On The Mark

Should Investors Bail on Bonds?

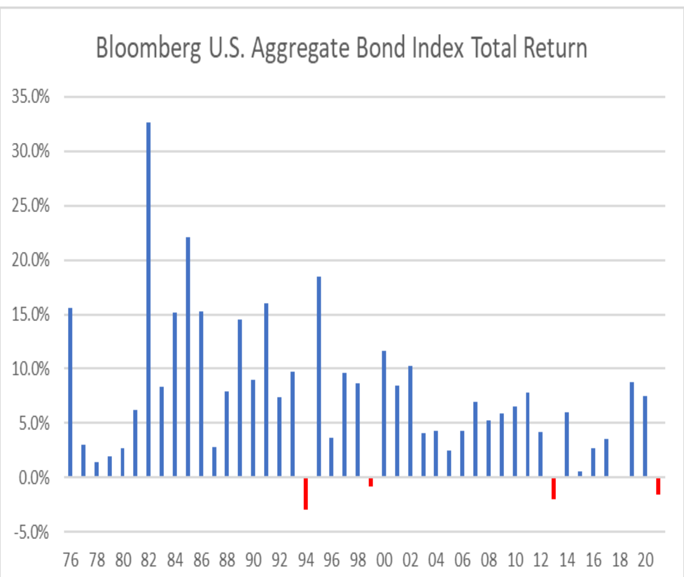
April 2022

Bonds are off to a rough start in 2022. The Bloomberg US Aggregate Bond Index, the proxy for core US bonds, has declined nearly 6% in the first three months of 2022. This loss is compounded by those from 2021, when the index returned -1.5% for the year[1].

Bond investors have been schooled in the simple principle that when interest rates go up, bond prices go down. Going forward, as the Fed (Federal Reserve) embarks on an aggressive path to tame inflation by raising interest rates, investors may be left wondering whether they should simply bail on bonds.

Are Bonds Losses Common?

To understand the implications of recent bond returns, it is important to gain historical context of the index. For fixed income, negative annual returns are rare. Since its inception in 1976, the Bloomberg US Aggregate Bond Index has only ended with negative return four times—in other words, less than 10% of the time. This was despite periods of both rising and falling interest rates.

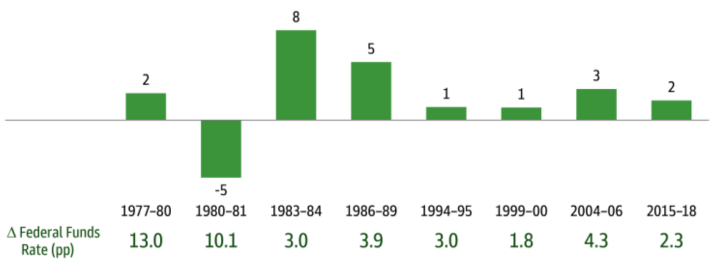


Source: FactSet

Bonds During Past Rising Rate Environments

Looking specifically at periods of rising interest rates sheds additional light. Since 1976, there have been eight sustained periods when the Fed increased interest rates, which are highlighted below[2].

Bloomberg US Aggregate Bond Index Total Return During Fed Tightening Cycle (%)



Source: Goldman Sachs Asset Management

It's important to note that no two periods of rising interest rate cycles have been the same. For example, in the 1977 cycle, the federal funds rate rose 13% from its starting level amid elevated inflation, while the 1999 cycle saw a rise of just 1.8% with modest inflationary pressures. Despite the variation, with one notable exception, the total return for core bonds during past Fed interest rate hikes has always been positive.

The notable exception to the rule above was the rising interest rate period of June 1980 through July 1981. Over just 13 months, the Fed doubled the funds rate from 10% to 20%[3]. The bond market lost 5% during that cycle, surprising bond investors who hadn't expected interest rates to move so fast. Yet, a patient investor didn't have to wait long to recover the losses.

To understand why that may be, one need only consider basic bond math. Rising interest rates can trigger a short-term drop in the value of current held bonds since investors would rather buy the new bonds with a higher interest rate. However, this near-term loss overlooks the longer-term benefits of rising interest rates. This is because over time the coupon payments and new bonds are purchased at higher yields, so the portfolio earns more income than it would under a scenario where interest rates remain unchanged. Thus, fixed income portfolios can benefit from rising interest rates over time as the portfolio is reinvested.

What's Next?

The Fed has only raised interest rates 0.25%, since 2018 but interest rates have risen dramatically across varied maturities[4]. For example, yields on the 2-year US Treasury rose from 0.17% on April 1, 2020 to 2.44% on April 1, 2021, an increase of 2.27%[5]. In other words, the market has already priced in the additional forecasted interest rate hikes. Therefore, it is not necessarily rate hikes themselves that will drive fixed income returns going forward, but how these hikes compare to what the market is already pricing in.

Looking ahead, investors will likely need to temper expectations for bond returns. Over long enough time frames, bond returns tend to mirror the starting yield. While no forward-looking assumption will be perfect, for bonds, the starting yield for the Bloomberg US Aggregate Bond Index has been shown to be a good predictor of future bond returns[6]. Today, core bonds using the Bloomberg US Aggregate Bond Index yield 2.9%, as of March 31, 2022[7], providing a reasonable estimation for future return expectations over the next decade.

Conclusion

Despite the recent loss in bond returns and modest expectations for bond returns, bonds can still play a meaningful role in investors' portfolios. Bonds continue to provide ballast against stock market volatility. While the last few months have been challenging for high-quality core fixed income, higher yields mean more income and better potential returns going forward.

Lastly, bond investors also have options beyond traditional passive fixed rate bonds. Adding floating rate bonds, inflation-protected securities, and shorter-term bonds, as well as incorporating tactical management, are just a few examples of simple changes that can be made within bond portfolios that can have a meaningful impact to blunt the short-term pain of rising interest rates.

[1] FactSet
[2] Goldman Sachs Asset Management https://www.gsam.com/content/dam/gsam/pdfs/common/en/public/articles/market-pulse/us/2022/Market-Pulse-March.pdf?sa=n&rd=n
[3] https://fred.stlouisfed.org/series/FEDFUNDS
[4] https://www.federalreserve.gov/newsevents/pressreleases/monetary20220316a.htm
[5] https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field_tdr_date_value_month=202204
[6] https://www.reuters.com/markets/europe/tip-toeing-back-bonds-already-2022-02-18/
[7] FactSet

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