

FIXED INCOME MARKET UPDATE

Fourth Quarter 2020

QUARTER IN REVIEW

Positive Returns Mask a Challenging Year

If an investor had been lucky enough to take a Van Winkle-like nap through all of 2020, he or she may have awakened on New Year's Eve, checked the full-year market returns, yawned, and gone back to sleep to await the start of the football games. Equity markets rose, Treasuries produced good returns, investment grade and high yield bonds were positive, and most sectors performed reasonably well. Of course, the full-year results disguise an abundance of big headlines and extreme market volatility. In the first quarter of 2020, COVID fears gripped the world, and bond spreads widened to levels not seen since 2009. In the second quarter, the Federal Reserve stepped in with massive stimulus measures and risk assets began to recover. By midway through the third quarter corporate bond issuance had already surpassed all previous calendar-year records, and as the quarter drew to a close the market turned its focus to the second wave of the coronavirus along with uncertainty around the upcoming elections. In the fourth quarter, the election cycle ended and vaccine-related optimism drove a strong acceleration in risk assets, with investment grade (IG) corporate bonds returning 3% and high yield (HY) bonds up 6.5%. Treasury returns lagged in the quarter, down nearly 1%, but still returned 8% for the full year versus IG at 9.9% and HY at 7.1%. Despite the year's positive returns across most asset classes, 2020 was anything but a relaxing nap, and it highlighted the need to construct portfolios carefully and with a healthy respect for the unpredictable.

MARKET SUMMARY

The fourth quarter favored risk assets as both investment grade and high yield corporates outperformed Treasuries and municipals. All major fixed income categories navigated the volatility of 2020 to finish in positive return territory.

YIELDS & RETURNS (%)¹

	Duration (years)	Yield	Q4 Return	YTD Return
Treasuries	7.09	0.57	-0.83	8.00
Investment Grade Corporates	8.75	1.74	3.05	9.89
High Yield Corporates	3.40	4.18	6.45	7.11
Municipal Bonds	4.84	1.07	1.82	5.21

U.S. TREASURY MARKET

The Treasury curve steepened during the quarter, driven by an increase in the intermediate and long parts of the curve. Short Treasuries remain anchored to very low yields.

TREASURY YIELDS (%)¹

	Q4 Change	Year-to-Date Change	12/31/2020	11/30/2020	10/31/2020	9/30/2020
90-Day T-Bills	-0.02	-1.47	0.08	0.09	0.09	0.10
2-year Treasury	-0.01	-1.44	0.12	0.15	0.15	0.13
5-year Treasury	0.09	-1.32	0.36	0.36	0.38	0.27
10-year Treasury	0.23	-1.00	0.91	0.84	0.86	0.68
30-year Treasury	0.19	-0.74	1.64	1.57	1.63	1.45

Treasuries gave up ground during the risk-on fourth quarter but ended the year with very positive returns. Long Treasuries were a notable outperformer for the year.

TREASURY RETURNS (%)¹

	Duration (years)	Q4 Return	YTD
90-Day T-Bills	0.25	0.03	0.67
2-year Treasury	2.00	0.04	3.07
5-year Treasury	4.96	-0.22	7.26
10-year Treasury	9.47	-1.91	10.61
30-year Treasury	23.72	-4.18	18.72
U.S. Treasury TIPS	7.61	1.62	10.99

BROAD INVESTMENT GRADE

Corporate bonds drove the positive performance of the U.S. Agg during the fourth quarter. For the full year, Treasuries and corporate bonds were the most significant contributors to the positive returns.

INVESTMENT GRADE INDEX & SECTOR RETURNS (%)¹

	Duration (years)	Yield	Q4 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
U.S. Aggregate	6.42	1.12	0.67	1.34	7.51	0.28
Treasuries	7.09	0.57	-0.83		8.00	
Agencies	3.74	0.48	0.04	0.31	5.48	-0.07
Mortgage-Backed Securities	3.37	1.25	0.24	0.34	3.87	-0.17
Asset-Backed Securities	2.10	0.45	0.36	0.34	4.52	1.06
Intermediate Corporates	4.54	1.08	1.76	2.08	7.47	1.17
Long Corporates	15.31	2.78	5.14	7.39	13.94	-1.33

Since spiking in March, corporate bond spreads have steadily decreased, ending the year very close to where they began.

Spreads on mortgage-backed securities benefited from Federal Reserve purchases and ended the year much tighter.

INVESTMENT GRADE SPREADS (basis points)²

	Q4 Change	Year-to-Date Change	12/31/2020	11/30/2020	10/31/2020	9/30/2020
Intermediate Corporates	-35	-2	68	76	94	103
Long Corporates	-48	4	140	148	177	188
MBS Current Coupon Spread	-29	-37	43	49	55	72

Returns were positive across the investment grade (IG) quality spectrum during the fourth quarter, with riskier IG bonds outperforming higher-rated credits.

INVESTMENT GRADE CORPORATE CREDIT QUALITY RETURNS (%)²

	Duration (years)	Yield	Q4 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
AAA	12.73	1.59	1.47	3.18	12.30	-0.32
AA	9.59	1.40	1.74	2.92	9.00	0.37
A	8.57	1.49	2.22	3.26	10.06	0.68
BBB	8.65	2.01	3.99	5.03	9.88	0.47

All investment grade sectors tightened significantly in the fourth quarter, led by a recovery in the Energy sector. Most sector spreads shared a common trajectory for the year: sharp widening in March, followed by a recovery through much of the rest of the year.

INVESTMENT GRADE CORPORATE BOND SPREADS BY SECTOR (basis points)²

	Q4 Change	Year-to-date Change	12/31/2020	11/30/2020	10/31/2020	9/30/2020
Consumer Non-Cyclical	-32	-2	90	95	113	122
Technology	-31	1	75	81	98	106
Energy	-63	9	137	158	195	200
Consumer Cyclical	-41	-11	82	90	111	123
Transportation	-42	19	115	122	150	157
Basic Industry	-45	-11	121	130	153	166
Communications	-36	10	120	125	147	156
Capital Goods	-42	16	98	109	131	140
Utilities	-35	9	106	111	131	141
Financials	-43	3	83	93	112	126

HIGH YIELD

High yield enjoyed a strong fourth quarter recovery, which drove most of the positive full-year performance. BBs were the best performer in 2020 among high yield ratings categories, and CCCs rebounded from severe weakness earlier in the year to post a positive full-year return.

HIGH YIELD SECTOR RETURNS (%)²

	Duration (years)	Yield	Q4 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
High Yield Corporates	3.40	4.18	6.45	6.69	7.11	2.25
BB	4.20	3.21	5.69	6.03	10.17	4.84
B	2.48	4.43	5.83	5.95	4.59	0.14
CCC	2.32	7.12	9.91	9.96	2.27	-2.18

HIGH YIELD OPTION-ADJUSTED SPREADS (OAS) (basis points)²

	Q4 Change	Year-to-Date Change	12/31/2020	11/30/2020	10/31/2020	9/30/2020
High Yield OAS	-157	24	360	412	509	517
BB OAS	-118	82	264	296	373	382
B OAS	-161	55	379	433	532	540
CCC OAS	-293	-211	658	749	936	951

Spreads tightened across every high yield sector in the fourth quarter. For the full year, spreads widened for most sectors.

The best full-year spread performer was the Energy sector, while the worst was Transportation.

HIGH YIELD CORPORATE BOND SPREADS (OAS) BY SECTOR (basis points)²

	Q4 Change	Year-to-date Change	12/31/2020	11/30/2020	10/31/2020	9/30/2020
Consumer Non-Cyclical	-155	-32	287	347	416	442
Technology	-86	78	314	349	409	400
Energy	-305	-108	538	656	822	843
Consumer Cyclical	-151	54	342	387	483	493
Transportation	-345	172	633	725	988	978
Basic Industry	-151	25	372	414	493	523
Communications	-77	12	325	356	424	402
Capital Goods	-148	82	350	384	484	498
Utilities	-107	39	274	295	382	381
Financials	-167	82	324	375	481	491

The number of high yield issuers in default remains high from a historical perspective. The default rate rose for the full fourth quarter but fell in December, marking the first monthly improvement since February 2020.

HIGH YIELD DEFAULT RATES²

	Q4 Change	Year-to-Date Change	12/31/20	11/30/20	10/31/20	9/30/20
Number of Issuers in Default	3	38	67	69	67	64
Issuer Default Rate	0.6%	5.6%	9.5%	9.7%	9.4%	8.9%
Number of Issuers in Default (ex-commodities)	-3	16	31	32	34	34
Issuer Default Rate (ex-commodities)	-0.5%	2.8%	5.2%	5.4%	5.7%	5.7%

MUNICIPALS & OTHER

Municipal bond returns were led by the long-duration segment for both the fourth quarter and the full year. Munis continue to benefit from high credit ratings and favorable tax treatment.

MAJOR MUNICIPAL BOND INDEX RETURNS (%)¹

	YTW	Duration (years)	Q4 Return	YTD Return
Short Duration (1-5 Years)	0.45	2.78	0.44	3.15
Intermediate (1-15 Years)	0.77	4.28	1.33	4.73
Long Duration (22+ Years)	1.84	6.36	3.02	6.25

MUNICIPAL YIELDS BY RATING CATEGORY AND DURATION (%)²

	AAA	AA	A	BBB
1 Year	0.11	0.22	0.47	1.05
5 Year	0.19	0.35	0.63	1.14
10 Year	0.67	0.84	1.17	1.64
30 Year	1.41	1.61	1.99	2.45

AA MUNICIPALS – HYPOTHETICAL AFTER-TAX YIELDS BY EFFECTIVE TAX RATE (%)⁴

	20%	25%	30%	35%
1 Year	0.28	0.29	0.32	0.34
5 Year	0.44	0.47	0.50	0.54
10 Year	1.05	1.12	1.20	1.29
30 Year	2.01	2.14	2.30	2.47

All “other” fixed income sectors posted positive results for both the quarter and the full year. Convertible bonds benefited from equity market growth to post very strong returns.

OTHER SECTOR RETURNS (%)^{1,2}

	Duration (years)	Yield	Q4 Return	Duration adj. vs. Treasuries	YTD Return	Duration adj. vs. Treasuries
Emerging Markets	5.51	5.63	7.62	8.23	4.26	-2.04
Global Treasuries (Unhedged)	8.69	0.49	3.19	4.32	9.50	0.08
S&P/LSTA Leveraged Loan 100	–	3.98	3.81	–	3.12	–
Wells Fargo Hybrid & Pref. Securities Aggregate Index	–	5.12	4.54	–	6.84	–
U.S. Convertibles	1.55	1.33	21.68	–	50.27	–

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¹Source: Bloomberg.

²Source: yields from Barclays.

³Source: Bank of America Merrill Lynch.

⁴Hypothetical yields are calculated as the AA municipal yield divided by (1-tax rate). Actual tax-adjusted yields will depend on individual tax circumstances.