COLUMBIA THREADNEEDLE INVESTMENTS

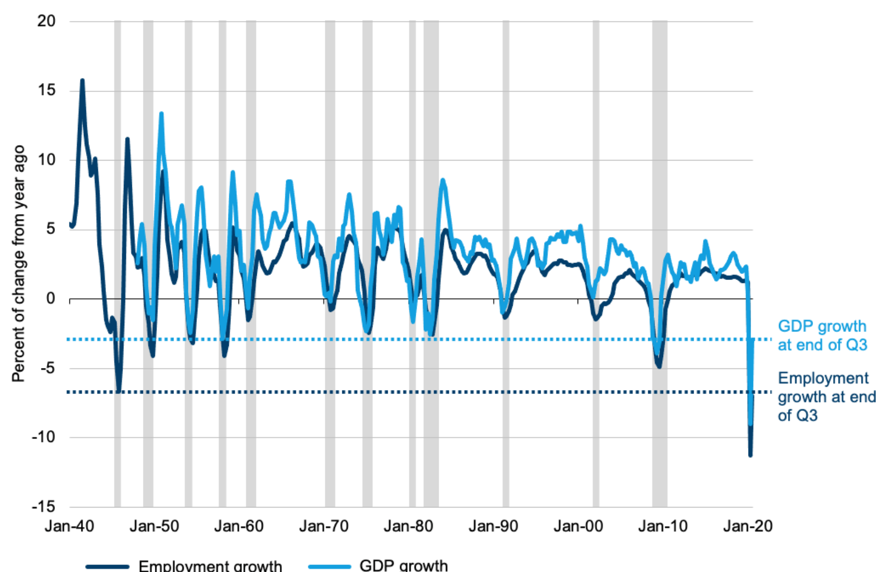
KATHERINE NUSS
CLIENT PORTFOLIO MANAGER

FIXED-INCOME OUTLOOK: FOCUS ON CREDIT

Overview

We enter 2021 with current economic activity well below pre-pandemic levels and on par with some of the worst recessions in the last 80 years (Exhibit 1). We expect the Federal Reserve (Fed) to remain accommodative, which supports favoring credit risk versus duration-centric assets. The current below-average risk premiums constrain future expected returns, however, and increase the importance of individual security selection.

Exhibit 1: Employment and GDP growth – year over year



Source: FRED/St. Louis Fed, Bureau of Economic Analysis; Bureau of Labor Statistics; and Columbia Threadneedle Investments. Employment growth measures Total Nonfarm Payroll, not seasonally adjust (PAYNSA). GDP is Real Gross Domestic Product, seasonally adjusted.

The Fed's pervasive influence

We believe the most likely scenario for 2021 is that the economy will continue to recover, though at a more subdued and potentially uneven pace than what we have seen to date. Extraordinary fiscal and monetary policy in 2020 drove much of the initial economic rebound from the pandemic shock.

At the end of 2020, Congress approved a $900 million stimulus package that included an extension of unemployment benefits, but it remains to be seen how this will impact economic growth.

What is clearer is that insufficient fiscal stimulus increases downside risks for the economy and places a greater burden on the Fed to provide additional accommodation. Thus, we expect that the Fed will use its balance sheet to ease policy further, by either increasing the pace or honing the maturity focus of U.S. Treasury purchases in the new year.

The Fed's ongoing policy response will have investment implications across the fixed-income landscape. The current labor market weakness and low inflation outlook present a high hurdle for achieving its dual mandate, suggesting that the Fed will keep policy rates at zero for at least two to three years. Such policy anchors short-maturity Treasury yields and provides little opportunity for income or price appreciation; and extending the maturity focus of asset purchase would potentially lower the ceiling on intermediate and longer Treasury yields. While this may prevent yields from rising materially, it doesn't ensure that they'll fall. In fact, the risk appears asymmetric to the downside, given that current low yields fail to protect against even modestly higher rate movements. As a result, we believe more credit-centric areas of the bond market should offer better return potential.

Opportunity in credit

The same factors that constrain the return potential in duration risk should continue to support opportunities in credit. The Fed's efforts to suppress high-quality government yields creates a powerful source of demand for credit assets by forcing income-seeking investors further out on the risk spectrum. Additionally, many of the tail risks that existed early in the pandemic have been mitigated by: 1) the ability of corporations to access low-cost financing; 2) the preservation of strong household balance sheets; and 3) the ongoing rollout of several COVID-19 vaccines. These developments, coupled with the prospect of continued economic progress, support a broadly positive outlook for risk assets.

However, much of this "good news" is already reflected in prices, and risk compensation is currently below long-term averages across most fixed-income sectors. This shouldn't be a deterrent to owning credit risk, but it does necessitate a change in how to approach it.

During the final three quarters of 2020, fixed-income investors could have owned any variety of risky asset and watched prices climb by 20% or more. We expect gains to be far more muted, with greater differentiation between the pandemic economy's winners and losers.

Historical parallel

Rather than passively owning market risk, an emphasis on security selection could help investors avoid downside risks that have the potential to significantly impair already constrained income and total return opportunities.

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The three-year period from 2004 to 2006 provides a relevant historical comparison to the current market dynamic. During that period, investment-grade corporate credit spreads remained within a narrow, and below-average, range of 80 to 100 basis points. This resulted in lowered price appreciation, but the Bloomberg Barclays Investment Grade Corporate Index's 0.57% of annualized excess returns versus similar-duration Treasuries validated ownership of credit over duration risk. Opportunities to enhance performance were much more evident at the industry level, demonstrated by wide excess return dispersion (Exhibit 2). Though most industries offered positive excess return potential, significant losses in a select few could have easily negated gains elsewhere. Credit research that can identify potential tail risks can boost returns and avoid loss when markets move sideways. Today, changing demand patterns and prospects for an uneven recovery will impact industries and issuers in dramatically different ways. For this reason, we view credit research, and resulting security selection, as an indispensable tool for driving value in a lower-return world.

Exhibit 2: Annualized excess returns by industry – 2004 through 2006

Bloomberg Barclays Investment Grade Corporate Index

Past performance is not a guarantee of future results.

Source: Bloomberg; Columbia Threadneedle Investments. Each bar represents an industry that is included in the Bloomberg Barclays Investment Grade Corporate Index. Excess return is the three-year annualized excess return vs. a comparable duration-neutral 10-year U.S. Treasury bond.

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There are risks associated with **fixed-income** investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

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