2020 income outlook

An exceptional year for bonds, but finding yield got harder

Payson F. Swaffield, CFA
Chief Income Investment Officer
Eaton Vance Management

- The bond market in 2019 was a double-edged sword – plummeting rates resulted in capital gains in most sectors, but also made the search for yield harder.
- In the wake of the 2019 rally, many fixed-income sectors are rich relative to their median spreads over the past five years.
- A few sectors stand out as offering potential value to investors: mortgage-backed securities, collateralized loan obligations (CLOs) and floating-rate loans.
- In 2020, investors are left with fewer choices for income, a lot of interest-rate risk and good reasons to be cautious in credit selection. We believe actively managed strategies are particularly well suited to address the challenges of this environment.

The bond market in 2019 was a double-edged sword. Investors pocketed sizable capital gains in most sectors, thanks to plummeting rates. But the flip side hurts: As has often been the case since the 2008 financial crisis, the search for yield got harder. In fact, negative yields still exist in two of the world's largest economies.

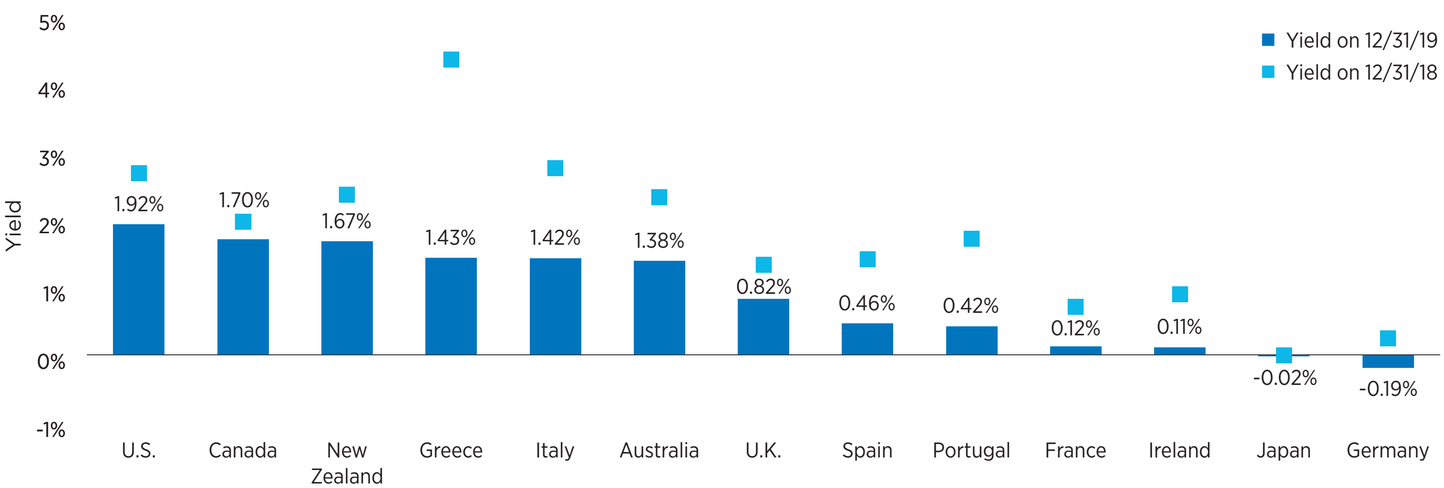
The negative yield phenomenon began in 2014, as central banks went to extremes to pump up their economies. By the end of 2019, sovereign issuers including Japan and Germany still required investors to pay them for the privilege of lending them money (Exhibit A). Globally, about $14 trillion of debt is negative yielding.

A cooling global economy

In 2019, signs of cooling global growth began to weigh on financial markets, against the backdrop of an escalating U.S.-China trade war and Brexit uncertainty. It was not until the end of the year that some visibility emerged for both issues, with progress on a potential first-round trade-talk resolution, and greater certainty about Brexit. In the U.S., personal consumption and strong employment figures have managed to keep the economy moving, but volatile U.S.-China trade negotiations and manufacturing weakness remain.

Exhibit A

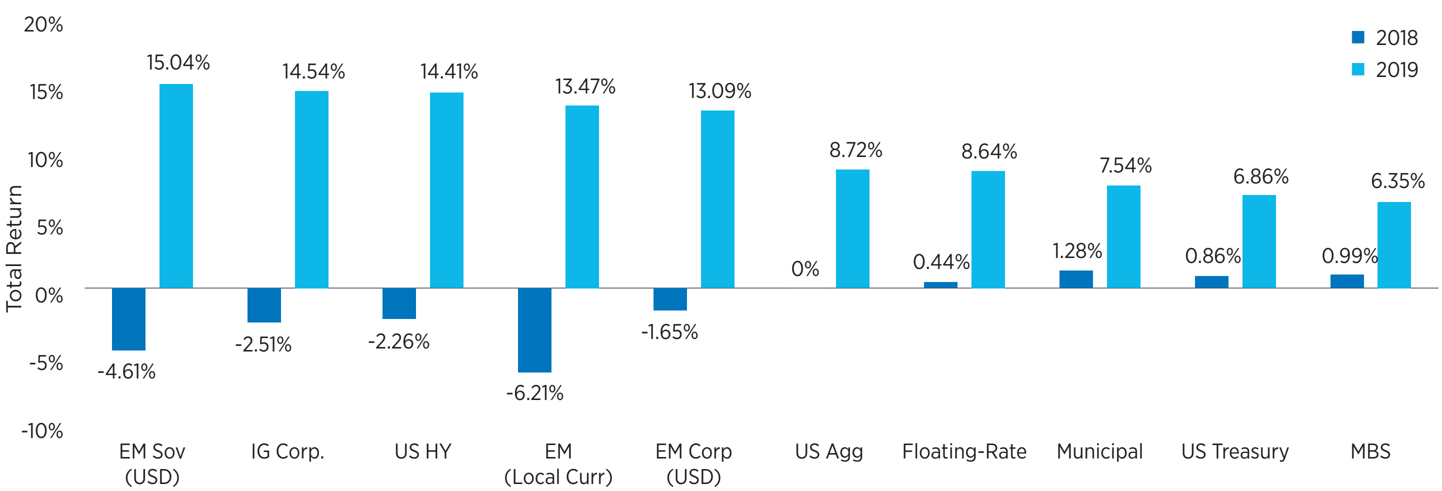
Global yields plunged in 2019, and 2 countries still have negative yields



Sources: Bloomberg LLC, Eaton Vance, as of 12/31/19. Data represent the benchmark 10-year yields for the respective countries. Data provided is for informational use only. **Past performance is not a reliable indicator of future results.**

Exhibit B

The 2019 bond rally generated large gains in most sectors



Sources: ICE BofAML, Bloomberg Barclays, S&P/LSTA, J.P. Morgan, as of 12/31/19. Data provided is for informational use only. Past performance is not a reliable indicator of future results. It is not possible to invest directly in an index. See end of report for important additional information. The U.S. Treasury is represented by the Bloomberg Barclays U.S. Treasury Index. MBS is represented by the Bloomberg Barclays U.S. Mortgage Backed Securities Index. Investment-Grade Corp. is represented by Bloomberg Barclays U.S. Corporate Investment Grade Index. U.S. HY is represented by the ICE BofAML U.S. High Yield Index. EM Sovereign is represented by the J.P. Morgan EM Bond Index (EMBI) Global Diversified. EM Local Currency is represented by the J.P. Morgan Government Bond Index (GBI-EM). EM Corp. (USD) is represented by the J.P. Morgan Corporate EM Bond Index (CEMBI) Broad Diversified. Floating-Rate Loans are represented by the S&P/LSTA Leveraged Loan Index. U.S. Agg is represented by Bloomberg Barclays U.S. Aggregate Bond Index.

The change in sentiment from an outlook of modest global growth to one of slowing growth sparked a pivot by investors away from sectors typically favored in a strong economy. This included lower-duration, lower-credit-quality issues and floating-rate debt – sectors that would benefit in an anticipated rising-rate environment. Instead, investors piled into longer-duration, higher-credit-quality sectors that were expected to fare better in an environment of slower growth or a recession, and falling rates.

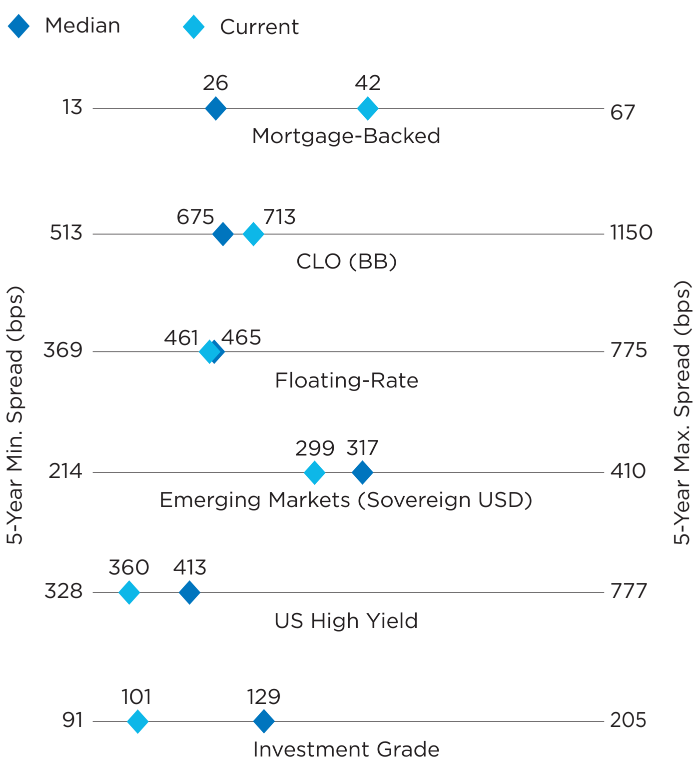
Emerging markets led fixed income in 2019

The biggest beneficiary of this pivot was dollar-denominated, emerging-markets (EM) sovereign debt, which led fixed-income sectors with a total return of 15.04% (Exhibit B). Investment-grade corporate debt was second, with a total return of 14.54%, the highest return for the sector since 2009. U.S. high-yield was third, at 14.41%.

The strong demand for fixed income in 2019, combined with investors' preference for safer "risk assets," pushed up valuations in most credit sectors and tightened

Exhibit C

MBS, CLOs and loans offer relative value



Sources: ICE BofAML, Bloomberg Barclays, S&P/LSTA, J.P. Morgan, as of 12/31/19. Data provided is for informational use only. Past performance is not a reliable indicator of future results. It is not possible to invest directly in an index. See end of report for important additional information. MBS is represented by the ICE BofAML US Mortgage Backed Securities Index. Investment Grade is represented by the ICE BofAML US Corporate Index. CLOs are represented by the J.P. Morgan Collateralized Loan Obligation Index (CLOIE) Post Crisis. Emerging markets (Sovereign USD) is represented by the ICE BofAML US Emerging Markets External Sovereign Index U.S. HY is represented by the ICE BofAML U.S. High Yield Index. Floating-Rate Loans are represented by the S&P/LSTA Leveraged Loan Index.

spreads (Exhibit C). In Exhibit C, the dark blue diamonds represent the five-year median spreads, and the light blue represent current spreads. Light-blue diamonds positioned to the right of the dark ones indicate that current spreads are wider than the historical five-year median – i.e., they are relatively cheap. When the light-blue diamonds are on the left, they are historically rich. Diamonds that are close together indicate fair value.

Not surprisingly, sectors with the strongest gains are among the "richest," including investment-grade and high-yield bonds. Sectors that remain cheap relative to their historical spreads are mortgage-backed securities (MBS) and CLOs, while floating-rate loans are fairly valued. All are worthy of consideration in a balanced fixed-income portfolio. Below we discuss in greater detail the opportunity we see in floating-rate loans and MBS.

Finding relative value in loans

Turning first to loans, Exhibit D shows one clear measure of their relative value: yield. At 6.13%, loans have the highest yield of major fixed-income asset classes – usually, they place third, behind emerging-markets sovereign debt (USD) and high yield.

Loan yields are high relative to historical patterns because of volatile retail fund flows, which were negative in 2019. As Exhibit E demonstrates, retail flows often drive pricing. For example, strong fund net inflows in 2017 and most of 2018 helped keep loan prices around 99% of par, as the market anticipated tightening by the U.S. Federal Reserve. Retail sentiment flipped at the end of 2018 and continued through 2019, as it became clear that the Fed would be loosening rather than tightening.

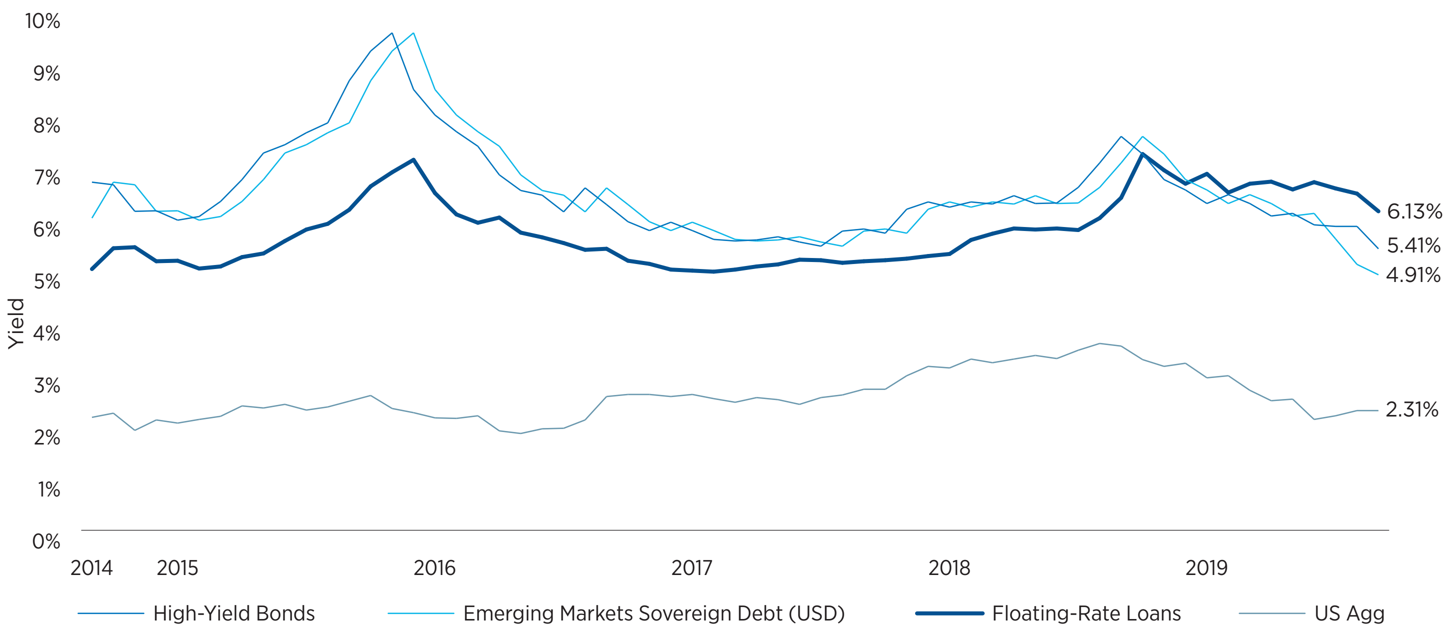
With loans trading at about 97 on December 31, based on the S&P/LSTA Leveraged Loan Index, we believe retail fund flow volatility has created a solid opportunity in the loan market. For example, rate cutting by the Fed is expected to be largely in the rearview mirror – the consensus among economists is that the Fed will now pause after having cut its benchmark rate, which is now in a range of 1.5% to 1.75%. That means loan prices may be less likely to be under pressure from fund net outflows, which have gradually been diminishing.

Moreover, the surprising resiliency of the U.S. economy is a positive for below-investment-grade sectors like loans, because it improves business fundamentals. Further, in our view, the three percentage points the Index is trading below par represent a potential source of appreciation if credit conditions stay the same or improve.

To see why, the current annual default rate is around 1.5%, and we believe it is likely to creep up to around its 2% historical annual average. But the three-point discount from par discount implies an average annual default rate of more than 3.3% — if actual defaults are less than that going forward, it creates a positive environment for price appreciation.

Exhibit D

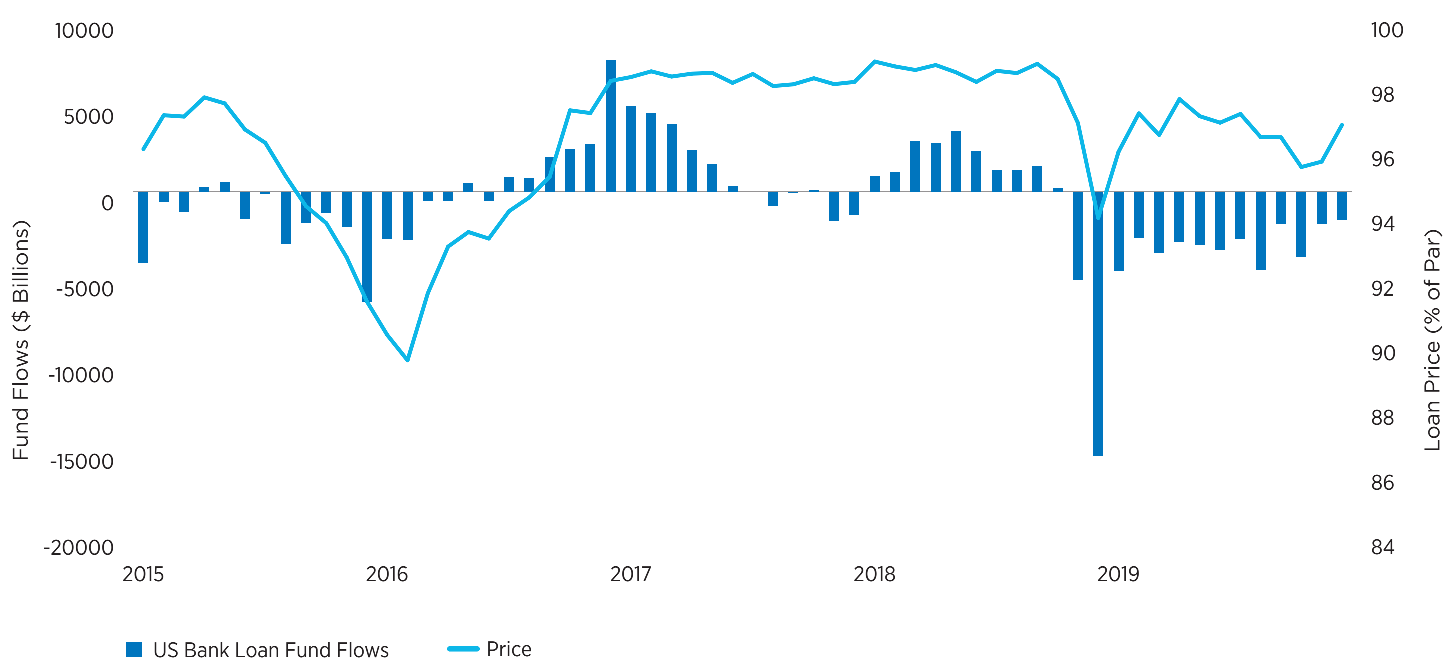
Loans have the highest yield of major fixed-income asset classes



Sources: ICE BofAML, Bloomberg Barclays, S&P/LSTA, J.P. Morgan, as of 12/31/19. Data provided is for informational use only. Past performance is not a reliable indicator of future results. It is not possible to invest directly in an index. See end of report for important additional information. U.S. HY is represented by the ICE BofAML U.S. High Yield Index. Emerging markets are represented by the J.P. Morgan EM Bond Index (EMBI) Global Diversified. Floating-Rate Loans are represented by the S&P/LSTA Leveraged Loan Index. U.S. Agg is represented by Bloomberg Barclays U.S. Aggregate Bond Index.

Exhibit E

Negative retail fund flows drove loan prices lower in 2019



Sources: Morningstar, S&P/LSTA, Eaton Vance, as of 12/31/19. Data provided is for informational use only. Loan prices are based on the S&P/LSTA Leveraged Loan Index. Fund flows are based on the Morningstar U.S. Fund Bank Loan Category, including open end and ETF vehicles. Past performance is not a reliable indicator of future results. It is not possible to invest directly in an index. See end of report for important additional information.

Finding value in MBS

MBS represents another clear opportunity to us. Current spreads are 60% higher than their median level over the past five years, and wider than any point since 2011. Unlike most bonds, which benefited greatly from the sharp, 76-basis-point drop of 10-year U.S. Treasury yields in 2019, they hurt the agency MBS market – bonds backed by Freddie Mac, Fannie Mae and Ginnie Mae.

MBS were negatively affected by an unexpectedly large drop in rates, which sparked a refinancing boom by homeowners, who are responsible for MBS interest and principal payments. The refinanced home loans constituted a wave of new supply that swamped the market, driving MBS prices down and spreads wider.

We believe that 2019's pain is setting up 2020's gain. Agency MBS are an asset class implicitly backed by the U.S., yet spreads are wider for AAA MBS than they are for AA corporate and most A corporates.

Caveats for 2020

There are two important general caveats for bond market investors in 2020, pertaining to both credit and interest-rate risk. In the late stages of the economic cycle, credit selection is especially important. For example, while I have discussed the attractiveness of the loan sector overall, fundamental quality varies greatly among issuers. That is a key consideration in favor of active management – buying a passive, index-based portfolio bypasses necessary professional judgment and due diligence.

Investors also need to be aware of the significant interest-rate risk embedded in most fixed-income sectors in the current environment. There are many crosscurrents in the global economy, and with yields near historic lows, any uptick in rates could quickly erode bond values. In Exhibit F, for example, an increase in yield of just 39 bps on the Bloomberg Barclays U.S. Aggregate Bond Index would cause a price drop that offsets a year's worth of yield.

In 2020, investors are left with fewer choices for income, a lot of interest-rate risk and good reasons to be cautious in credit selection. We stand ready to assist our clients with these and other challenges to successful fixed-income investing. We wish you a very healthy and prosperous new year.

Exhibit F

Even small rate bumps can wipe out a year's worth of yield

	Yield 12/31/2018	Yield 12/31/2019	Duration (Yrs.) 12/31/2019	Yield Change Breakeven (bps)
Treasury	2.61%	1.80%	6.5	28
Municipal	2.69%	1.78%	5.3	34
Investment-Grade Corp.	4.20%	2.84%	7.9	36
US Agg	3.28%	2.31%	5.9	39
EM Sovereign (USD)	6.86%	4.91%	7.6	65
MBS	3.39%	2.54%	3.2	79
High-Yield Corp.	7.95%	5.41%	3.3	164
Floating-Rate Loans	7.23%	6.13%	0.1	6130

Sources: ICE BofAML, Bloomberg Barclays, S&P/LSTA, as of 12/31/19. Assumes a parallel upward shift in yield curve. Data provided is for informational use only. Past performance is not a reliable indicator of future results. It is not possible to invest directly in an index. See end of report for important additional information. US Treasury is represented by the Bloomberg Barclays U.S. Treasury Index. MBS is represented by the Bloomberg Barclays U.S. Mortgage Backed Securities Index. Investment-Grade Corp. is represented by Bloomberg Barclays U.S. Corporate Investment Grade Index. High Yield is represented by the ICE BofAML US High Yield Index. EM Sovereign is represented by the J.P. Morgan EM Bond Index (EMBI) Global Diversified. Floating-Rate Loans are represented by the S&P/LSTA Leveraged Loan Index. U.S. Agg is represented by Bloomberg Barclays U.S. Aggregate Bond Index.

Index Definitions

Bloomberg Barclays U.S. Aggregate Index is an unmanaged index of domestic investment-grade bonds, including corporate, government and mortgage-backed securities.

Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index measures agency mortgage-backed pass-through securities issued by GNMA, FNMA, and FHLMC.

Bloomberg Barclays U.S. Treasury Index measures public debt instruments issued by the U.S. Treasury.

Bloomberg Barclays Municipal Bond Index is an unmanaged index of municipal bonds traded in the U.S.

Bloomberg Barclays U.S. Corporate Investment Grade Index is an unmanaged index that measures the performance of investment-grade corporate securities within the Barclays U.S. Aggregate Index.

ICE BofAML U.S. High Yield Index is an unmanaged index of below-investment-grade U.S. corporate bonds.

ICE BofAML US Mortgage Backed Securities Index tracks the performance of U.S. dollar denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by US agencies in the US domestic market.

ICE BofAML US Corporate Index tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the US domestic market.

ICE BofAML US Emerging Markets External Sovereign Index tracks the performance of U.S. dollar emerging markets sovereign debt publicly issued in the U.S. and eurobond markets.

J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified is an unmanaged index of USD-denominated bonds with maturities of more than one year issued by emerging markets governments.

J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified is an unmanaged index of local-currency bonds with maturities of more than one year issued by emerging market governments.

J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad Diversified is an unmanaged index of USD-denominated emerging market corporate bonds.

J.P. Morgan Collateralized Loan Obligation Index (CLOIE) Post Crisis comprises solely cash arbitrage CLOs backed by broadly syndicated leveraged loans.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

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Important Additional Information and Disclosures

Source of all data: Eaton Vance as of November 30, 2019, unless otherwise specified.

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For further information, please contact:

Eaton Vance Management
Two International Place, Boston, MA 02110
800.836.2414 or 617.482.8260 | eatonvance.com

Eaton Vance Management (International) Limited
125 Old Broad Street, London, EC2N 1AR, United Kingdom
+44 (0)203.207.1900 | global.eatonvance.com