Quarterly Newsletter Bringing You Financial Insights From The Leaders | VOL 13 | ISSUE 4

SIA

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THE SIA REPORT

FIXED INCOME GOING FORWARD

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With the election over (for the most part), a likely divided government in 2021, and an effective Covid vaccine on the way (hopefully sooner than later), most investors have been heavily focused on the equity side of their portfolio. It's certainly understandable. The S&P 500® has soared to record highs in recent months. But faced with the reality that bond returns over the next decade will likely be lower than they were the previous decade, investors would be misguided in overlooking the fixed income portion of their portfolios at this time.

Before we get into the past, present, and future for bond investors, let's recall why we own bonds in the first place. Fixed income assets typically serve two primary purposes:

1. **Yield**: in a well-constructed portfolio, regular interest payments can combine with other income sources like dividends* to provide a valuable income stream.

2. **Diversification**: bonds can dampen overall portfolio volatility when held alongside riskier assets such as equities. Investment-grade fixed income assets are not only less volatile but may rise in price when equities fall.**

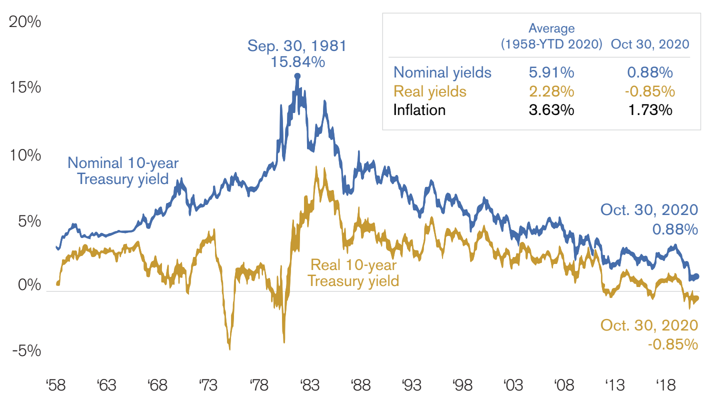
Looking back

Ever since Federal Reserve Chairman Paul Volcker raised the fed funds rate to 20% back in June of 1981, fixed income assets have been in a secular bull market. While the move caused a recession, it crushed inflation and set up a bull market for stocks that lasted until 2000. During the four decades since Volcker's move, bond yields have steadily fallen – dropping to almost nothing for benchmark government securities in 2020 (Exhibit 1).

Bond investors have benefited greatly from these long-term trends. In return for taking generally lower credit and equity market risks, Treasury bond investors were handsomely rewarded (with double-digit returns for longer-term bonds) over the last decade. But those returns were largely driven by the steady trend of falling interest rates, combined with a recent flight to safety during the Covid draw-down, and unfortunately don't appear to be mathematically sustainable over the next decade.

EXHIBIT 1

Nominal and real 10-year Treasury yields



Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management

Looking ahead

Conveniently, the best predictor of future bond returns is where interest rates are when you start. As illustrated below (Exhibit 2), there's a clear relationship, and the 2020s are on pace for the lowest returns for bonds since the 1960s.

*The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.
**Investing involves risk including the potential loss of principal. No investment strategy, including diversification, can guarantee a profit or protect against loss. Past performance is no guarantee of future results.

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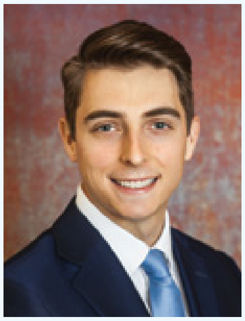
RUNAWAY INFLATION OR REFLATION?



BY **Josh Woodard**
CFA®
Research Analyst

Summary

- With unemployment levels still elevated, inflation should not be a short term concern
- The Fed has made clear their intention to maintain rates at low levels for the foreseeable future—even if inflation meets or surpasses their historical 2% target
- Asset classes such as real assets, commodities, equities, and TIPS provide a good hedge against inflation

Where do we stand today?

Not too long ago, the economy was coming to a screeching halt and deflation concerns were top of mind. Deflation is typically a feared situation—indicating that an economy has stalled and yet consumers continue to defer spending despite falling prices. Modest inflation, on the other hand, is generally a positive sign, as it points to a healthy, growing economy.

What we know today is that market expectations for inflation have certainly rebounded as indicated by the 10-year Breakeven Inflation Rate, which has bounced back to 1.88% as of 12/7/2020.

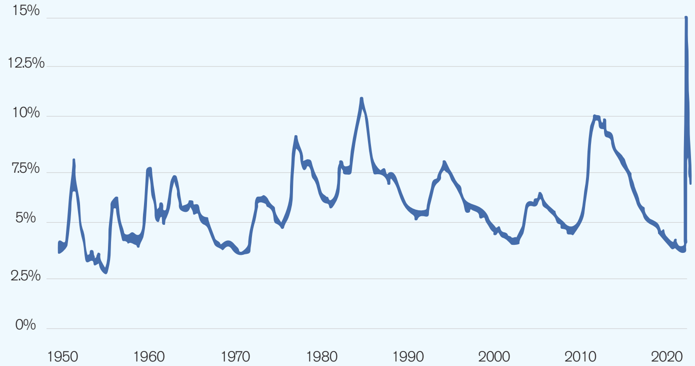
At Jackson Hole, WY on August 27, Federal Reserve Chair Jerome Powell formally announced a new policy path that should have significant market implications going forward. According to Powell, the Fed intends to keep interest rates low and let inflation run for longer than usual. Remember, the Fed has two primary monetary policy goals: maximum employment and stable inflation (measured by Personal Consumption Expenditures). Historically, the Fed has aimed for a 2% inflation target—meaning that while short-term dips and spikes may occur, inflation should *consistently* run at about 2%.

While this new policy is subject to interpretation, the main takeaway is that the Fed will not raise rates when and if we see inflation tick across the 2% threshold. Bottom line: The Fed is hoping to spur economic growth, and in turn, see that growth trickle down to wage growth and a healthy rise in prices.

What will drive inflation?

Currently, runaway inflation is not a concern for SIA's Investment Committee. While the July and August prints showing some bounce-back in inflation are encouraging, we see no *current* signs of high inflation. Of course, this could change. But first, there are some structural issues that will need to be worked out.

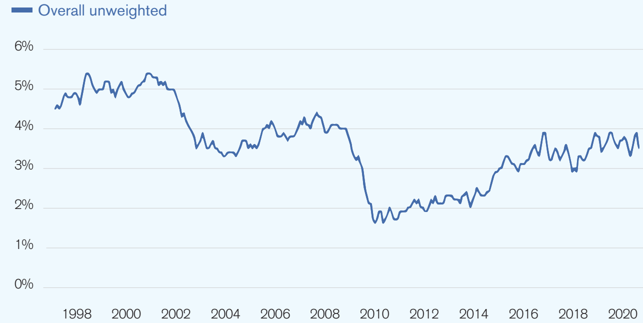
Unemployment Rate



Source: U.S. Bureau of Labor Statistics

Inflation is measured as a basket of goods and services. So, to see a significant rise in inflation, almost the entire basket would need to go up. Since housing/shelter costs account for one-third of the Consumer Price Index (CPI) basket, we closely monitor residential rents along with wages, for signs of sustained inflation. With unemployment at present high levels (6.7% as of November 2020), however, we expect that it will take a fair amount of time for wages and rents to pick up meaningfully.

Wage Growth Tracker
3-month moving average of median wage growth



Source: Current Population Survey, Bureau of Labor Statistics and author's calculations

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> I believe successful wealth management is the result of an ongoing collaboration between investor and advisor, built upon trust and maintained according to the highest standards of integrity and expertise.

Brian D. Holmes,
MS, CFP®, CMFC, AIF®,
President & CEO

ABOUT SIA

Signature Investment Advisors® (SIA) is a Registered Investment Advisor firm offering investment management solutions that are tailored to meet the unique needs of affluent individuals and organizations. In partnership with your wealth manager, we bring our combined experience, expertise and high level of service to provide a dynamic process that can meet your investment objectives and goals.

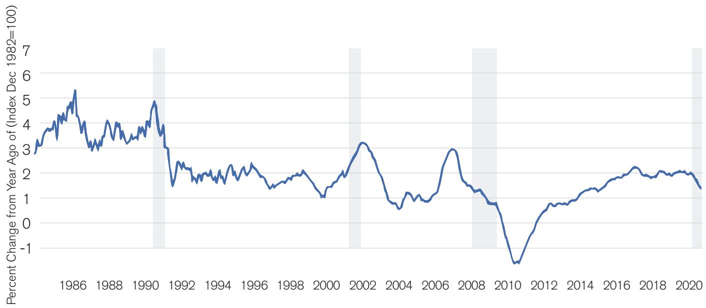
2021 TAX BRACKETS

Tax rates did not change; however, tax bracket amounts were adjusted to account for inflation:

Rate	Married Joint Return	Single Individual
10%	$19,900 or less	$9,950 or less
12%	Over $19,900	Over $9,950
22%	Over $81,050	Over $40,525
24%	Over $172,750	Over $86,375
32%	Over $329,850	Over $164,925
35%	Over $418,850	Over $209,425
37%	Over $628,300	Over $523,600

Source: IRS

Consumer Price Index for all Urban Consumers:
Owners' Equivalent Rent of Residences in U.S. City Average



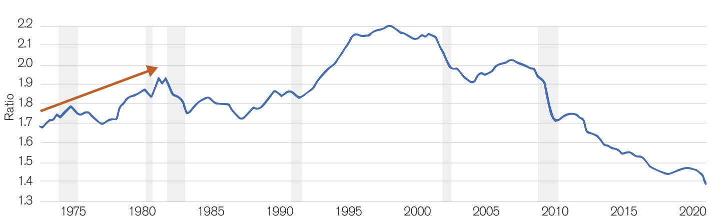
Shading indicates U.S. recessions;
the most recent one is ongoing

Source: FRED and U.S. Bureau of Labor Statistics

While current monetary policy has steadily fueled the money supply, the increase in supply alone should not cause inflation. Instead, it's the velocity of that money which potentially leads to inflation. The velocity of money can be defined as the rate of money being exchanged between individuals in an economy. As more transactions take place (e.g., You go out and buy a car, the car salesman in turn goes out and buys a house, which allows the mortgage broker to take a vacation, etc.) this number increases.

There are other factors which could lead to inflation, such a supply shock to certain industries. This was precisely the driver of the high inflation experienced during the 1970s—as the 1973 oil shock sent energy prices soaring. Additionally, a pickup in fiscal policy could potentially lead to a pickup of inflation (e.g., a massive infrastructure package). The 20's could very well wind up being the decade of joint monetary and fiscal spending.

Velocity of M2 Money Stock



Shading indicates U.S. recessions;
the most recent one is ongoing

Source: Federal Reserve Bank of St. Louis

What assets can help hedge against inflation?

Asset classes that have historically provided solid inflation protection include real assets, commodities, equities, and Treasury Inflation Protected Securities (TIPS).

Real assets are physical assets well suited for hedging inflation—things like real estate and infrastructure which are attractive due to their cash flow. For example, when housing costs begin to rise, landlords are able to raise their rents to offset the impact of inflation. Compared to owning an asset like a fixed rate bond, this feature makes real assets highly attractive during inflationary times.

Gold, silver, and other precious metals typically hold up well to inflation as a result of a weakening U.S. Dollar in this type of environment. And commodities such as oil and energy products are also good inflation hedges as their costs tend to rise with inflation.

TIPS are specifically designed to help protect against inflation-induced fixed rate bond losses. The price of TIPS will increase as current inflation and future expectations increase. Semi-annually, TIPS interest payments will also adjust.

Finally, stocks tied to the economy can serve as solid inflation hedges thanks to the pricing power many companies have—allowing them to keep pace with inflation. During periods where both the economy and inflation are growing, stocks have historically outperformed inflation. In fact, small cap equities have outperformed inflation every decade going back to the 1930s.

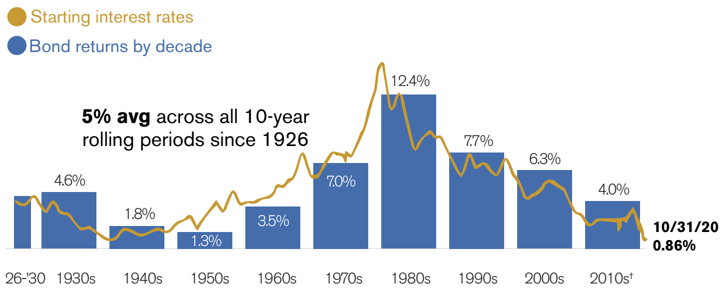
Conclusion

While current data shows significantly higher inflation expectations compared to the lows we experienced back in Q2, it does not appear to pose any serious risk. The adoption of this new Fed policy may lead to systemic inflation somewhere down the road, depending on how far beyond the 2% target they'll allow inflation to run before starting to raise rates. Money printing alone, however, won't be the culprit. We will also need to see a meaningful pickup in the circulation of this money through the economy. In the meantime, hard assets and assets with regular cash flows can offer investors solid protection against future inflation.

EXHIBIT 2

U.S. Bond Returns Follow Interest Rates

(Avg. annual 10-year returns since 1926)



Source: Morningstar and U.S. Treasury as of 10/31/20. †Represents return decade to date (1/1/10 to 10/31/20). U.S. Bonds represented by the IAUSIT Govt Tr Index before 1979 and by the BBgBarcUSAggBond Index after 1979. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. You cannot invest directly in the index.

Outside of the U.S., the picture isn't any rosier. Near record levels of negative-yielding bonds (with close to $16T of bonds yielding negative rates[1]) means investors are essentially paying for the privilege of tying up their money for a fixed period of time.

And with forward guidance from central banks like the Fed and the ECB signaling no rate increases for at least 2-3 years, it's quite possible rates will remain low well into the decade – making things challenging for investors who rely on income from their portfolio.

It might be tempting to react to this new reality by directing assets into areas of the bond market with higher current yields. But caution is necessary, as certain areas are starting to show weakness. In both the investment grade and high yield spaces, leverage is the highest it's been in a decade, while interest coverage (an indication of the ability of companies to service debt) is heading lower. Additionally, recent years have seen loan covenants (or protections for investors) being stripped away, resulting in more risk.

So what's an investor to do? In our view, you have two options going forward:

1. **Reset your expectations lower** (at least temporarily). Understand that interest rates are near record lows and thus your fixed income portfolio returns are going to be lower too.
2. **Expand the opportunity set** and be willing to take on more risk in the process.

For those who favor the latter option, two areas worthy of your consideration would be Preferred Stocks and Private Credit Facilities.

Preferred Stocks

Preferred stocks are a hybrid asset class with characteristics of both bonds and stocks. Similar to bonds in that they pay a stream of income, preferreds also have certain characteristics of stocks (e.g., they're subordinated in the capital structure). In the event of a corporate bankruptcy, preferred shareholders would get paid after all other creditors including subordinated or senior unsecured debt but before common stockholders, to the extent possible given the assets available to creditors. To compensate for that risk, they generally pay higher rates of income.

Why do we favor them now? Most U.S. preferreds are bank and insurance company obligations[2]– corporations which currently have stronger balance sheets and high asset quality due to mandated regulatory changes in the aftermath of the financial crisis of 2007-2008.

Beyond that, from a tax standpoint, distributions from most preferreds are deemed 'qualified dividend* income' and therefore taxed at lower rates than ordinary income. Shifting your portfolio into preferreds removes some investor protections and potential collateral and certainly may come with an increase in volatility relative to a corporate bond, but in our view the pick-up in yield more than compensates for the increased risk, while at the same time reducing inflation and interest rate risk as well.

Private Credit

Another way to expand your opportunity set is through private credit facilities – direct lending to private companies. While this category isn't often on most investors' radar, it's a category comprised of nearly 200,000 companies employing about 52 million people[3].

One of the chief reasons this asset class is often overlooked, despite relatively higher returns compared to traditional fixed income, is because of its illiquid and opaque nature. Additionally, just like traditional bonds issued by public corporations, default risk is an important consideration. Because of these risks, we believe it's an asset class where partnering with the right investment manager is critical.

While bond returns may be challenging going forward, they don't have to be problematic for your portfolio. As long as you're willing to reset expectations and consider broadening your toolkit (while understanding the pros and cons of your positioning), you'll still have an opportunity to meet your income and diversification goals. Your SIA advisor is here to help you navigate the road ahead.

1 Bloomberg, as of 8/31/2020
2 S&P Dow Jones https://www.spglobal.com/spdji/en/indices/fixed-income/sp-us-preferred-stock-index/#overview
3 Cion Investments: https://www.cioninvestments.com/insights/measuring-middle-market/
*The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

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Holiday Greetings to You and Yours

After a forgettable year, we look forward to 2021
with a great deal of hope and optimism.

We thank you for being a valued member of the SIA family
and look to the future with hopeful expectations.

Our Best Wishes to You and Yours for a Joyous Holiday Season.

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