# Fixed Income: Stay the Course

EAGLE Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

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After three consecutive years of very strong returns in the bond market – thanks in large part to falling interest rates – many bond investors were surprised to see their bond portfolios in the red in 2021. Indeed, calendar year 2021 was a tough year for bonds, with the Bloomberg U.S. Aggregate Bond Index posting the third-worst calendar year return in the history of the index. The Bloomberg U.S. Intermediate Govt/Credit Index, a proxy for short-to-intermediate investment-grade taxable bonds, posted the second-worst calendar year in the history of the index. Put simply, rising interest rates caused bond prices to drop, while tight credit spreads – having already retraced most of the widening we saw during the onset of the pandemic by the end of 2020 – did not offer much of an offset despite the positive macroeconomic backdrop. This resulted in negative total returns for many segments of the bond market. Bond sectors viewed as safe havens, like U.S. Treasuries, for example, were the worst performers. Conversely, riskier segments of the fixed income market, like high-yield bonds, outperformed, with the most speculative credits faring best.

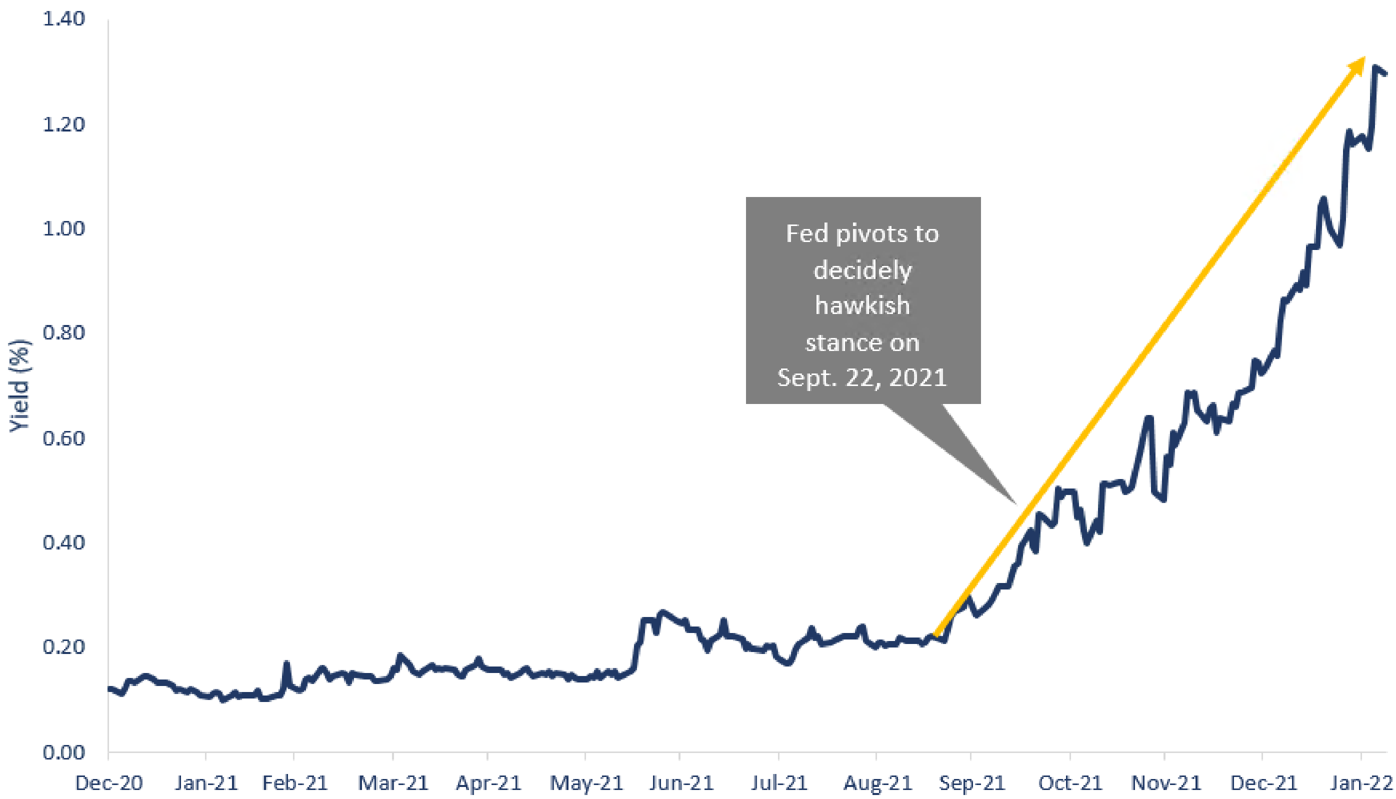
| Asset Class | Bloomberg Index | 2021 Total Return |
|---|---|---|
| U.S. Treasuries | Bloomberg U.S. Treasury Index | -2.32% |
| Mortgage Backed Securities | Bloomberg U.S. Mortgage Backed Securities Index | -1.04% |
| Investment Grade Corporates | Bloomberg U.S. Corporate Bond Index | -1.04% |
| High Yield Corporates | Bloomberg U.S. Corporate High Yield Index | 5.28% |
| BB Corporates | Bloomberg BB U.S. High Yield Index | 4.61% |
| B Corporates | Bloomberg B U.S. High Yield Index | 4.85% |
| CCC Corporates | Bloomberg CCC U.S. High Yield Index | 8.59% |
| CC to D Corporates | Bloomberg CC - D U.S. High Yield Index | 12.53% |

*Source: Bloomberg; data as of 12/31/21*

Within Eagle Asset Management's taxable bond portfolios, we were positioned well for what occurred in 2021. Across our taxable bond programs, we shortened the duration of our portfolios heading into the year to limit interest rate sensitivity. Moreover, we increased our exposure to corporate bonds at the expense of U.S. Treasuries. For the portfolios that allow high-yield as part of their mandate, we began to add to high-yield corporate bonds in late 2020. Lastly, within our multi-asset class programs, which combine stocks and bonds, we reduced exposure to bonds and used those proceeds to buy specific stocks that tend to perform well in reflationary/inflationary environments, like banks and energy companies, for example. All of these moves were productive for portfolio returns.

Given the prospect of menacing inflation and rising rates, investors may be considering selling their bond allocation to avoid the impact of U.S. Federal Reserve (Fed) rate hikes. However, the time to adjust positioning was more than a year ago as we have cited in our monthly and quarterly commentary during that time. The bond market has already priced in roughly four hikes into the yield curve, as evidenced by the repricing in short-term bond yields like the 2-year U.S. Treasury yield in the picture on the next page. By selling now, investors risk locking in mark-to-market losses and would fail to realize the benefits of higher income streams as a result of reinvesting at higher interest rates.

## 2-Year U.S. Treasury Yield




*Source: Bloomberg; data as of 2/07/2022*

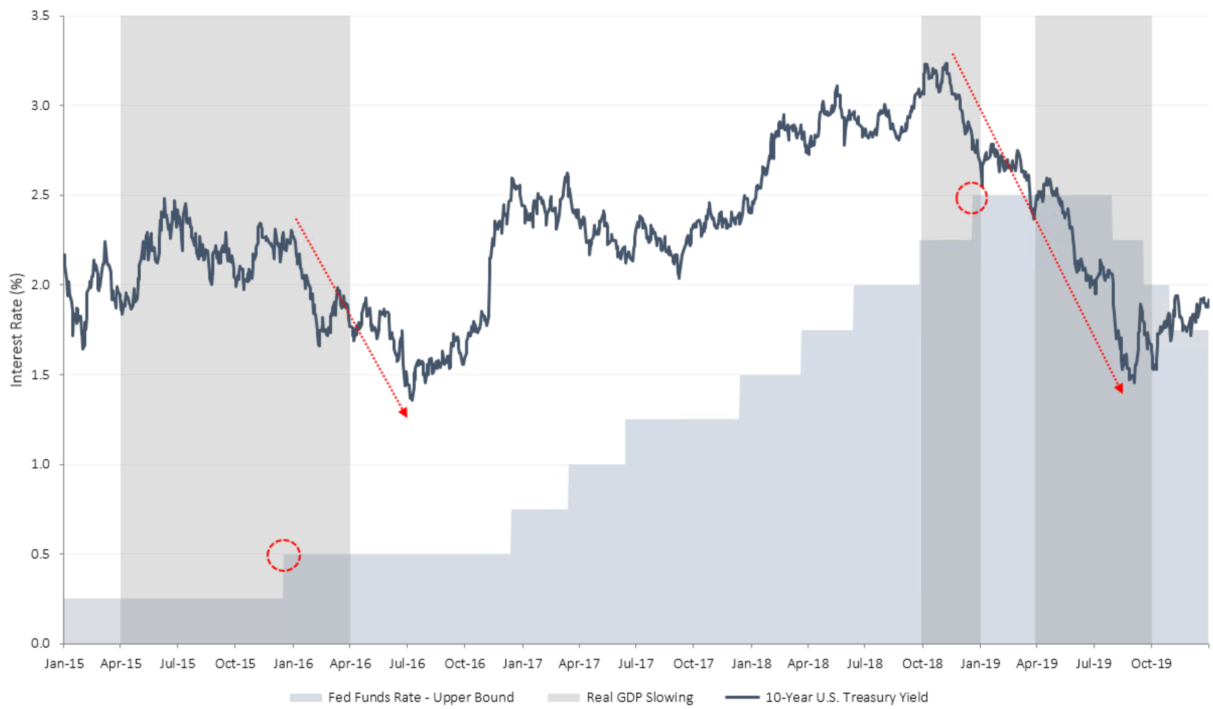
Furthermore, weak returns have historically been a pretext for strong returns in the bond market. In the history of both the Bloomberg Intermediate Govt/Credit Index (short-to-intermediate investment grade taxable bonds) and the Bloomberg Aggregate Bond Index (intermediate investment-grade taxable bonds), there have been 14 and 17 negative rolling one-year periods, respectively. In the following one-year period, both indices have produced positive returns more than 80% of the time. Admittedly, the table below includes periods when interest rates were materially higher than they are today, and it's reasonable to expect forward one-year returns to be more muted in today's environment. Still, the takeaway is that past is not prologue when it comes to fixed income returns.

| | Bloomberg Intermediate Govt/Credit Index | Bloomberg Aggregate Bond Index |
|---|---|---|
| Since index's inception, number of negative rolling one-year returns | 14 | 17 |
| When negative | | |
| Number of positive forward one-year returns | 13 out of 14 | 15 out of 17 |
| Maximum forward one-year return | 15.33% | 35.21% |
| Minimum forward one-year return | -0.58% | -2.61% |
| Median forward one-year return | 6.35% | 7.87% |
| Average forward one-year return | 7.24% | 9.80% |

*Source: Bloomberg; as of 12/31/20*

Finally, it's important to recognize that an increase in the Fed funds rate does not inevitably lead to increases in interest rates across the yield curve. In fact, the 10-year U.S. Treasury yield has declined during periods of previous Fed rate hike cycles, especially those periods in which real gross domestic product (GDP) growth is slowing. This is because intermediate- and long-term bond yields are a reflection of growth and inflation expectations rather than a direct measure of Fed policy. We've already established that the outlook for growth and inflation is more muted in 2022 than it was in 2021, so it would not be completely outlandish to see the 10-year yield decline if Fed officials' hopes for "liftoff" come into conflict with a less favorable economic backdrop. Dynamic adjustments in asset allocation, yield curve positioning, and sector exposure will be critical since interest rates rarely move in a straight line.

**10-Year U.S. Treasury Yield During Previous Rate Hike Cycle**




*Source: Bloomberg. Data from 1/1/2015 to 12/31/2019*

Recent poor fixed income returns are a result of six consecutive quarters of accelerating growth and inflation when we also saw unprecedented fiscal and monetary stimulus. The onus on security and sector selection, flexibility, and risk management is increasing as this remarkable period is starting to sunset in 2022, and we transition to something "less great." Bonds traditionally serve two roles in investors' portfolio: providing income and hedging against the riskier assets in a portfolio. Given the murkier outlook for 2022, the risk mitigation component of bonds may be more relevant than many investors realize. High-quality, investment-grade bonds still fill the role of offsetting equity risk in investors' portfolios. If COVID-19 has taught us anything, it's that the unexpected can happen and it can happen quickly. A diversified portfolio consisting of high-quality, negatively correlated asset classes allows investors to participate in the market while also hedging against various risks.

## About Eagle Asset Management

Eagle Asset Management is built on the cornerstones of intelligence, experience, and conviction, driven by research and active portfolio managers. Our long-tenured investment teams manage a diverse suite of fundamental equity and fixed income strategies designed to meet the long-term goals of institutional and individual investors. Our teams have the autonomy to pursue investment decisions guided by their individual philosophies and strategies.

## About Carillon Tower Advisers

Carillon Tower Advisers is a global asset management company that combines the exceptional insight and agility of individual investment teams with the strength and stability of a full-service firm. Together with our partner affiliates – ClariVest Asset Management, Cougar Global Investments, Eagle Asset Management, Reams Asset Management (a division of Scout Investments), and Scout Investments – we offer a range of investment strategies and asset classes, each with a focus on risk-adjusted returns and alpha generation. Carillon Tower Advisers believes providing a lineup of institutional-class portfolio managers – spanning a wide range of disciplines and investing vehicles – is the best way to help investors seek their long-term financial goals.

### Risk Considerations

Investing involves risk, including risk of loss.

Diversification does not ensure a profit or guarantee against loss.

Investing in bonds involves risks that may adversely affect the value of your investment such as inflation risk, credit risk, call risk, interest rate risk, and liquidity risk, among others. The two most prominent factors are interest rate movements and the credit worthiness of the bond issuer. Investors should pay careful attention to the types of fixed income securities that comprise their portfolios and remember that, as with all investments, there is the risk of loss of capital. A Real Estate Mortgage Investment Conduit (REMIC) is a type of multiclass mortgage-related security in which interest and principal payments from mortgages are structured into separately traded securities. These classes are distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, they may be more or less sensitive to prepayment risk, bear different interest rates, and have various average lives and final maturities.

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Investment grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's. Convertible securities and preferred stock combine the fixed income characteristics of bonds with some of the potential for capital appreciation of equities and, thus, may be subject to greater risk than pure fixed-income instruments. Unlike bonds, preferred stock and some convertible securities do not have a fixed par value at maturity, and in this respect may be considered riskier than bonds. Convertible securities may include convertible bonds, convertible preferred stocks and other fixed-income instruments that have conversion features.

Investments in high-yield bonds and convertible securities are subject to the client's authorization, as set forth in the Investment Management Agreement. Such investments may be subject to greater risks than other fixed-income investments. The lower rating of high-yield bonds (less than investment grade) reflects a greater possibility that the financial condition of the issuer or adverse changes in general economic conditions may impair the ability of the issuer to pay income and principal. Periods of rising interest rates or economic downturns may cause highly leveraged issuers to experience financial stress, and thus markets for their securities may become more volatile. Moreover, to the extent that no established secondary market exists, there may be thin trading of high-yield bonds, which increases the potential for volatility.

Duration incorporates a bond's yield, coupon, final maturity and call features into one number, expressed in years, that indicates how price-sensitive a bond or portfolio is to changes in interest rates. Bonds with higher durations carry more risk and have higher price volatility than bonds with lower durations.

Reflation is the act of stimulating the economy by increasing the money supply or by reducing taxes, seeking to bring the economy (specifically price level) back up to the long-term trend, following a dip in the business cycle.

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

The Bloomberg U.S. Aggregate Bond Index is composed of the total U.S. investment-grade bond market. The market-weighted index includes Treasuries, agencies, commercial mortgage-backed securities (CMBS), asset-backed securities (ABS) and investment-grade corporates. The inception date of the index is January 1, 1976.

The Bloomberg U.S. Intermediate Govt/Credit Index measures the performance of U.S. Dollar-denominated U.S. Treasuries, as well as government-related and investment-grade U.S. corporate securities that have a remaining maturity of greater than one year and less than 10 years. The inception date of the index is January 1, 1973.

The Bloomberg U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

The Bloomberg U.S. Mortgage Backed Securities (MBS) Index tracks fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Bloomberg U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market.

The Bloomberg U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and Standard & Poor's is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on the indices' EM country definition, are excluded.

The Bloomberg BB U.S. High Yield Index measures the portion of the Bloomberg U.S. Corporate High Yield Bond Index with a Standard & Poor's rating of BB.

The Bloomberg B U.S. High Yield Index measures the portion of the Bloomberg U.S. Corporate High Yield Bond Index with a Standard & Poor's rating of B.

The Bloomberg CCC U.S. High Yield Index measures the portion of the Bloomberg U.S. Corporate High Yield Bond Index with a Standard & Poor's rating of CCC.

The Bloomberg CC-D U.S. High Yield Index measures the portion of the Bloomberg U.S. Corporate High Yield Bond Index with Standard & Poor's ratings between CC and D.

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