MADISON SCOTTSDALE INSURANCE SOLUTIONS

4Q 2020 Investment Strategy Letter - SMA

The fourth quarter of 2020 saw a resurgence of Covid-19 case levels, hospitalizations, and deaths. The political response varied by state and region. The states that had shut down hard earlier in the year responded with some reversion to stricter regulations while other states followed less stringent policies. As in the prior two quarters, the economy's major sectors negatively impacted continue to be hotels, restaurants, brick and mortar retail, and airlines. Housing and autos continued to see healthy demand despite elevated levels of unemployment.

Despite the increase in government orders, which negatively impact economic activity, expectations for Q4 gross domestic product (GDP) continue to run in the mid to high single digits, e.g., the Atlanta Fed GDPNow Index is forecasting a 10.4% quarter over quarter growth rate. Most forecasts for 2021 see growth in the mid-single digit range for the full year. While the current surge in cases may create drag early in the year, increasing vaccinations levels should lead to a pent-up demand-led recovery in the second half of 2021.

Politics was a primary focus for the markets for much of the quarter. Despite the change of party for the executive branch, stocks continued to rally through the end of the year, apparently based on the assumption of continued divided government, ongoing accommodative monetary policy, and additional fiscal stimulus, as well as hopes of widespread vaccinations in the first half of 2021.

The Federal Reserve has continued to forecast an extended period of ultra-easy monetary policy, probably through 2022 or 2023, depending on the pace of economic recovery and inflation. Specifically, the Fed wants to see a significant inflation period running above their 2% target before considering monetary stimulus removal. The Fed's preferred measure of inflation, the Core Personal Consumption Index, runs at about 1.4% currently and is not expected to increase dramatically anytime soon. The low level of interest rates has contributed to increased demand for risk assets, i.e., government bonds and stocks.

Both political and economic considerations will drive the level of additional fiscal stimulus.

The yield curve steepened as the two-year treasury dropped one basis point from 0.13% to 0.12% for the quarter. The ten-year treasury rose from 0.69% to 0.92% as market participants began pricing in some level of economic recovery in 2021.

During the fourth quarter, the Barclays Intermediate Government/Credit Index returned 0.48% and 6.43% for the entire year. As we did in the third quarter, we found value for our customized insurance portfolios in taxable municipal bonds issued by high-quality issuers in areas of the country less severely impacted by the pandemic shut down. These bonds included general obligation bonds, school districts, and water and sewer authorities. Additionally, we purchased some callable agency securities that offered attractive yields versus credits of similar duration. We purchased some short, high-quality corporate debt to offset some of the longer duration securities. Agency MBS was unattractive for most of the quarter as prepayments accelerated due to a combination of refinancing's and agency buybacks of mortgages in arrears due to the shutdown.

With more than 18 trillion in negatively yielding global government debt, demand far outstrips supply in the fixed income markets. Investment-grade sectors are aggressively bid, especially in the short end, which provides principal protection from an eventual rate rise to more normal levels.

Looking forward, we expect some market volatility early in the year as continued uncertainty regarding the end of the pandemic continues as cases continue to spike around the globe.

Capturing yield will remain a challenge in investment-grade fixed-income portfolios as the current Federal Reserve (Fed) inflation targeting policy continues over the next couple of years. As always, we will continue to balance our insurance client's need for income against the credit and durations risks present in the current market environment.