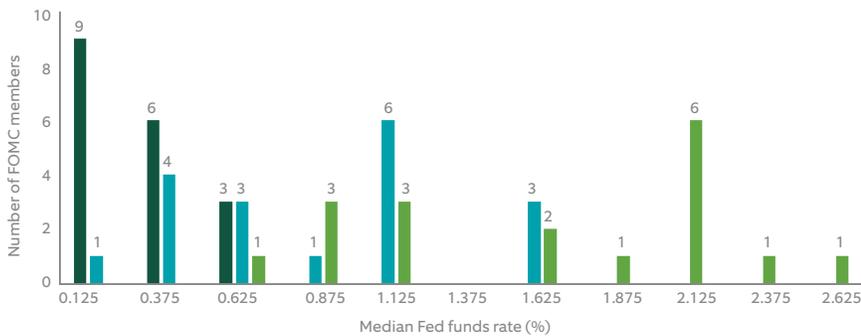
Members of the Federal Open Market Committee have turned more hawkish as the economy has improved, raising the probability of a rate hike in 2022.

EXHIBIT 3: DOT PLOT SUGGESTS EARLIER RATE HIKE

The dot plot signals where Fed policymakers believe the median Federal funds rate should be at a specific future time. Members of the Federal Open Market Committee have turned more hawkish as the economy has improved, raising the probability of a rate hike in 2022.

Federal Reserve Dot Plot

■ 2022 ■ 2023 ■ 2024



Source: Northern Trust Asset Management, Federal Reserve. As of September 30, 2021

GLOBAL CENTRAL BANKS

- Leading industrial nations left their key interest rates unchanged. However, numerous central banks — including Russia, Mexico, Turkey and the Czech Republic — began to raise rates.
- European Central Bank President Christine Lagarde said the bank will modestly slow its emergency pandemic bond purchases. She said this is “recalibration” rather than “tapering.”

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EXHIBIT 4: GLOBAL RATES MOSTLY FLAT

Although U.S. rates remain historically low, they are high relative to those of other developed economies.

Global Government Rates (%)

	1Y	5Y	10Y	30Y	1Y	5Y	10Y	30Y
	6/30/2021				9/30/2021			
Australia	0.01	0.83	1.53	2.28	0.01	0.78	1.49	2.37
Eurozone	-0.63	-0.59	-0.21	0.29	-0.65	-0.56	-0.20	0.28
Germany	-0.64	-0.59	-0.21	0.29	-0.68	-0.56	-0.20	0.27
Japan	-0.10	-0.10	0.06	0.69	-0.10	-0.08	0.07	0.68
U.K.	0.03	0.33	0.72	1.23	0.24	0.64	1.02	1.37
U.S.	0.07	0.89	1.47	2.09	0.07	0.96	1.49	2.04

Source: Northern Trust Asset Management, Bloomberg. As of September 30, 2021

## ULTRA-SHORT/CASH

- Short-end credit spreads, as measured by the Bloomberg 1-3 Year option adjusted spreads, were flat over the quarter as investor demand for short-term fixed income remained strong.
- Bill supply cuts and the lack of a debt ceiling resolution pressured short-term maturities. As a result, usage of the Fed’s reverse repo facility set new all-time highs, including usage of more than \$1.6 trillion by quarter-end.

### EXHIBIT 5: REVERSE REPO FACILITY SET NEW ALL-TIME HIGHS

The Federal Reserve’s reverse repo facility (RRF) accepts extra cash in the repo market, creating a floor for the Fed funds rate. Bill supply cuts and the lack of a debt ceiling resolution pressured short-term maturities, driving the RRF to new highs.

#### The Fed’s Reverse Repo Facility



Source: Northern Trust Asset Management, Bloomberg, as of September 30, 2021

## Performance

- Contributors: sector allocation, duration
- Detractor: curve positioning

## Current Positioning

Portfolios are positioned neutral-to-long duration relative to their benchmark. Their cash benchmark means purchasing corporate or Treasury bonds makes the portfolios long duration.

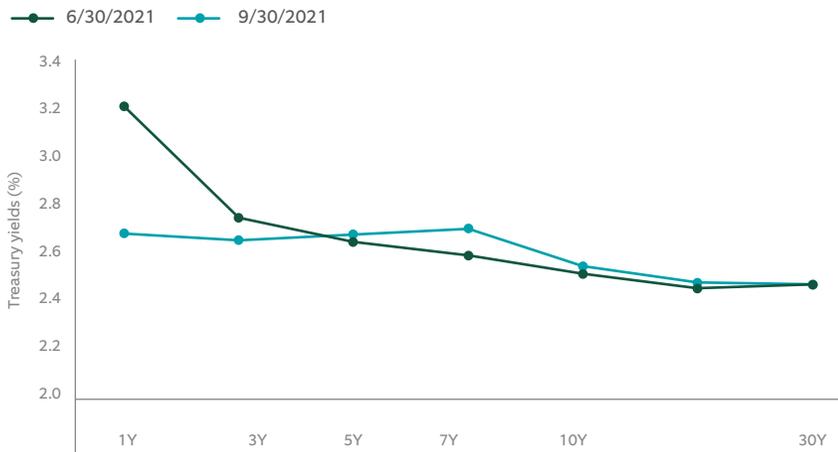
**TREASURYS AND TREASURY INFLATION-PROTECTED SECURITIES (TIPS)**

- The Treasury curve “bull flattened” meaningfully, with rates temporarily near year-to-date lows in the quarter due to high inflation data, reduced fiscal stimulus expectations and re-pricing of rate hikes. However, the curve ended roughly flat as Treasurys sold off into the quarter’s end.
- TIPS are supported by near-term inflation data, however, their breakeven curve remains inverted as market participants believe inflation will not prove too sticky over the medium term.

**EXHIBIT 6: FLATTENING AT THE LONG END**

TIPS’ breakeven curve flattened as shorter-term breakeven points moved lower and longer term TIPS traded in a tight range.

**U.S. TIPS Breakeven Yield Curve**



Source: Northern Trust Asset Management, Bloomberg, as of September 30, 2021

**Performance**

- Contributors: inflation carry and longer dated rates
- Detractor: duration in the belly of the curve

**Current Positioning**

Portfolios are positioned neutral-to-long duration relative to their benchmarks because we believe the market is incorrectly pricing in inflation and the Fed tightening cycle.

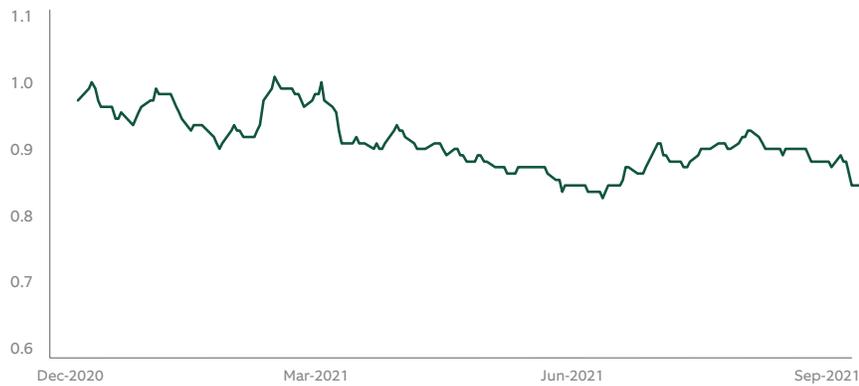
## INVESTMENT GRADE BONDS

- Companies continued to issue investment grade bonds to hefty demand from investors. On average, corporate bond deals were oversubscribed 3.03x. Lower quality corporates outperformed higher quality, with BBB-rated bonds returning 0.11% while AAA-rated bonds returned -0.34%.

### EXHIBIT 7: TIGHT SPREADS FOR INVESTMENT GRADE BONDS

Investment grade spreads continued to trade in a tight range.

#### Investment Grade Option Adjusted Spreads (%)



Source: Northern Trust Asset Management, Bloomberg, as of September 30, 2021

## Performance

- Contributors: sector allocation, security selection
- Detractors: curve positioning, duration

## Current Positioning

Portfolios are positioned neutral-to-long duration relative to their benchmarks, while maintaining a moderate overweight to corporate bonds.

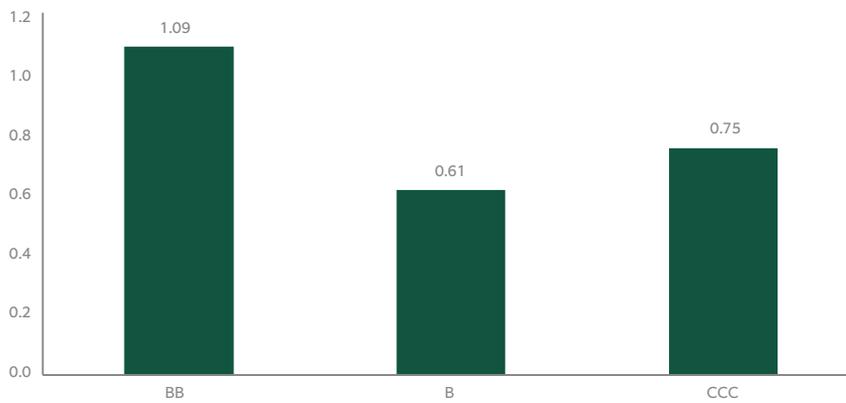
## HIGH YIELD BONDS

- High yield bonds delivered solid performance despite yield spreads widening (by 21 basis points) over the quarter for the first time since 2020. Momentum in higher quality credits persisted from the end of the second quarter into July and early August as interest rates fell before reversing for the rest of the quarter.
- No high yield companies defaulted, thanks to an improving economy. This pushed the long-term default rate to 2.3%, its lowest level since 2019.

### EXHIBIT 8: HIGH YIELD RETURNS

High yield bonds continued to deliver solid performance during the third quarter.

#### Third Quarter High Yield Returns by Credit Quality (%)



Source: Northern Trust Asset Management, Bloomberg, as of September 30, 2021

## Performance

- Contributors: security selection
- Detractor: duration

## Current Positioning

- Portfolios are positioned to manage the impact of market and sector volatility, while focusing on income generation and downside risk protection. We will continue to be positioned in the mid-range of the credit risk spectrum.

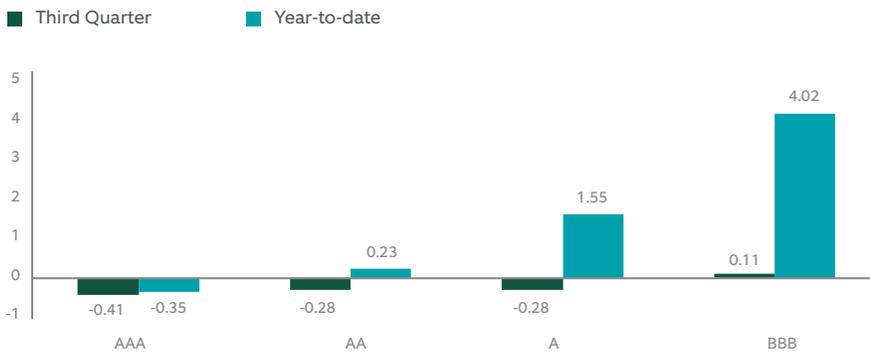
MUNICIPAL BONDS

- Expensive valuations created challenges against a backdrop of volatile Treasury rates and heavy new issuance of municipal bonds.
- The rate of low quality outperformance slowed dramatically, as many of these credits and sectors are more expensive than their pre-pandemic levels.

EXHIBIT 9: CREDIT QUALITY MADE LESS OF A DIFFERENCE

During the third quarter, credit quality made less of a difference in returns than earlier this year when low quality rallied due to investors reaching for yield.

Third Quarter Municipal Bond Returns by Credit Quality (%)



Source: Northern Trust Asset Management, Bloomberg, as of September 30, 2021

Performance

- Contributor: duration
- Detractors: yield curve, higher quality credit bias

Current Positioning

- Interest rate risk should typically be defensive to neutral to start the fourth quarter but trending to long by quarter-end. We aim to take advantage of better yields and a steeper curve at the start of the fourth quarter.



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