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Income Is Back: So Is the Case for Bonds

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SUMMARY

- Current bond market conditions offer investors a chance to reassess the strategic role of investment grade fixed income in their portfolios.
- A broad repricing would result in higher yields and income that potentially provide more cushion against additional rate increases.
- While short-term cash provides liquidity, high-quality duration may generate positive price returns during a conventional slowdown, offsetting weaknesses elsewhere in a portfolio.

Since interest rates began rising at the beginning of 2022, investors in intermediate duration fixed income securities have earned meager returns compared to returns during the prior decade, when interest rates were falling. The five-year return through the end of July 2026 for the Bloomberg (BBG) Intermediate U.S. Government/Credit Bond Index was 98 basis points (bps). For municipal bonds, the Bloomberg Managed Money Short/Intermediate (1-10) Index five-year return was 60bps for the same period.

The low returns combined with the recent rise in Treasury yields have led many to question the value of investing in longer duration bonds. Investors can't ignore the painful experience of 2022, but annual returns since that time look much more reasonable (See Figure 1) and, while cash may have been the right place to "hide" a few years ago, it may not be the best place to compound wealth going forward.

FIGURE 1: RETURNS HAVE IMPROVED SINCE 2022

	BBG Intermediate U.S. Gov/Credit 1-Year Return	BBG Managed Money Short/Intermediate 1-Year Return
12/31/2025	6.97	5.24
12/31/2024	3.00	-0.17
12/29/2023	5.24	4.48
12/30/2022	-8.23	-5.43

Source: Bloomberg, as of August 31, 2026.

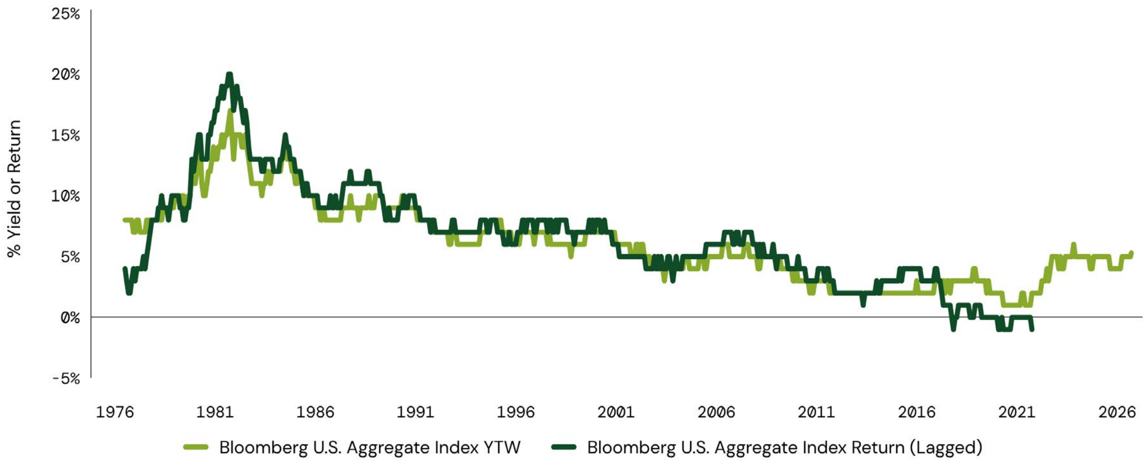
Today's yields are at multi-year highs, and in our view, the yield curve now compensates investors for extending duration. By gradually extending into high-quality intermediate bonds, investors can potentially lock in income, reduce reinvestment risk, and regain the potential for capital appreciation if growth or inflation eventually slows.

Starting Yield is Dramatically Better than it was Five Years Ago

At the beginning of 2022, the Bloomberg Intermediate US Government Credit and Bloomberg Managed Money Short/Intermediate indices yielded 1.3 percent and 0.71 percent respectively. Fast forward to August 31, 2026, and those index yields are now 4.70 percent and 3.03 percent.

For future returns, starting yield matters a lot. An intermediate bond portfolio yielding approximately 4.5 percent offers a starting yield that is considered a reasonable predictor of its multi-year return, assuming limited credit losses and that the investor holds through normal volatility. The investor is no longer dependent primarily on price appreciation to earn an acceptable return (See Figure 2).

FIGURE 2: CURRENT YIELDS & 5-YEAR SUBSEQUENT RETURNS - BLOOMBERG U.S. AGGREGATE BOND INDEX



Source: BBG U.S. Aggregate Bond Index, as of September 15, 2026.
The charts illustrate the lag time between the yields at the time of purchase and subsequent realized returns.
Past performance is not indicative of future returns.

Cash's Advantage May be Near its Peak

Money market investment returns feel safe because prices are more stable. Money market yields, however, reset continuously. If inflation moderates, growth slows, or unemployment rises, the Federal Reserve (Fed) can reduce short-term rates quickly. Investors holding cash might be forced to reinvest at lower yields, often after intermediate and longer bond prices have already appreciated.

The decision is therefore not: "Would I rather earn 4 percent in cash or accept bond volatility?"

It is: "Would I rather accept today's cash yield for an unknown period, or try to lock in roughly 4.5 percent to 5 percent for several years and gain potential upside if rates decline?"

Deficits are a Real Risk, but Much of that Risk is in the Price

Recent news coverage suggests that rising yields relate to unsustainable U.S. federal deficits. There is merit in this argument, but it is likely only a partial explanation for rising interest rates. The Federal Reserve Bank of New York's measure of the 10-year term premium shows it moving sideways over the last year, which puts it below the term premium[1] of 10-year government bonds for Germany and Japan. This suggests higher rates are as much explained by monetary policy as fiscal concerns. The bond market is simply adjusting to the reality that the Fed is considering hiking interest rates, as opposed to the three cuts expected at the beginning of the year.

In addition, today's deficits are not *new* information. The long end of the Treasury curve, with 20- and 30-year yields above 5 percent, already reflects a substantial fiscal and term premium. The relevant question now is whether yields adequately compensate for

1. The Federal Reserve Bank of New York Treasury Term Premia estimates the extra compensation investors require for holding long-term bonds instead of rolling over short-term bills.

that risk.

Lastly, the relationship between deficits and long-term bond yields is poorly correlated. Long-term yields are also highly influenced by inflation, nominal growth, Fed policy, global demand for safe assets, bank and pension demand, and the business cycle.

Notably, the Congressional Budget Office (CBO) projects federal debt will rise to 175 percent of US GDP by 2056. It also assumes the 10-year Treasury rate remains around 4.3 percent to 4.4 percent over that time frame.[2] So, the economy's foremost federal debt-prognosticator seems to suggest a fast-growing debt ratio with a largely constant long-term bond yield. It's a potential acknowledgment that monetary policy has a very strong influence over long-term yields.

Bonds are a Diversification Hedge

Cash provides liquidity but cannot offer capital appreciation when growth deteriorates or risk assets sell off. By contrast, high-quality duration can potentially generate positive price returns during a conventional slowdown, offsetting weakness elsewhere in a portfolio.

The potential diversification benefit of fixed income is especially valuable when equities are richly valued, which often corresponds with when credit spreads are tight. An investor does not need to predict the next recession or equity market reversal. The investor is purchasing an asset that pays income, while also providing exposure to downside economic scenarios that may offer potential for positive returns as interest rates fall.

The Potential Benefits of Measured Duration Extensions

For investors seeking a measured duration extension in the current environment, the intermediate portion of the curve offers increased yields while avoiding a commitment to a 20- or 30-year outlook. The intermediate segment of the curve offers:

- A meaningful current yield advantage over cash: Per Bloomberg, at September 15, 2026, yields on Treasury bills maturing in less than 1 year were below 4 percent, while Treasury bonds maturing in 2, 5, 7, and 10 years offered yields of 4.17, 4.64, 4.81, and 4.98 percent, respectively.
- Less fiscal and term-premium sensitivity than the 30-year segment of the curve.
- Duration that may allow appreciation if rates decline.
- A manageable income cushion if rates rise moderately.

2. As of February 2, 2026.