MARCH 2021

BOND iQ
Intra Quarter Update

The Role of High-Quality Bonds in a Low Interest Rate World (Part 2 of 3)

Last month, we introduced a three-part "BondiQ" series aimed at addressing the three most common questions we hear from investors regarding our outlook for high-quality fixed income portfolios in a low rate environment. In part-one, we explored how effectively traditional bond portfolios might "hedge" risk asset volatility given the historically low level of interest rates. While investors should take comfort in knowing that the "bond hedge" is still alive and well, we also recognize that recent trends have left many investors anxious over the prospect of faster inflation and, in turn, higher interest rates. In the second part of this three-part series, we focus on addressing these concerns regarding the fundamental outlook for inflation and rates.

Question #2: What is your outlook for inflation given the prospect of additional fiscal stimulus on top of broadening vaccinations and continued economic reopening, and how does that factor into your forecast for interest rates as the recovery continues to mature?

When evaluating the outlook for inflation, we believe it is crucial for investors to separate short-term, cyclical trends from the long-term, secular outlook. There is no question, that near-term trends favor a modest acceleration in the official inflation statistics. In fact, even without unleashing pent-up pandemic demand, the year-over-year inflation statistics are likely to rise simply because of the COVID induced deflation that we experienced last March, April, and May. Additionally, as the population becomes more broadly vaccinated, demand for foregone services spending such as restaurant meals, vacations, and concerts are likely to move higher. However, as this one-time burst in demand subsides, the long-term secular forces that have driven decades of subdued inflation and sluggish economic growth are likely to regain control once again. Throughout the last recovery, aging demographics, bloated public and private sector debt, and stubbornly low productivity have all acted as governors against robust growth and higher inflation. If anything, these trends not only remain in place, but have actually worsened since COVID.

As a result, we believe that the Federal Reserve is likely to be quite patient in regard to tightening monetary policy. In fact, the Fed has gone through painstaking effort to articulate its willingness to look beyond modest, short-term inflation tailwinds. Instead, they have been adamant about prioritizing full employment as a condition for raising interest rates, which may take many years. As a result, our base case outlook for monetary policy is for eventual liftoff in early 2024, accompanied by a 2.5% terminal rate. Additionally, we may employ a simple term-structure interest rate model to derive a range of possible fair values for various tenors of the yield curve based upon expectations for monetary policy. The results of this exercise are displayed in the table below.

	Bull Case	Base Case	Bear Case
Liftoff Date	1/1/2025	1/1/2024	6/1/2022
Terminal Rate	2.00%	2.50%	2.75%
2Y Fair Value	0.13%	0.13%	0.32%
5Y Fair Value	0.23%	0.56%	1.47%
10Y Fair Value	1.06%	1.52%	2.11%
30Y Fair Value	2.00%	2.50%	2.75%

As you can see, our base case Fed scenario yields estimates of fair value that are quite similar to today's interest rate levels. While the market can always overshoot or undershoot fair value estimates, this does help provide us with a more constructive view on the current value of longer-term interest rates.

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We also understand there is a great deal of uncertainty with forecasting Fed policy many years in advance and provide a "bear case" where the Fed tightens much sooner and more aggressively than we believe is likely. Even in this scenario, long-term rates have somewhat limited upside from today's levels. If you have a scenario-you would like us to run through the model, we are happy to do that at your request!

In next month's "BondiQ," we conclude this three-part series with a look at the role of traditional fixed income within diversified asset allocations. Low bond yields have tempted investors to reduce or even remove traditional fixed income allocations from portfolios in search of more robust returns. In the third and final installment, we explore the potential consequences of such action.

As always, should you have any questions please do not hesitate to reach out to a member of the Johnson Team.

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Brandon A. Zureick, CFA
Director, Portfolio Manager, Principal