Bell
Institutional Investment Management

EQUITY & FIXED INCOME OUTLOOK DECEMBER 2020

For investors, the need for income has not gone away – but the yield on bonds that traditionally provides this income has. We have been in a low-yield rate environment for some time. The 10-year U.S. Treasury bond began this year with a yield of 1.75%, then declined to 0.50% in early August before rising back to 0.83% where it is today. Adjusting the current 10-year Treasury yield for inflation (currently at 1.2%) means investors lose about 0.4% of purchasing power annually – and that's before paying income taxes on the interest earned.

To capture more interest income, the industry increasingly is calling for larger allocations to high-yield bonds, also known as junk bonds. These are bonds with low credit ratings that pay higher interest rates in exchange for increased risk of defaulting – which means an increased chance that investors will not receive timely interest and principal payments. To us, junk bonds remain counterintuitive to the strategy of allocating money to bonds in the first place. The whole idea behind bonds is to have a stable, income-producing asset, with little risk of default.

As you know, the stock market was nothing short of a wild ride in 2020 – and a great reminder of why investors allocate some of their portfolios to bonds, in an effort to smooth out the valuation drawdowns that stocks can generate. Stocks performed well over the last 10 years, with the Morgan Stanley Capital International (MSCI) world stock index generating a 9.27% annualized return. The U.S.-based S&P 500 did even better, with an annualized return of 12.99%, while the Bloomberg Barclays Aggregate Bond Index had an annualized return of 3.80%.

That was then, this is now. Moving forward, we believe returns will be more muted in common asset allocations including stocks, bonds and real estate. While there could be years of outstanding market performance, we anticipate the coming 10-year average returns will be below long-term averages, with bond returns around 1.5%, stock returns around 4.5% to 6% and real estate somewhere in between. We also expect interest and dividend income to represent a larger share of the overall returns than it did in the last decade.

Recent data suggests that, while our economy has demonstrated its ability to move in the direction of a V-shaped recovery, the right side of that "V" has not fully returned to where it started. Recent increases in virus case counts, hospitalizations and deaths and the growing government mandates for business closures suggest the full impact of a V-shaped recovery will be delayed further. The good news is that, globally, we are closer to the end of this pandemic than to the start. One of the next challenges for the economy will be to overcome the effects of potential government tracking of a vaccination, via some form of identity card or digital badge. Will people who aren't vaccinated be excluded from air travel, sporting events, concerts or other large gatherings? What measures will restaurants, hotels or retail stores implement? Using current data, a validation requirement would limit the return of the consumer by upwards of 50%, extending the drag on the economy.

So here we sit today. Because investors are confident the Federal Reserve will leave interest rates low for an extended period of time, fixed income (bond) portfolio managers are taking increasing credit risks to generate income. At the same time, the stock market is placing its confidence in the Fed's "low for longer" interest rate theme. This excess liquidity is driving bond and stock prices higher. With markets increasingly disconnected from underlying economic activity, our concern is that there will be a credit and valuation reckoning at some point. Large levels of liquidity won't save investors from company bankruptcy risk.

In this environment, investment managers must walk a very fine line. Failure to keep up with a rising market opens up the manager to criticism, as does losing value when the market declines. How does an investment manager generate enough income and stock returns to keep investors happy – and do so in a manner which avoids the potential pitfalls? After all, managing for less risk also means less return. In short, we continue to directly underwrite the credits we purchase in the bond market, while looking to properly allocate stock positions among large, medium and small companies – along with value and growth characteristics among domestic and foreign allocations. We are confident that time will again validate the effectiveness of this approach as part of our overall strategy.

Since this is the December outlook, we also wish you a Merry Christmas. Thank you for your business and for your confidence in the team at Bell.

Greg Sweeney, CFA
SVP/Chief Investment Officer

Tenure: 09/1992

Years of Investment Experience: 35 years

Education: Greg holds a bachelor's degree in business from the University of North Dakota and is a CFA charter holder.

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