Mitch on the Markets

Best Fixed Income Investments for 2017

By Mitch Zacks
Portfolio Manager

At Zacks Investment Management, we continue to favor individual corporate and municipal bonds for investors seeking income and diversification in their fixed income portfolios. U.S. treasuries, while not providing as much income, still remain a great way to lower volatility and risk present from equity securities. So far in 2017, our outlook has served us and our fixed income clients well: through the first half of the year, municipal bonds as measured by the Muni Bond 10-year Index are up +4.2%, and U.S. Corporate Bonds aren't far behind at +3.8%. Those year-to-date returns are better than U.S. Treasuries (1.9%), TIPS (0.9%), the Barclays U.S. Aggregate Bond Index (2.3%), and Mortgage-Backed Securities (1.3%). With long-term yields compressing, longer duration bonds outperform shorter bonds.

I'll focus on corporate bonds in this column. The Zacks Investment Management Fixed Income Portfolio Manager, Manish Jain, notes that even as investment grade bond issuance is on pace to exceed 2016 levels, strong domestic – as well as international – demand is keeping downward pressure on yields. Except for a few circumstances in the high yield arena, corporations are not having any trouble raising funds to either refinance higher cost debt or to use for share buybacks and dividend payouts.

And corporations are doing just that. Think about this environment from a personal finance standpoint – if you could borrow money today at lower rates to pay off old debts that carry higher interest rates, would you do it? Of course! Many strong corporations are in that very position – they have high cash balances, robust earnings, quality balance sheets, and low default rates to borrow at attractive rates.

We say "many" corporations, but investors should be careful to be selective when purchasing corporate debt. The temptation is often to chase yield, but in the current environment doing so could be a trap – since high demand and relatively low default rates are keeping yields low, many weaker corporations are able to enter the market and capture lower yields than they probably should, given their risk profile. At Zacks Investment

Management, our fixed income team looks at *credit quality* as a primary metric when we're selecting corporate bonds to own. Our selection method is rigorous and thorough.

What is the Outlook for Fixed Income?

On the corporate bond side, it may be difficult to match the performance seen in the first half, but we believe the outlook remains positive. Returns may come more from coupon payments than price appreciation, but we think it still makes sense to own high-quality corporates within a fixed income allocation. The S&P 500 saw its best quarterly (Q1) earnings growth rate since 2011, and we still expect corporate earnings to grow by close to 10% for 2017, in aggregate. That should support positive performance from corporate bonds.

Looking at the fixed income world from a more macro standpoint, there are a few things to note as it relates to the Federal Reserve. At its June meeting, the Fed hiked the fed funds rate as expected by 25 basis points. More importantly, however, were the stated plans to unwind the Fed's balance sheet. From the looks of it, the Fed is planning to run off $6 billion in Treasuries and $4 billion in mortgage backed securities per month (starting next quarter perhaps), and increase them on a quarterly basis until they reach $30 billion and $20 billion per month respectively. This unwinding means that a major buyer of U.S. government debt is starting to step away from the table, leaving a fairly large void in its place. Demand from international investors remains strong, but those institutions do not have the same gravitas as the Fed. If the balance shifts, we may finally start to see some upward pressure on the long end of the yield curve (10-year and 30-year U.S. Treasuries). Even more reason, in our view, to favor corporate and municipal bonds in the current environment.

Bottom Line for Investors

Overall, it has been a reasonably good year so far to be a fixed income investor – nearly all fixed income asset classes have delivered a positive return in 2017. Fixed income markets have largely been calm, as equities markets continue to rally on a global basis. A diversified portfolio of stocks and bonds has likely put smiles on many investors' faces.

-**Mitch**

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

Zacks
INVESTMENT
MANAGEMENT

of Zacks Investment Research. Zacks Investment Management is an independent Registered Investment Advisory firm and acts an investment manager for individuals and institutions. Zacks Investment Research is a provider of earnings data and other financial data to institutions and to individuals. This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Do not act or rely upon the information and advice given in this publication without seeking the services of competent and professional legal, tax, or accounting counsel. The information contained herein has been obtained from sources believed to be reliable but we do not guarantee accuracy or completeness. Publication and distribution of this article is not intended to create, and the information contained herein does not constitute, an attorney-client relationship. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.

Returns for each strategy and the corresponding Morningstar Universe reflect the annualized returns for the periods indicated. The Morningstar Universes used for comparative analysis are constructed by Morningstar (median performance) and data is provided to Zacks by Zephyr Style Advisor. The percentile ranking for each Zacks Strategy is based on the gross comparison for Zacks Strategies vs. the indicated universe rounded up to the nearest whole percentile. Other managers included in universe by Morningstar may exhibit style drift when compared to Zacks Investment Management portfolio. Neither Zacks Investment Management nor Zacks Investment Research has any affiliation with Morningstar. Neither Zacks Investment Management nor Zacks Investment Research had any influence of the process Morningstar used to determine this ranking.