Reams Unconstrained Bond Fund -- A sub-fund of Raymond James Funds (UCITS umbrella under Luxembourg Law)

No shortage of fiscal or monetary pitfalls

Reams Asset Management
Sub-manager of the fund

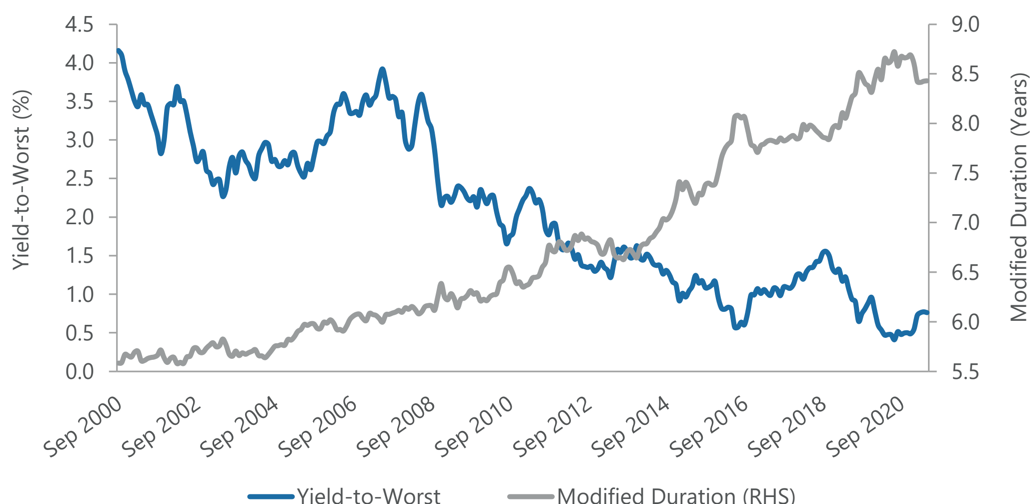
What are your views on inflation's potential impact in the next year?

Reams Asset Management adheres to the aphorism from Yogi Berra, a famous American baseball player: "It's tough to make predictions, especially about the future." This holds true for growth and inflation over the balance of 2021 and into 2022. Much has been written about "base effects" and inflation being "transitory." Move along, nothing to see here. This view may ultimately prove correct and the recent uptick in inflation may be nothing more than a blip rather than the beginning of a regime shift. There is a chance, however, that higher inflation becomes more sustained than predicted due to a confluence of forces: loose monetary policy, massive fiscal stimulus, supply chain disruptions, and shifting labor market dynamics that may lead to upward pressure on wages.

We don't know with any degree of certainty that this perfect storm will coalesce and lead to problematic inflation, but it might, and the resulting impact on fixed income markets would be negative and potentially severe. U.S. Treasuries would suffer change as rates adjust upwards to reflect a higher plateau of inflation expectations, similar to what occurred in the first quarter of 2021. Although rising inflation in a robust growth environment is generally brushed aside by risk assets, if inflation rises too much, too quickly, it becomes a different proposition altogether. And if rising inflation coincides with rapidly decelerating growth, then things could get dicey indeed.

Preparing for these possible outcomes is straightforward: Skew portfolio durations towards the lower end of allowable ranges and avoid exposure to the long end of the yield curve. Thankfully the opportunity cost of this defensive positioning, in the form of foregone yield, is currently very low.

Bloomberg Barclays Global Treasury Index Yield-to-Worst vs. Duration



Source: Bloomberg, as of May 31, 2021

The Bloomberg Barclays Global Treasury Index tracks fixed-rate government debt of investment grade countries. It represents the treasury sector of the Global Aggregate Index and includes 37 countries denominated in 24 currencies.

How do you see Fed policy on interest rates playing out if the U.S. economy continues a strong recovery?

To mix metaphors, in our opinion U.S. Federal Reserve (Fed) policy is attempting to walk a tightrope between a rock and a hard place. The Fed has already committed to holding the Fed funds policy rate at the zero bound until 2023. This rigid stance constrains its policy response options in an environment that is very fluid as the world continues to recover from the pandemic. This is especially true if the U.S. recovery proves stronger than expected and higher inflation is not in fact transitory. The competing goals and cross-currents in this scenario may prove irreconcilable.

With the backdrop that interest rates are already artificially low, if the U.S. recovery is exceptionally robust and inflation is higher for longer, the orthodox response would be for the Fed to raise the policy rate. Even though Fed officials have repeatedly stated they won't raise rates until 2023, let's say they do just that. The rate increase will need to be precisely calibrated to tamp down inflation without simultaneously choking off growth, something the Fed has not proven particularly adept at doing. Adding to the degree of difficulty, the Fed would presumably need to continue quantitative easing purchases to help fund massive federal budget deficits and also prevent rates at the long end of the curve from rising significantly. This last point is critical due to the ever-increasing debt burden at both the federal and corporate levels. If rates rise too much and financing costs subsequently increase significantly, this has the potential to bring the whole party to an abrupt and unpleasant end.

How can investors solve the challenge of a low-yield environment?

Investors must consider, first and foremost, why they have exposure to fixed income. It has historically offered four primary benefits: income, capital preservation, diversification of equity risk, and liquidity. The current environment affects each of these. So it is vital to think carefully about which roles are most important to the overall portfolio objectives and what tradeoffs are acceptable to prioritize one role over another. There is no easy solution to the "low yield" dilemma, but the starting point should be to define objectives and set reasonable expectations based on those objectives.

In the past you could comfortably generate a 4% or 5% yield with a diversified mix of investment-grade bonds. In addition to income, the potential existed to earn higher total returns via declining risk-free rates. Those days are long gone, and achieving a similar yield today would require a portfolio comprised entirely of speculative-grade bonds. Baseline returns for traditional investment-grade fixed income are probably going to be in the 0% to 2% range for the foreseeable future. If this is an acceptable return in exchange for capital preservation, diversification of equity risk, and liquidity, then you can continue to target that same high-grade bond portfolio.

If you can't accept low-single-digit returns, however, then adjustments will be required. Bond portfolios will need to become more flexible and less benchmark-oriented, especially with respect to duration positioning. Multi-sector bond portfolios with broad guidelines and flexibility provide the potential to take advantage of opportunities and the ability to sidestep the significant risks that are in play right now.

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