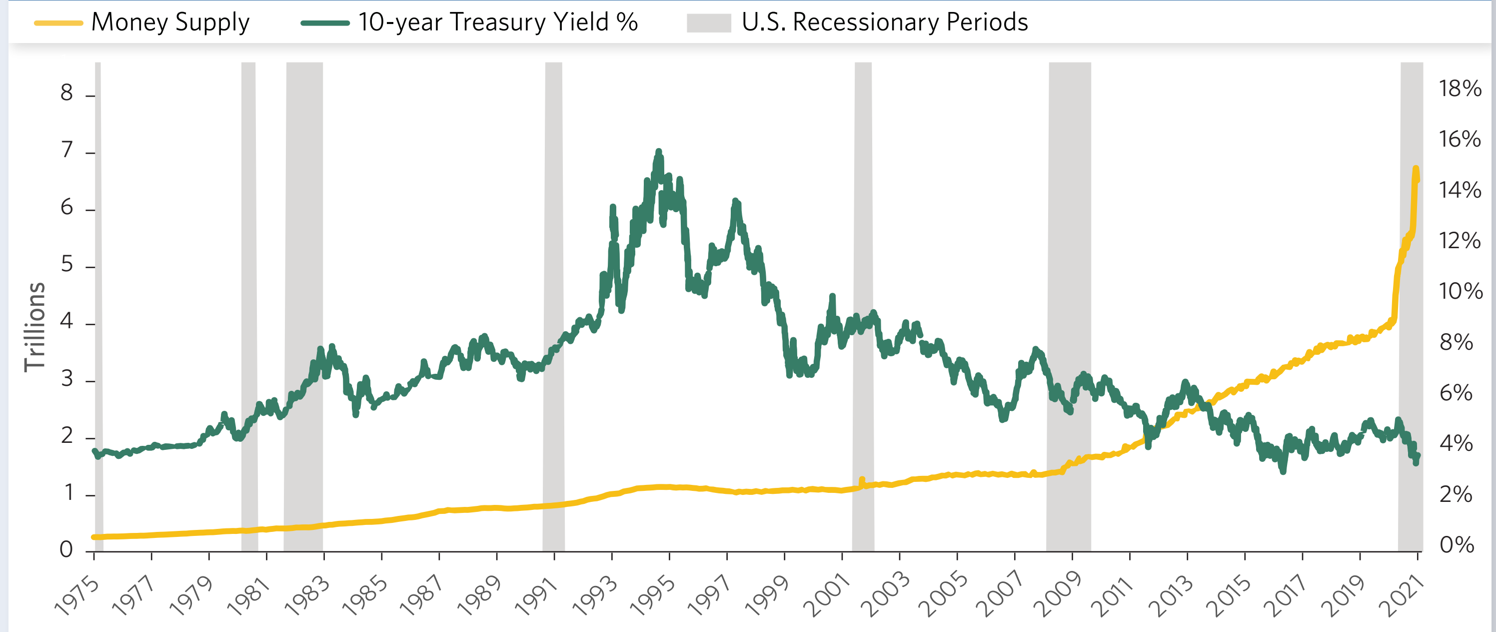

Source: Federal Reserve Economic Data.

QUARTERLY MARKET OUTLOOK: **FIRST QUARTER 2021**

Fixed-income Outlook

Ongoing Federal Reserve stimulus and a firming economic rebound will exert opposing force on interest rates this year. While we think the Fed can hold short-term rates at zero, longer-term rates should see a modest lift. Bond yields will remain muted by historical standards, but fixed income can help protect against spurts of market volatility.

Fed stimulus will stay longer – Significant monetary stimulus will 1) keep short-term rates near zero, 2) prevent longer-term rates from rising with the economic rebound, and 3) continue to supply liquidity to support investor risk appetite. We think this sets a backdrop for stocks to outperform bonds again this year. The Fed's new approach to average inflation targeting will, in our view, keep Fed stimulus in place longer into this expansion than in the past. But we expect the financial markets will eventually have to wrestle with the prospects of tighter Fed policy.

Slightly steeper yield curve – We think longer-term rates will trend modestly higher, driven by a rebound in economic activity and expectations for increased fiscal stimulus. Ten-year Treasury rates recently rose above 1% for the first time in nearly 10 months. While yields are likely to remain well below historical levels, we don't think we'll revisit the lows experienced in 2020.

Debt and inflation are longer-term factors – Slack in the labor market and economy will prevent inflation pressures from rising meaningfully in the near term. But Fed stimulus and improving demand raise the specter of higher inflation as the expansion matures. At the same time, we expect the budget deficit and federal debt to rise notably this year. Inflation and debt are likely to be an upward influence on rates longer term.

▶ *Action for Investors*

We think appropriate allocations to investment-grade bonds and exposure to high-yield bonds can offer some increased yield for fixed-income portfolios. Despite low rates, we believe a neutral allocation to fixed income will help protect portfolios against market volatility.

Before investing in bonds, you should understand the risks involved, including credit risk and market risk. Bond investments are also subject to interest rate risk such that when interest rates rise, the prices of bonds can decrease, and the investor can lose principal value if the investment is sold prior to maturity.

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