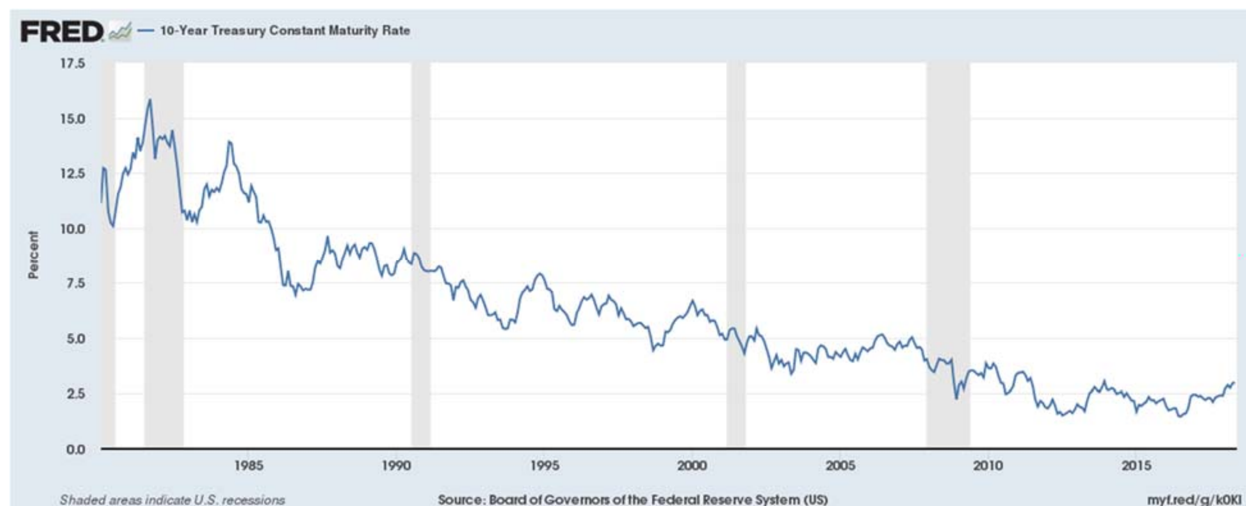
Can bonds still save the day?

Global Financial Private Capital

Our traditional understanding is that bond prices go up when stock prices go down. This has not been the case in 2018, however, as stocks sold off in the first quarter and bonds have also posted negative returns. The reversal of an established trend has led some to question whether bonds remain a good investment and, more importantly, whether they can still act as a hedge to stocks. The short answer is yes, but investors need to be nimble with bonds going forward and broaden their opportunity set.

A look back in history

For much of the past 30 years, investors have enjoyed a bond bull market. The yield on the 10-year U.S. Treasury bond rose to over 15% in 1980, which means investors could have earned 15% a year just by clipping U.S. Treasury coupons back in the '80s. That same 10-year Treasury yield is now around 3%. Bond prices have an inverse relationship with yields: As yields drop, their prices rise. In this case, the drop in the 10-year yield from 15% in 1980 to 3% today caused the price of the generic 10-year bond to more than double over that time.



How did bonds perform during other rising rate environments?

Looking back through history, the overall trend in interest rates has been declining. However, there have been several periods during which the Fed raised the fed funds target rate more than once. Recently, the Fed first raised rates in December 2015, and Treasury yields have been rising since the Brexit referendum in July 2016. History shows us that when the Fed has taken a slow and steady approach to raising rates, as was the case from 2004-2006, bonds fared well. However, when the Fed has raised rates at a more rapid pace, such as from 1999-2000 and 1994-1995, bond returns were weaker. Notably, the Fed often raises rates to combat inflation. As such, even during periods when interest rates rose quickly, Treasury Inflation-Protected Securities (TIPS) performed well.

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Rising Rate Cycle	Months	Fed Funds Rate	Bloomberg Barclays Aggregate Bond Index	Bloomberg Barclays Investment Grade Corporate Bonds	Bloomberg Barclays High Yield	Bloomberg Barclays US TIPS Index
12/2015-5/2018*	29	0.0 - ?	1.92	3.97	9.9	2.99
6/2004 -8/2006	27	1.0 - 5.25	4.06	4.18	8.44	5.01
6/1999 - 6/2000	13	4.7 - 6.5	4.55	3	-1.02	7.29
1/1/1994 - 4/1995	16	3.0-6.0	2.56	2.61	5.64	N.A.

Source: Bloomberg as of 5/31/18. Fred Economic Data.

Understanding what protection really means going forward

As interest rates rise, bonds may be less effective as portfolio shock absorbers. It's also worth taking a step back and asking what protection really means. It is never fun to lose money. Nonetheless, when the stock market fell 10% during the first quarter of this year, bonds declined only 2%. It's tempting to focus on direction and say they both fell together, but nonetheless, bonds fell materially less than stocks did. This smaller loss is perhaps not what everyone would like in terms of protection, but it is still a far better outcome than holding stocks alone. John Lynch, Chief Investment Strategist at LPL, noted: "Since 1980, the average annual peak-to-trough decline in the S&P 500 has been 14%, and pullbacks generally arrive without warning. Investors need to be prepared for such events and high-quality bonds may help provide protection for diversified long-term portfolios." The table below highlights the pattern of this relationship through several pullbacks over the last decade.

BONDS HAVE HISTORICALLY OUTPERFORMED STOCKS DURING STOCK MARKET PULLBACKS

Pullback Start	Pullback End	S&P 500 Index Change	Bloomberg Barclays Aggregate Bond Index Change	Difference	60/40 Portfolio* Return	Difference from All-Equity Portfolio
01/26/18	02/08/18	-10.2%	-1.0%	9.2%	-6.5%	3.7%
11/03/15	02/11/16	-13.3%	1.9%	15.2%	-7.2%	6.1%
05/21/15	08/25/15	-12.4%	0.0%	12.4%	-7.4%	5.0%
07/07/11	08/08/11	-17.3%	2.7%	20.0%	-9.3%	8.0%
05/012/10	06/07/10	-10.3%	1.2%	11.5%	-5.7%	4.6%
02/09/09	03/09/09	-22.2%	-0.1%	22.1%	-13.4%	8.8%
01/06/09	01/20/09	-13.9%	0.4%	14.3%	-8.2%	5.7%
11/13/08	11/20/08	-17.4%	0.4%	17.8%	-10.3%	7.1%
11/04/08	11/12/08	-15.3%	0.8%	16.1%	-8.8%	6.5%
10/20/08	10/27/08	-13.9%	-0.1%	13.8%	-8.4%	5.5%
09/19/08	09/29/08	-11.9%	0.2%	12.1%	-7.0%	4.9%
08/11/08	09/17/08	-11.4%	2.0%	13.4%	-6.0%	5.4%
05/19/08	07/15/08	-14.8%	-0.4%	14.4%	-9.1%	5.7%
Average		-14.2%	0.6%	14.8%	-8.3%	5.9%

Source: LPL Research, Bloomberg 02/12/18
*The 60/40 portfolio represents a 60% weighting to the S&P 500 and 40% weighting to the Bloomberg Barclays Aggregate Bond Index.

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Bottom Line

Navigating the complexities of the bond market can be tricky, particularly in a rising rate environment. With yields at historic lows, and the U.S. potentially entering a new regime of rising rates, it's probable that bond returns will be less attractive, especially since the current yield is a good indication of bond returns. However, that doesn't mean bonds' role as shock absorbers has ended. For most investors, the decision is not whether to go all in with bonds or fold completely. Rather, it's a matter of selecting what types of bonds – as well as considering their maturity and credit quality – to include in a well-diversified portfolio. Investors can also select certain alternative investments that are less interest-rate dependent for additional sources of returns. Remember, bonds are in your portfolio to help provide diversification and potential income, and can also still offer some level of protection against stock market volatility.*

*Diversification does not ensure a profit or guarantee against loss.

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