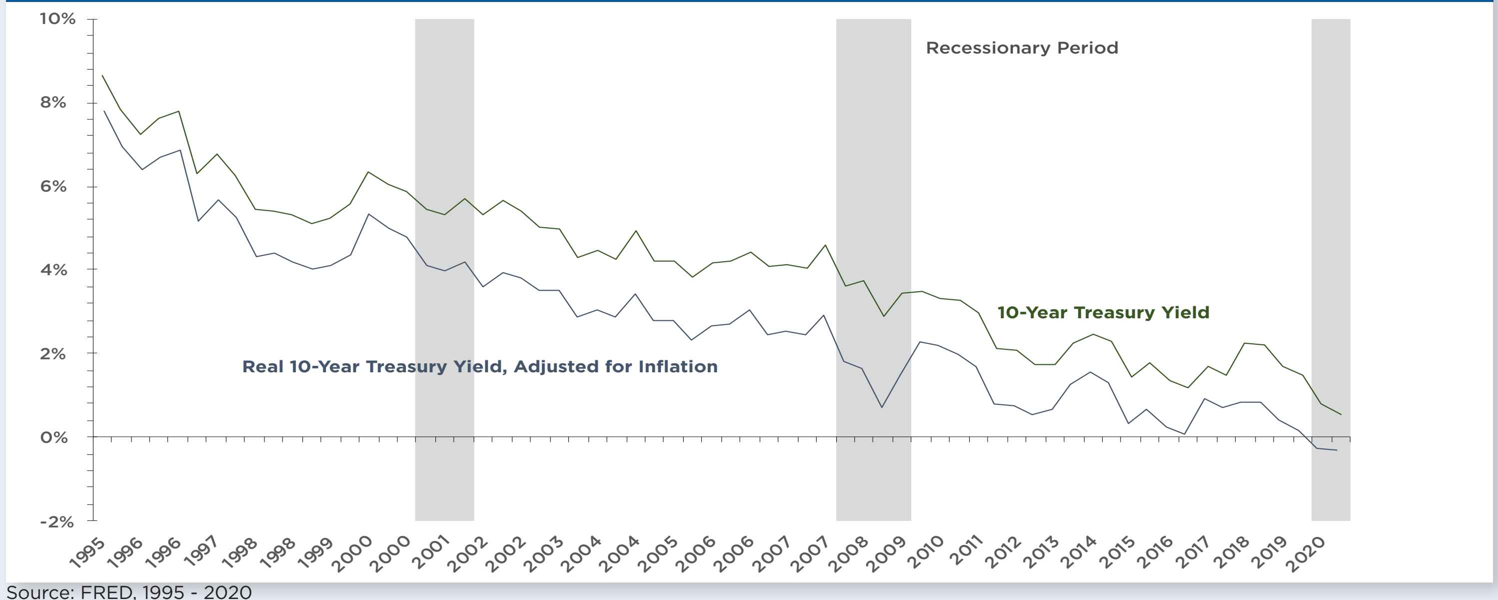

Source: FRED, 1995 - 2020

QUARTERLY MARKET OUTLOOK: **FOURTH QUARTER 2020**

Fixed-income Outlook

Through a combination of near-zero rates, bond purchases, and newly enacted credit facilities, the BoC and Federal Reserve (the Fed) have gone to extraordinary measures to provide ample liquidity to the fixed income market. We expect that monetary policy will remain highly accommodative in North America for several years to come to support the economic recovery.

- **Heavy-handed central bank policy continues-** The BoC has pledged to continue its aggressive stimulus measures throughout the Canadian economic recovery. Meanwhile, the Fed is likely to keep the benchmark federal funds rate, which provides an anchor for short-term rates, near zero through 2023. Additionally, both central banks have committed to continued purchases of bonds (treasuries, corporate and mortgage securities) to keep borrowing costs low for consumers and firms in order to support economic growth by encouraging household spending and business investment.

- **New Fed inflation policy could keep benchmark rates low for years-** In September the Fed announced that it would no longer preemptively raise interest rates as inflation crept above its 2% target. Instead, higher levels of inflation would be tolerated "for some time" before the Fed hiked interest rates to cool an economy on the verge of overheating. The COVID-19 pandemic has been deflationary in the short term. In Canada the inflation rate fell from 2.2% in February to 0.2% by the end of the third quarter. Even though we expect inflation to rise modestly as the economy improves, still moderate levels of price increases give central banks the latitude to keep rates low in order to stimulate the economy and by doing so, help drive down the unemployment rate back closer to pre-pandemic levels.

- **With yields this low, why own bonds-** There is still a diversification benefit with fixed-income securities because even at low rates, bonds tend to move in opposite direction to equities. That means when stocks decline, bonds either rise, or fall less. Moreover, real yields (nominal rates adjusted for inflation) are below zero as shown in the chart. That means cash, and other short-term debt instruments are unlikely to hold their value in the current macro environment. Owning bonds across a range of maturities allows an investor to reinvest maturing securities at higher yields as the economy recovers. Additionally, to enhance fixed-income returns we recommend investors own across investment-grade and high-yield corporate debt and emerging market debt securities, as appropriate.

▶ *Action for Investors*

Though bonds can play an important role in reducing risk even when rates are low, investors should revisit their expectations for a fixed-income portfolio's ability to generate the income needed to help achieve financial goals and to determine if other financial planning strategies may be warranted.

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.

You must evaluate whether a bond ladder and the securities held within it are consistent with your investment objectives, risk tolerance and financial circumstances.

Edward Jones

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