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Market Perspectives: Boring Bonds

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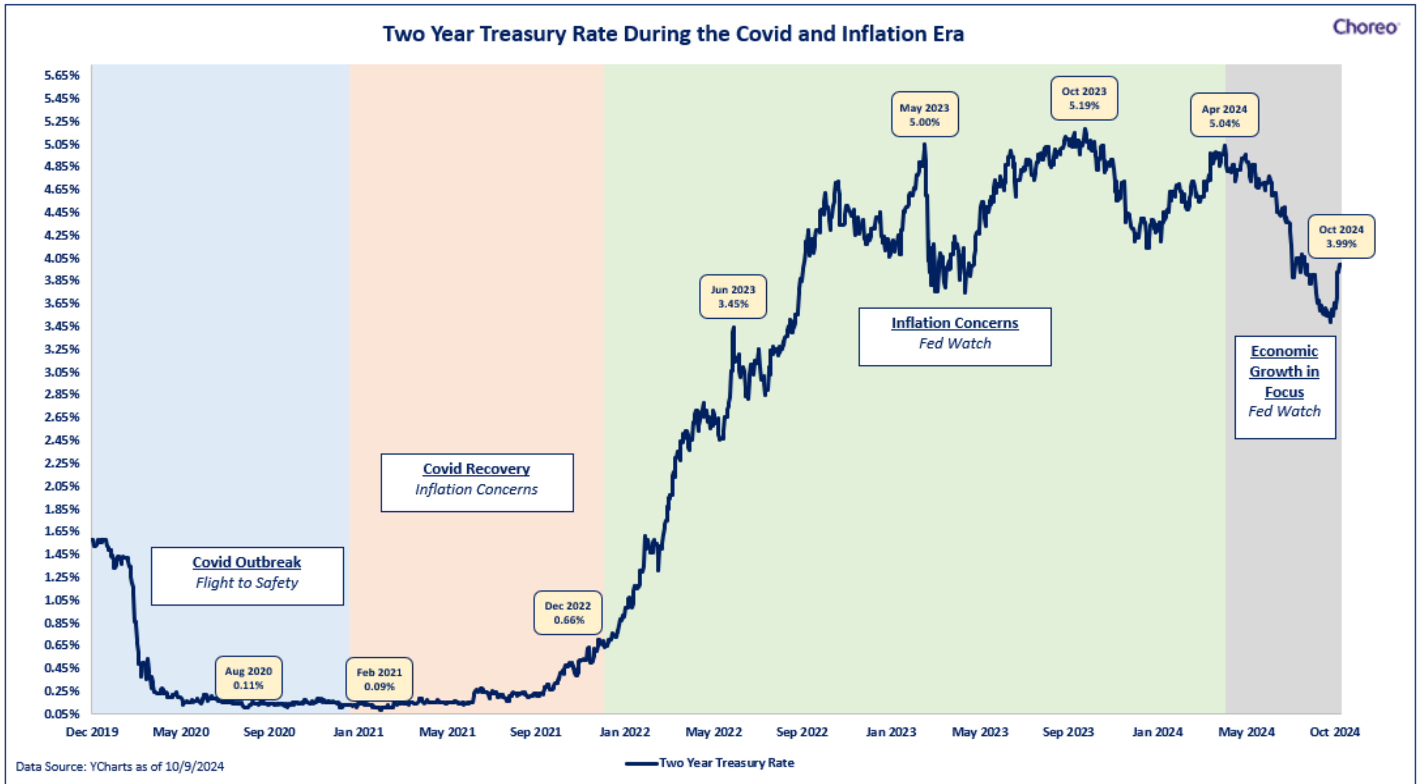
MARKET PERSPECTIVES: BORING BONDS

"You know what the happiest animal on earth is? It's a Goldfish. You know why? It's got a 10 second memory. Be a goldfish Sam."

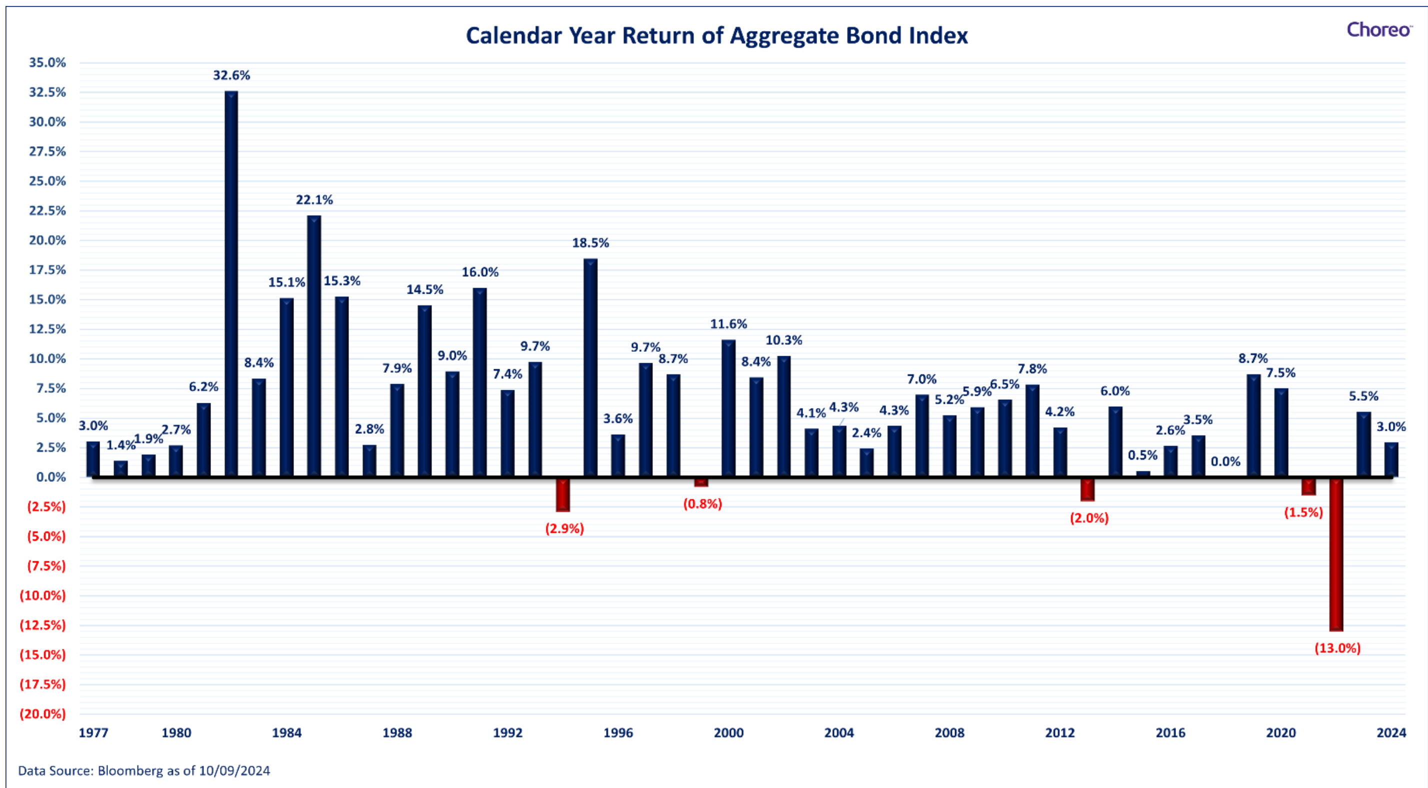
~Ted Lasso (aka Jason Sudeikis)

- The Federal Reserve (the "Fed") officially ended the multi-year cycle of rate hikes with the first round of rate cuts in four years during the month of September. The future path of additional cuts remains uncertain, but more reductions are expected by market participants.
- Equity markets have embraced lower rates thus far with the positive developments of lower capital costs for businesses and consumers alike.
- Inflation has cooled, and the labor market and broad economy have remained reasonably strong providing a base argument for the Fed initial actions.

In the world of investing, the traditional balanced portfolio is designed with two primary components: equity and fixed income. In a purely theoretical world, the rationale of having those components is to reduce risk to some degree. Fixed income, which for these purposes will also be referred to as bonds, are generally the boring part of the equation. When there are market-generating headlines, the equity markets generally receive the attention because equity market volatility is typically more prone to larger swings. Bonds *should be* boring. Investors want bonds to be boring. However, the last four years have proven this is not always the case. Note the simple path of the most commonly utilized Bond Index's performance below (the Bloomberg Aggregate Bond Index):



Investing involves a mix of thinking long term, not overly focusing on short term volatility (other than thinking opportunistically when short term volatility rears itself), and essentially "being a goldfish" as implied by the quote above from the popular TV series *Ted Lasso*. This is to say overly focusing on the recent past may be a hindrance to achieving long term goals. Examining a longer time frame shows that bonds have historically delivered positive total returns in all but a few relatively rare calendar years.



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The most important relationship to remind ourselves of is that when interest rates rise, prices of bonds generally fall and vice versa. This can also clearly be observed above in the first graph. Often this can be explained with an example. If an investor purchases a bond at $100 expected to earn 5% (i.e., $5) per year for one year, at which time the investor will receive the $100 back, this is easily observable as a 5% return. However, if six months into that holding period, the prevailing interest rate moves to 15%, investors will seek to purchase bonds with higher returns and the price may move down. While the investor would still make the 5% if they held the bond until it matured, the opportunity to earn a greater return exists. If the investor went to sell the $100, there would likely be no one who would purchase the bond at $100 since now they could earn more elsewhere. The sale price of the bond would likely be lower than $100 to compensate the new buyer for the current 15% interest rate environment. In other words, yields rose, and the price of the existing bond would have to fall to equalize the market price. In reality, the example above may not see much price movement because the timeframe is relatively short until maturity. The largest price movements will occur when longer term yields rise and fall. [1]

As described above, this implies there are three primary components of the return for owning a bond, two of which are mentioned in the example above:

1. Interest income earned: This amount has to do with the interest rate, often a coupon. In the example above, this would be $5 or 5%. This is often the primary return investors receive.

2. Price movement: As described above, this can also be a factor, particularly when interest rates move meaningfully. The longer the timeframe until the bond matures, generally speaking, the more movement in price from movement of interest rates (a concept called duration).

3. Credit Risk: The final component described in more detail in the graph below, is credit risk. As a company becomes more or less risky, the spread over which is trades against a comparable risk-free asset will tighten or widen, providing an opportunity to achieve modestly better or worse returns than say owning a treasury. The graph below highlights that yield spreads have tightened over the last year as the odds of recession of a few years ago have faded, offering investors an additional source of positive return.

[1] Information presented is for illustrative purposes only. The example described does not represent recommendations made to clients. The reader should not assume that a particular recommendation will be profitable or favorable.

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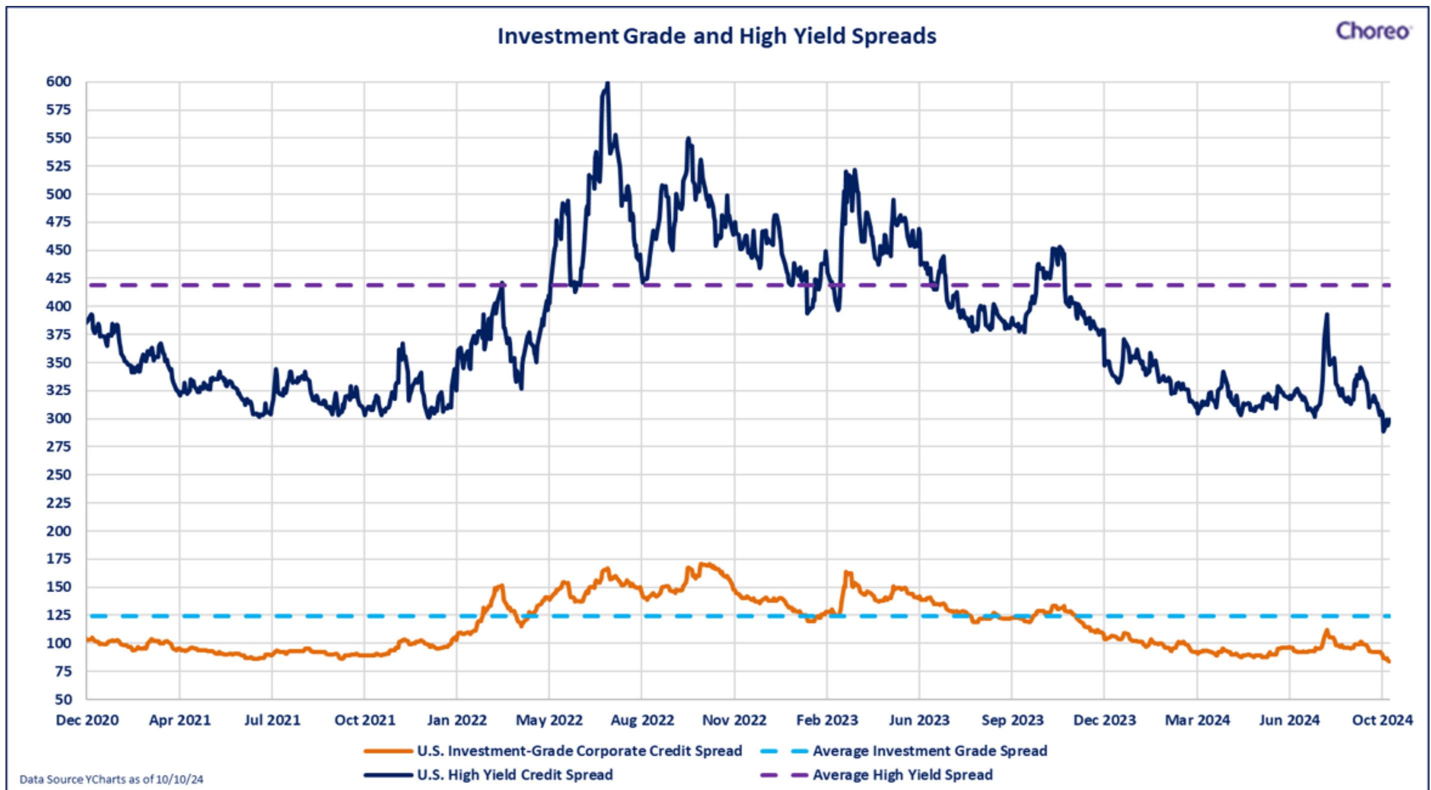
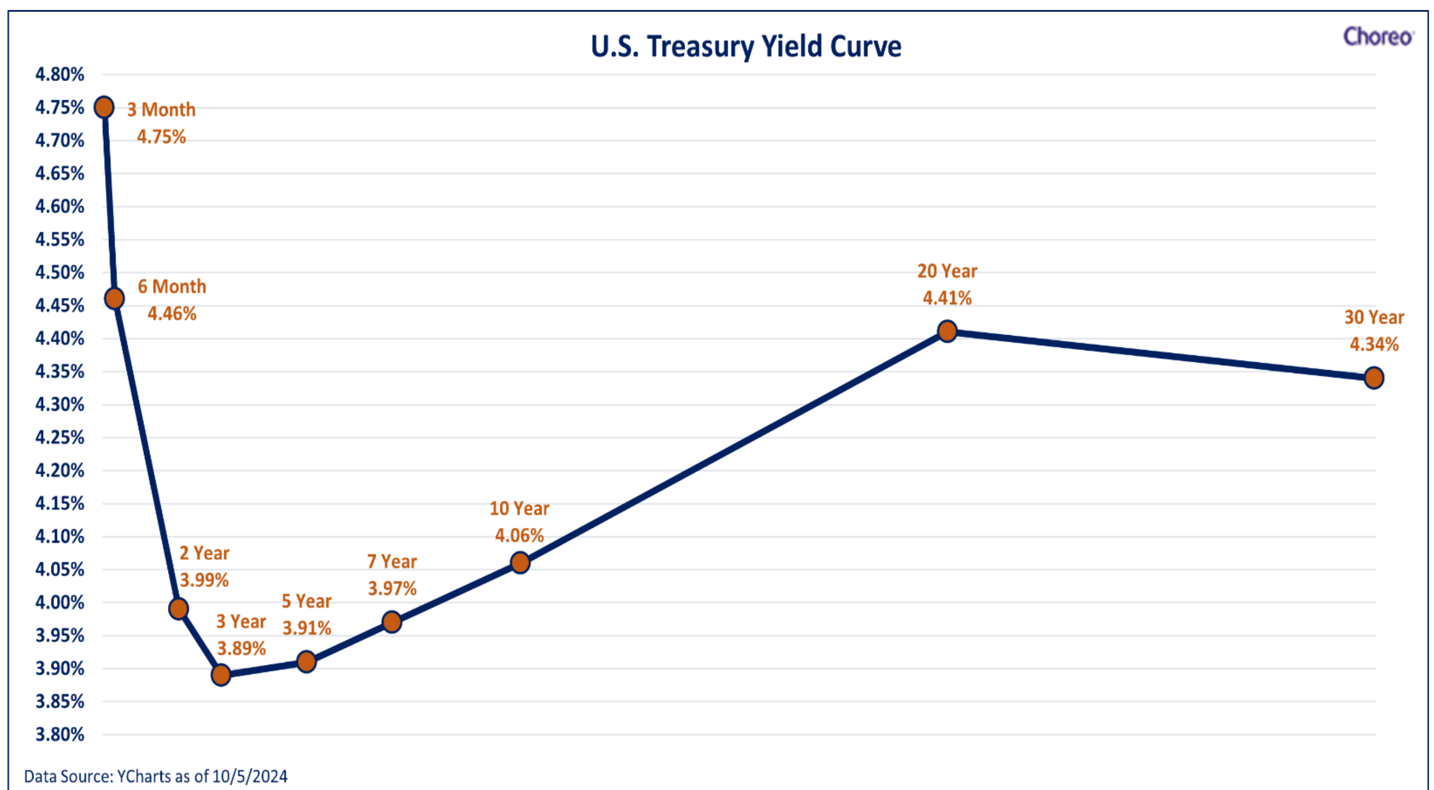
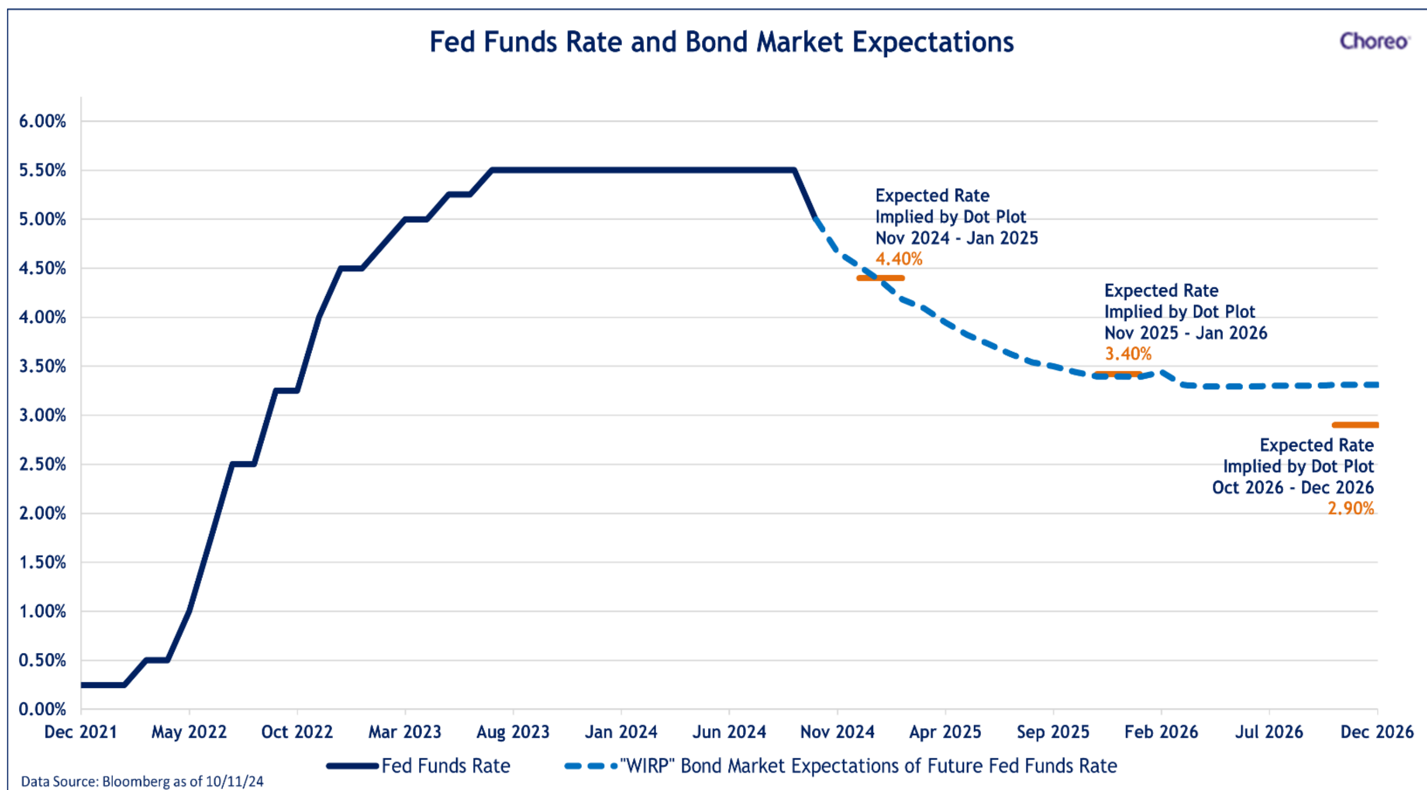


The "where are interest rates now?" question is perhaps second only to "where are interest rates headed?" First, the where are we now question is relatively simple. The graph below demonstrates a once again normal yield curve. This graph begins with very short-term interest rates, which are currently still elevated as the Fed has yet to entirely reverse more restrictive policy. However, the majority of the yield curve is sloping upwards. Often this is looked at as two year compared to 10 year bonds which are amongst the most common holding periods.



The “where are rates headed?” question looms larger over the entire economic environment, both in the U.S. and globally as similar central bank scenarios play out around the world. While market expectations have been inaccurate, the Federal Reserve members do publish their expectations for where interest rates may head. The graph below represents the so-called “Dot plots” for Fed member forecasts in the coming years as represented by the orange bars. The dotted line is market expectations for future rate cuts.



There remains a high degree of uncertainty as to where the rate cut cycle will end as it has just begun, and the economic data and outlook which drives this process is in flux. A strong economy, jobs market and inflation that persists will lead to a slower pace and depth of cuts while the opposite could lead to a deeper and quicker pace of cuts. In other words, monitoring the jobs and inflation data trends remains essential.

Conclusion

Bond market normalization, away from the volatility experienced in recent years, would be a welcome signal for investors. Bonds serve a critical role in asset allocation and portfolio management over the long run. Close monitoring of Fed activity, and the global environment will help determine if a calmer, boring environment for bond investors may finally have arrived.

As always, we welcome your feedback. Please reach out to your Choreo advisor with any questions or comments.

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