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Bond Carnage, but What Next?

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With regard to negative returns, they say a bad year in bonds is about as scary as a bad day in stocks. The -4% for the Bloomberg Aggregate bond index over the first six weeks of this year is certainly challenging that notion.

The damage is widespread across the bond spectrum, as you can see from the table of returns. Usually stocks and bonds diversify each other, but that is not the case presently. According to SentimenTrader this is only the seventh time since 1946 that both stocks and bonds declined more than 5% at the same time from a 52-week high. We all know the culprit - interest rates have risen, as inflation has started to persist and expectations for Fed tightening have shifted significantly.

Index	YTD Total Return
S&P U.S. Treasury Bond Current 2-Year	-1.57
S&P U.S. Treasury Bond Current 5-Year	-3.17
S&P U.S. Treasury Bond Current 10-Year Index	-4.57
S&P U.S. Treasury Bond Current 30-Year	-9.82
ICE <u>BofA</u> US High Yield	-4.51
ICE <u>BofA</u> US Corporate	-5.71
Bloomberg Municipal Intermediate (5-10 Y)	-2.51
Bloomberg Municipal Long (22+ Y)	-3.65
S&P U.S. TIPS	-3.92

Table 1: YTD Total Return (01/01/2022 - 02/10/2022)

(Source: FactSet)

Higher interest rates may help separate the wheat from the chaff. Companies with strong cash flow will continue to have easy access to capital and likely continue to attract investors. Long shot deals are far less likely to be funded with higher borrowing costs, and companies and projects that do not have a path to self-sustainability in the near run may face extinction. Perhaps it is a time when active investment management can really shine and outpace benchmarks.

Another recent blog post “[What is the bond market telling us right now](#)” discusses what the bond market is currently signaling. So far, persistent problematic inflation is not in the cards. A 2% 10-year Treasury yield and 3% inflation breakeven rates show that the market is not pricing in runaway inflation lasting much beyond this year at this time. Now that could certainly change, and the market adjustment would be quite uncomfortable, especially for bonds. However, the other scenario could occur as well.

Since markets move in anticipation of economic developments, even though rising inflation is the current headline, there is a fairly good chance that much of the damage to the bond market has already occurred. Expectations are for seven 25 basis point rate hikes bringing money markets to a 1.75% yield by year end, but the 2-year Treasury’s rise from 0.73% at the start of the year to about 1.60% now is anticipating much of that. If evidence arises diminishing the odds of that happening, then the shorter maturity bonds that have had a very difficult time so far this year would rally. What could cause this? Inflation could subside, allowing for slower Fed action and a soft landing. On the other side of the coin, if stocks were to crash, then the Fed might react, and bonds could rally. If the economy were to cool, bonds could rally. Really if there is anything that would entice investors to safe havens, then bonds could rally. In short, bonds could do their job and diversify stocks from these corrected levels, because they now offer a higher level of income than the start of the year, and now price a more aggressive path for Federal Reserve policy.

Important Disclosure Information:

Sources include eSignal.com, Bureau of Economic Analysis, Bureau of Labor Statistics and FactSet. Not a substitute for tax or legal advice.

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