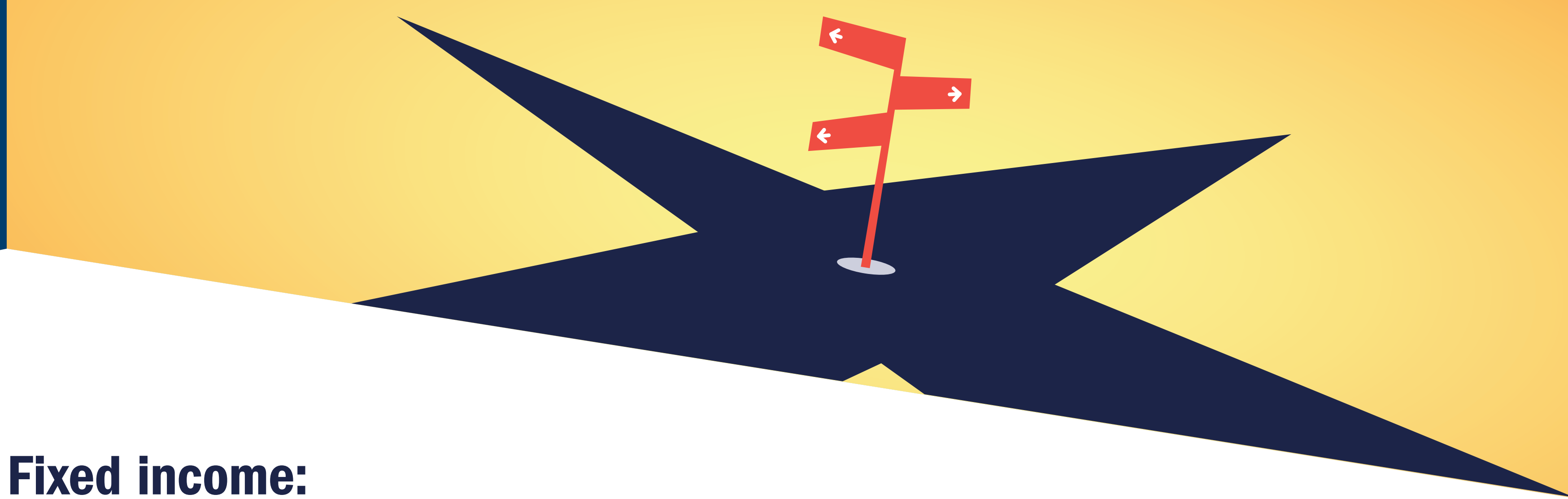
Global Perspectives 2021



Fixed income: security selection a key driver of outperformance

Gene Tannuzzo, Deputy Global Head of Fixed Income

- The US Federal Reserve's aggressive response to the coronavirus has driven yields on safe-haven debt to near zero, leaving "low-risk" portfolios increasingly susceptible to interest rate-driven price volatility.
- The Fed's efforts to depress high-quality government yields creates a powerful source of demand for credit assets by forcing investors further out on the risk spectrum to generate income. This demand, coupled with the prospect of continued economic growth, supports a broadly positive outlook for credit assets.
- Following a significant rally that saw prices recover 20% or more, risk compensation is currently below the long-term average across most fixed income sectors. Relative value relationships also appear fair, suggesting that a diversified approach to sector allocation may yield better risk-adjusted results than a narrow focus.
- We see an opportunity to diversify credit risk across corporate, consumer and sovereign balance sheets, which have all experienced fundamental repair since the depths of the crisis.
- Our base case is that the economy continues to recover through 2021, though with greater differentiation between the pandemic economy's winners and losers. Changing demand patterns and prospects for an uneven recovery will impact industries and issuers in dramatically different ways.
- Good credit research that identifies which trends are most likely to persist should be viewed as an indispensable tool in today's lower return world. Credit selection may prove to be the most valuable risk management tool in fixed income in 2021.

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The US Federal Reserve's aggressive response to the coronavirus pandemic has driven yields on safe-haven debt to near zero, leaving "low-risk" portfolios increasingly susceptible to interest rate-driven price volatility.

We believe the Fed's accommodative stance will persist for many years, which may prevent yields from rising materially. However, this doesn't ensure that they will fall, and the risk appears asymmetric given that low yields fail to protect against even modestly higher rates.

As a result we recommend that investors consider balancing their interest rate risk by focusing on more credit-centric areas of the bond market. The Fed's efforts to depress high-quality government yields creates a powerful source of demand for credit assets by forcing investors further out on the risk spectrum to generate income. This demand, coupled with the prospect of continued economic growth, supports a broadly positive outlook for credit assets.

Investors should remain flexible and diversified. Following a significant rally that saw prices recover 20% or more, risk compensation is currently below the long-term average across most fixed income sectors. Relative value relationships also appear fair, suggesting that a diversified approach to sector allocation may yield better risk-adjusted results than a narrow focus.

We see an opportunity to diversify credit risk across corporate, consumer and sovereign balance sheets, which have all experienced fundamental repair since the depths of the crisis. Equally important is that investors remain flexible and prepared to rebalance if and when relative value changes. Staying nimble will likely be a key factor to enhancing returns in 2021, better enabling investors to preserve the balance between income and capital preservation.

We expect security selection to be a key driver of outperformance. Our base case is that the economy continues to recover through 2021, though with greater differentiation between the pandemic economy's winners and losers. Changing demand patterns and prospects for an uneven recovery will impact industries and issuers in dramatically different ways.

Staying nimble will likely be a key factor to enhancing returns in 2021, better enabling investors to preserve the balance between income and capital preservation

Rather than passively owning market risk, we recommend that investors might consider focusing on security selection to avoid the potential downside scenarios that can significantly impair income and total return opportunities.

Good credit research that identifies which trends are most likely to persist – especially those that result in permanently reduced demand – should be viewed as an indispensable tool in today's lower return world.

Credit selection may prove to be the most valuable risk management tool in fixed income in 2021.

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