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FROM CRISIS TO CONFIDENCE: THE CHANGING LANDSCAPE IN BOND INVESTING

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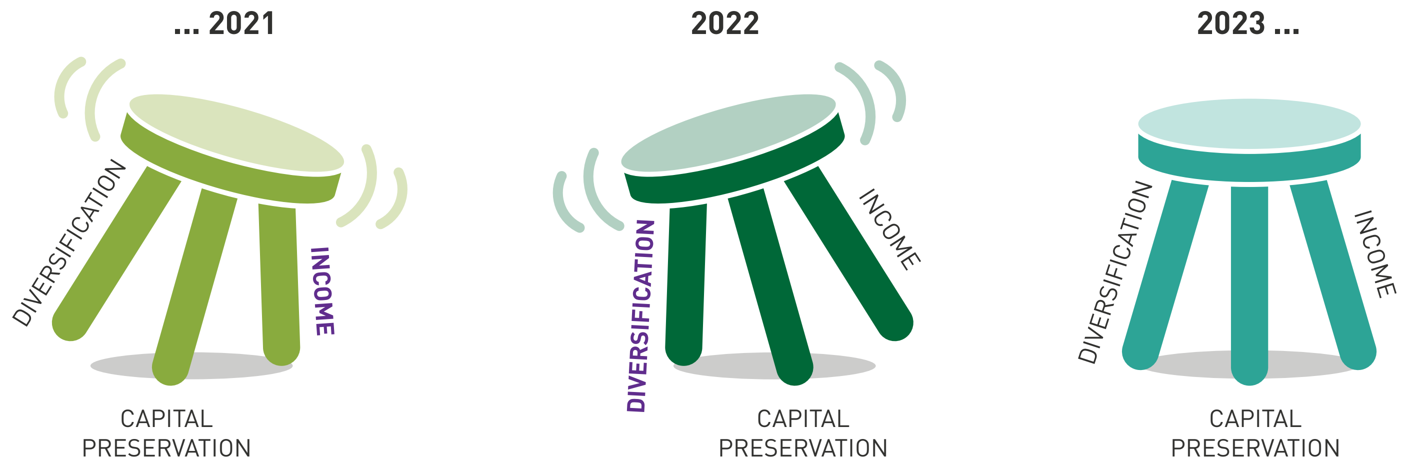
Key Takeaways

- Traditionally, investors have allocated to high-quality investment grade (IG) bonds with a goal of earning predictable income, diversifying their overall portfolio risk, and preserving capital.
- For more than a decade following the Global Financial Crisis, persistently falling and low-to-zero-bound interest rates challenged the investment case for increasing bond allocations. With current yields now approximating long-term historical averages, we view today's bond investing landscape as being more favorable than it has been in a long time.
- Inverted yield curves create temporary investor inertia and hesitance to extend duration from short-term cash equivalents, increasing the appetite to want to time the market, but getting the timing right can be difficult, and getting it wrong can be costly. With yield curves back in positive sloping territory, investors are more incentivized to consider extending duration now than they have been in recent years
- Earnings yields on equities and yields on nominal bonds have recently converged for the first time since the early 2000s DotCom[1] bubble. We believe that equity valuations in the current market environment are high relative to historical norms and expect that some investors may consider shifting to a more defensive posture by biasing their portfolios towards high quality, dividend paying stocks.
- Looking ahead, with nominal yields on bonds approximating historical averages, positively sloping yield curves, and attractive relative valuations, we believe that the case for increasing allocations to investment grade (IG) fixed income and extending duration of bond portfolios has been more compelling than it has been in a long time.

INVESTMENT CASE FOR BONDS: THE TALE OF THE THREE-LEGGED STOOL

Fixed income has played an important role in an investor's overall asset allocation strategy. The investment rationale for allocating to bonds is typically grounded in at least one of three reasons (i.e. legs of the stool): (a) to produce predictable income, (b) to diversify overall portfolio risk, and (c) to preserve capital. For 15 years leading up to 2023, the investment thesis typically supported by the three-legged stool was tested (See Figure 1).

FIGURE 1: EVOLUTION OF THE INVESTMENT CASE FOR FIXED INCOME



This figure is provided for illustrative purposes only.

> *The case for increasing allocations to high quality IG bond portfolios is more compelling than it has been in a long time.*

Bond yields experienced a multi-decade secular decline that was exacerbated by global central banks' unprecedented expansionary monetary policy response to the Global Financial Crisis (2007 through 2009) and the COVID-19 pandemic (2020 through 2021). The persistent low interest-rate environment provided the desired and necessary economic stimulus, but weakened the income leg of the stool, pushing some investors to take greater risks and stretch for yields.

The era of easy money ended in 2022, when inflation-induced Federal Reserve (Fed) tightening sharply moved rates higher, pushing bond and equity prices lower. While the income leg stood strong, the diversification benefits of fixed income that investors could typically rely on did not pan out. The great monetary policy reset marked the first time in 45 years that both stocks and bonds recorded annual losses, as measured by the S&P 500 Index and the Bloomberg (BBG) U.S. Aggregate Bond Index,[2] respectively.

Being a bond manager over that period required supporting the investment case for bonds with only two sturdy legs of the three-legged stool. Looking ahead, with real and nominal yields approximating historical averages, the case for increasing allocations to high quality IG bond portfolios is more compelling than it has been in a long time.

PSST! WE MAY HAVE FOUND THE YIELDS YOU HAVE BEEN LOOKING FOR ... IN LONGER-TERM BONDS

The future is uncertain, and capital market assumptions that drive portfolio allocation decisions need to account for that uncertainty. The level of confidence around outcomes that we can assign to any one financial instrument varies greatly across the asset class spectrum.

With that in mind, we know that high quality IG bonds rarely deliver surprises. While the value of fixed income investments is sensitive to interest rate moves, there is a big difference between unrealized losses, which many investors experienced in 2022, and permanent loss of capital. Graham and Dodd[3] referred to bond investing as a "negative art" meaning that, as long as bonds do not default, the yield at which you buy them, will be the return you get: no less ... no more.[4] In other words, historically there has been a strong relationship between yields and subsequent returns on high quality IG bonds (See Figure 2).

FIGURE 2: BOND YIELDS & SUBSEQUENT RETURNS

CURRENT YIELDS & 2-YEAR SUBSEQUENT RETURNS
BLOOMBERG U.S. GOVERNMENT 1-3 YEAR INDEX

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

Source: BBG U.S. Government 1-3 Year Index and BBG U.S. Aggregate Bond Index, as of September 30, 2024.
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.

For a decade and a half, yields on IG bonds hovered around very low single digits, resulting in low forward-looking return expectations. For many private clients and institutions, there may have been a tendency to over-index allocation decisions based on expectations derived from historical averages.

For example, during this easy money era, traditional 60/40 stock/bond investors looking for 6 to 7 percent returns had to think outside the box. With bonds at times yielding 2 percent on 40 percent of the portfolio, one would need to earn returns in excess of 10 percent on the remaining 60 percent to achieve the stated objective. As a result, to get bond-like returns, many investors had to stretch for yield, by reducing allocations to IG fixed income, while increasing exposure to new and different types of risk.

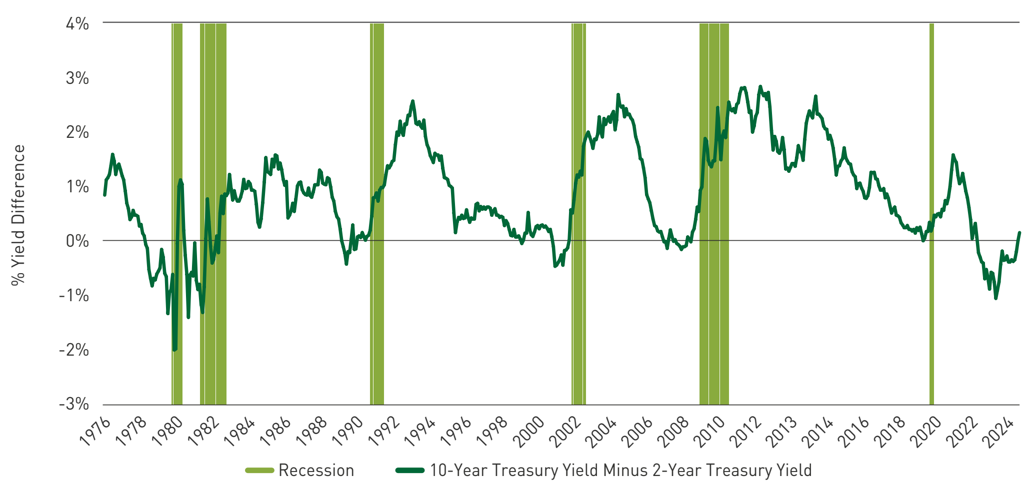
In many instances, investors increased exposures to private credit and other alternatives to approximate bonds' historical yield in a diversified portfolio. Moving forward, investors may once again achieve their goals with income, diversification, and capital preservation by returning to corporate, municipal, and government bond markets that are offering higher yields. The bottom line: we believe that with current yields approximating long-term historical averages, investors can more confidently rely on IG bonds to get bond-like returns.

TO EXTEND OR NOT TO EXTEND, THAT IS THE QUESTION.

Every trade consists of a buy and a sell decision, and the need to make those decisions quickly and concurrently was a necessity during the era of easy money. Simply stated, sitting in cash for too long when rates on cash-like instruments were close to zero likely resulted in a drag on investment performance.

But that all changed in July of 2022, when the U.S. Treasury yield curve inverted, pushing short-term bond yields higher than long-term yields. By July 2023, the disparity reached its widest margin since 1981[5] and by March 21, 2024, the inversion became the longest on record.[6] Figure 3 illustrates periods of time when 10-year Treasury yields exceeded 2-year Treasury yields (above the 0 on the y-axis) and when 2-year yields exceeded 10-year yields (below the 0 on the y-axis).

FIGURE 3: 2-YEAR & 10-YEAR TREASURY YIELD DIFFERENTIAL



Source: U.S. Treasury data, as of September 30, 2024. Past performance is not indicative of future returns.

Inverted yield curves create temporary investor inertia and hesitance to extend duration, increasing the appetite to want to time the market, but getting the timing right can be difficult, and getting it wrong can be costly. Given that "investment committee decision-making speed" is not as fast as market speed, the risk of missing out and managing regret is real.

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Mark Twain famously stated that "history never repeats itself, but it often rhymes." While not all recessions were preceded by curve inversions, there are some interesting lessons investors can glean from past business cycle transitions that could potentially inform current duration extension decisions.

As 2024 comes to a close, the Fed has shifted its stance from fighting inflation to sustaining employment with the market anticipating multiple additional rate cuts over the next 12 to 18 months. With the Treasury yield curve back in positive sloping territory, investors are once again compelled to extend duration to capture higher income potential. Thus, we feel the question on duration extension is less about *if* and more about *when*, meaning that moving out of cash and extending duration may be the next big step many investors take if they already haven't done so.

IF CURRENT BOND YIELDS & POSITIVELY SLOPING YIELD CURVES DON'T TIP THE SCALE, SHRINKING EQUITY RISK PREMIA MAY

For over a decade, the Fed provided ample and cheap liquidity, which often rewarded companies for leveraging balance sheets and taking more risks. With the era of easy money likely over and the Fed's 30-month tightening cycle ending earlier this year, a more favorable rate environment is improving investor sentiment towards IG fixed income.

One of the key reasons behind the positive sentiment shift is related to how attractive bond yields are relative to where they have been over the last few decades. The other is that earnings' yields on equities and yields on nominal bonds have recently converged for the first time since the DotCom bubble from the early 2000s (See Figure 4). We believe that equity valuations in the current market environment are high relative to historical norms and expect that some investors may consider shifting to a more defensive posture by biasing their portfolios towards high quality, dividend paying stocks.

FIGURE 4: HISTORICAL COMPARISON OF YIELDS ON STOCKS & BONDS

Source: BBG U.S. Aggregate Bond Index and S&P 500 Index, as of September 30, 2024.
Past performance is not indicative of future returns.

CONCLUSION

The traditional role of high-quality IG bond portfolios includes predictably earning income, diversifying investment risk, and preserving capital. With current yields now approximating long-term historical averages, and yield curves back in positive territory, we believe investors can more confidently rely on longer maturity IG bonds to get bond-like returns.[7] Further bolstered by favorable relative valuations, we believe that the case for increasing allocations to IG fixed income and extending duration of bond portfolios is more compelling than it has been in a long time.

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FOOTNOTES:

1. The DotCom bubble was a rapid rise in U.S. technology stock equity valuations fueled by investments in Internet-based companies during the bull market in the late 1990s. The value of equity markets grew exponentially during this period. The technology-dominated Nasdaq Index increased from under 1,000 to more than 5,000 between the years 1995 and 2000. Things started to change in 2000, and the bubble burst between 2001 and 2002 with equities entering a bear market.
2. The S&P 500 and the Bloomberg U.S. Aggregate Bond Indices are used as performance measures for the overall equity and bond markets, respectively. Investors cannot invest directly in an index.
3. *Security Analysis*, Benjamin Graham and David Dodd, McGraw-Hill, 1934.
4. There are risks to bond investing. These include interest rate, credit, prepayment and extension risks. All investments involve risks, including the loss of principal.
5. *https://www.cnbc.com/2023/07/07/yield-curve-inverted-the-lowest-since-1981-what-it-means-for-yo.html*.
6. "*U.S. Treasury key yield curve inversion becomes the longest on record*," Reuters, March 21, 2024.
7. All investments, including fixed income, involves risks. Loss of principal is a possibility.