Executive Summary

Fixed income funds posted a return of negative 0.94% on average during the first quarter of 2021. Both taxable bond funds and tax-exempt bond funds reported negative performance (-1.26% and -0.08%, respectively), marking their first quarters of negative performance since the start of the pandemic in Q1 2020.

The macroeconomic landscape has drastically shifted since then. We now have a growing number of the global population becoming vaccinated, lockdown/virus mitigation efforts currently being rolled back, and trillions of dollars of fiscal stimulus delivered on the back of loose monetary policy. Throughout Q1 the Federal Reserve constantly reminded us of its intention to keep rates low, keeping the current asset purchasing program in place, and using a steady hand in the face of any temporary inflationary spike. The Fed’s rhetoric along with improving jobs and reopening data sent shockwaves throughout the quarter in the fixed income universe as investors improved their 2021 global growth outlook. The increased growth forecasts led to selloffs in fixed income, causing a steepening of the yield curve and longer-dated Treasury yields to hit levels we haven’t seen in roughly two years.

How did all this play out for the fixed income Lipper classifications? Only 14 out of 51 Refinitiv Lipper fixed income peer groups recorded quarterly gains. The positive performers were among classifications that reduce interest rate risk. Interest rate risk is a fundamental principle in fixed income investing—when interest rates rise, bond prices fall. As new bonds get issued at higher yields, previously issued bonds lose their appeal. In reflationary periods, purchasing securities with higher yields, shorter durations, or adjustable rates are all central strategies to limit interest rate risk. Often this leads to investors taking on more credit risk, especially if they are moving into loan participation or high yield funds.

The top five performing Lipper classifications for Q1 2021 were Specialty Fixed Income Funds (+2.00%), Loan Participation Funds (+1.55%), Short High Yield Funds (+1.53%), High Yield Funds (1.11%), and Global High Yield Funds (0.85%).

General U.S. Treasury Funds (-8.27%), Emerging Markets Local Currency Debt (-6.41%), Corporate Debt A-Rated Funds (-4.19%), Corporate Debt BBB-Rated Funds (-4.03%), and International Income Funds (-3.89%) round out our bottom five quarterly performance Lipper classifications. Of the bottom five, General U.S. Treasury Funds is the only classification recording a trailing one-year loss (-0.04%).
Treasury bond yields took us on a ride during the first quarter of 2021. As you can see from Figure 1, yields across the curve increased quarter-over-quarter, resulting in a drastically steeper yield curve than just three months ago. The market attributes the rise in yields more to stronger growth forecasts than fears of runaway inflation. The inverse relationship between bond prices and bond yields hurt funds in the Government/Treasury group the most over Q1, after suffering their first average quarterly loss since Q3 2018 (-1.55%).

Each Lipper classification under this macro-group ended the quarter in the red. Funds within General U.S. Treasury reported the worst performance on average (-8.27%), followed by General U.S. Government Funds (-3.47%). Despite the poor quarterly performance, Government-Treasury ETFs still received inflows of $1.8 billion for the last Lipper fund-flows week, which lead all fixed income ETF groups. Short U.S. Government Funds and Short U.S. Treasury Funds led the macro-group in performance, returning negative 0.18% and negative 0.24%, respectively, highlighting here that shorter duration funds outperformed their longer-dated counterparts.

Funds within the Short-Term Intermediate Corporate Bond Funds macro-group returned negative 1.68% on average, logging their first negative performing quarter since Q1 2020. Investment grade spreads tightened a bit throughout the quarter as investors increased their appetite for higher yielding assets. Core Bond Plus Funds (-2.94%) and Core Bond Funds (-2.95%) were the primary laggards in this macro-group, marking their lowest quarterly performance since Q3 2008. Both classifications hold a majority of investment grade debt and report a weighted average maturity between five and 10 years.

It’s not all bad though—two Lipper classifications that finished the quarter in the black (or blue on our Figure 2 chart) were Short High Yield Funds and Ultra-Short Obligation Funds. On average Short High Yield Funds returned 1.53% and was the third best Q1 performer of the taxable-fixed income Lipper classifications. This classification consists of reported weighted average maturities of less than three years along with most of their investments being in high-yield debt. Ultra-Short Obligation Funds finished the quarter at 0.11%—their fourth quarter in a row of positive performance. The Short-Term Intermediate Corporate Bonds macro-group has joined our trend of investors moving into shorter-termed, higher-yielding assets. Remember, two ways to mitigate interest rate risk are to purchase assets with shorter durations and/or accept more credit risk through higher-yielding bonds.
General Domestic Taxable Bond Funds Summary
Although General Domestic Taxable Bond Funds posted a negative average group return (-0.22%), this macro-group showcased three of the four top quarterly performing Lipper classifications. Specialty Fixed Income Funds (+2.00%), Loan Participation Funds (+1.11%), and High Yield Funds (+1.11%) all recorded their fourth consecutive positive quarter. The top contributors to the Specialty Fixed Income Funds classification were levered inverse/short strategies related to U.S. Treasury performance. Hence rewarding them with the highest performing quarter since Q2 2009. Preliminary Lipper fund-flow estimates show Loan Participation Funds raking in their highest quarterly estimated net inflow total since Q1 2017. These funds invest a higher percentage of their assets in floating and variable rate securities which help protect against rising rates.

Corporate Debt A-Rated Funds (-4.19%) and Corporate Debt BBB-Rated Funds (-4.03%) were the largest detractors from this macro-group. Both Lipper classifications invest a significant portion of their assets in investment grade debt. For Corporate Debt BBB-Rated Funds, this was its weakest quarterly performance since Q3 2008. 2020 saw a record level of fallen angels, signaling future upgrades as the economy reopens and conditions improve. Investors are taking that bet on high yield and it’s showing.
World Fixed Income Funds Summary
The World Fixed Income Funds macro-group on average performed the worst (-3.24%) of all fixed income macro groups (including tax-exempt). Their Q1 return was the first negative return in four quarters. As yields rise, U.S. debt becomes increasingly attractive compared to non-domestic debt. U.S. Treasury yields, however, remain at historically low levels. These low levels help explain the persistent inflows into non-domestic fixed income funds. Even with the negative quarterly performance, U.S. Lipper Fund Flows reported last week that international & global debt conventional fixed income funds have now cited 25 positive weekly inflows in the last 26 weeks.

Emerging Markets Local Currency Debt Funds (-6.41%), International Income Funds (-3.89%), Emerging Markets Hard Currency Debt Funds (-6.41%), and Global Income Funds (-3.09%) all ended the quarter with negative returns. Our sole champion in this macro-group was Global High Yield Funds (shocker!). Global High Yield Funds’ Q1 return (+0.85) was the fifth highest among individual Lipper classifications and their fourth consecutive quarter of positive performance.

Municipal Debt Funds Summary
The Municipal Debt Funds macro-group recorded an average loss of 0.08% for the first quarter of 2021. General Municipal Debt Funds recorded a gain of 0.44%, which also extended their streak of positive quarters to four. This sub-group was led by the High Yield Municipal Debt Funds Lipper Classification (+1.24%).

Single State Municipal Debt Funds (-0.33%) and National Municipal Debt Funds (-0.12%) both saw quarterly losses on average, but should benefit in the coming quarters as revenue streams reopen in stride with the economy and a potential federal infrastructure program is rolled out.