Quarterly Perspectives

Fear and Loathing in the Bond Market

The Federal Reserve's path to higher interest rates is well underway and, if the Fed's so-called "dot plot" and the market consensus is believed, it could be at a faster clip than in previous years. After slashing the Fed Funds rate to near zero by the end of 2008 from 4.75% the previous year, the Fed reversed course slowly, starting with one 0.25% increase at the end of 2015. By 2018's first quarter, the Fed increased rates five more times, with a forecast of two to three more increases this year.

Investing in bonds during a period of rising rates can be a challenge and this particular environment poses its own risks. First and foremost, math is working against investors—as interest rates rise, bond prices fall. This is true for all bonds, though sensitivity to interest rates varies based on a number of factors with the two most impactful being the length of time to maturity (a longer time to maturity means a greater sensitivity) and riskiness of the bond (typically, higher risk bonds pay higher coupons and those coupons guard against some price depreciation).

After a prolonged period of near-zero interest rates, income-seeking investors flocked to higher-paying yet riskier bonds causing spreads to narrow considerably. (A "spread" is simply the difference between the yield of a non-Treasury bond and that of a Treasury bond of similar maturity. Typically, that spread is positive, meaning investors are paid more to take that additional risk). During times of market stress, bond spreads can widen dramatically as they did during the 2008 financial crisis.

Since that time, spreads have narrowed significantly. The average spread of the ICE BofA Merrill Lynch High Yield Master index, which represents the entire below-investment grade U.S. bond market, closed the quarter at 3.7%. The spread of the ICE BofAML US Corporate Master index, which represents the entire investment grade U.S. bond market, closed the quarter at 1.2%, which means an investor earned 1.2% more by lending to a riskier corporation versus lending to the "risk-free" U.S. government. Those spreads are significantly narrower than historical averages which, according to data from the St. Louis Federal Reserve going back to Dec. 1996, are 5.7% and 1.6%, respectively.

Another important consideration is that the duration of the average corporate bond has increased significantly as interest rates have fallen. Much of this is due to corporations locking in low interest rates for as long as possible. The duration of the US Corporate index was around 7.5 years at the quarter's end, longer than it's ever been and longer than the Bloomberg Barclay's U.S. Aggregate Bond index's six year duration. The Aggregate Bond index represents the entire investment-grade U.S. bond market, including corporate and government bonds as well as securitized assets.

Tight spreads and extended durations are a precarious combination during a period of rising rates.

Bear Market Blues

After an eerily calm 2017, the first quarter of 2018 wasn't ideal for bonds and the funds that hold them. Interest rates rose across the yield curve and credit spreads ended the quarter wider, causing losses on two fronts. Nearly every major bond index posted negative total returns except those tracking floating rate loans, also called bank loans. Interestingly, high grade corporate bonds fared worse than both the Aggregate Bond index and the High Yield index during the quarter with losses of 2.3%, 1.5%, and 0.90%, respectively.

Does 2018 mark the beginning of the long-anticipated bear market in bonds? It's impossible to know. Last year, the Fed raised interest rates three times and all the major bond market indexes posted positive returns. For example, the High Yield index gained 7.5% and, with an average yield for the index of 5.7%, nearly 2 percentage points of that return came from spread tightening, impressive, considering that spreads were already much tighter than average at the start of 2017.

Source: Morningstar

Is This Time Different?

For many investors bonds play a major role in portfolios due to typically low or negative correlation to equities during times of market stress. When the equity market plunges, Treasury bonds have historically provided positive returns (or certainly less negative returns) which helps mitigate overall portfolio losses. This was the case during the tech bubble, the financial crisis, and the commodity selloff in 2015 and 2016. Corporate bonds, especially non-investment grade, did worse than Treasuries during those periods as fears of increased defaults caused spreads to widen.

But, during the sharp correction in February, Treasury bonds did not hold up their end of the bargain. Long-dated Treasury bonds lost nearly 4% over the two-week sell off while the Aggregate Bond index lost over 1%. This was certainly less than the swift drop off in the equity market (many major indexes were down more than 10%), but hardly the portfolio stabilizer investors expect. What should investors, who may need or want to hold bonds, do? Whether through funds (mutual funds or ETFs) or individual bonds, there are a few options.

One option is to increase cash. Cash rates aren't high, but are better than they've been in a long time (and rising) as short-term interest rates have moved significantly higher in the last 12–18 months. The main selling point of cash is the guaranteed downside protection. And, if the market does sell off, liquid cash can be put to work buying investments at discounted prices.

Another option is to shorten the maturity of holdings. Floating rate bonds, also called bank loans or leveraged loans, have done well as rates have risen. These loans re-set their coupons as interest rates increase so they tend to do better when rates rise due to little to no price depreciation and increasing payouts over time. These loans, however, are made to companies of lower credit quality so default risk is higher than compared to an investment-grade corporate bond.

Investors can also look to short-term corporate or Treasury bonds. Though perhaps counterintuitive in a period of rising rates, the Treasury bond may in fact be a reasonable option. At the end of the quarter, a two-year Treasury bond yielded 2.3% and, at 2.6%, the average two-year investment grade corporate bond's yield was only a little higher. The Treasury bond has no risk of default. Shorter duration strategies are also common in many mutual funds and ETFs. Investors must be mindful of the duration of the individual holdings, not just headline duration, as well as the credit quality of the underlying holdings. Keep in mind that low fees are especially important in these lower-yielding shorter duration strategies.

Market Metrics

Returns for major stock and bond indexes during the quarter and over the trailing one-, three- and five-year periods are below.

Equities	Total Return Q1 2018 (%)	Total Return 1-Yr (%)	Total Return 3-Yr (Annlzd) (%)	Total Return 5-Yr (Annlzd) (%)
S&P 500	-0.76	13.99	10.78	13.31
Russell 2000	-0.08	11.79	8.39	11.47
MSCI EAFE	-1.53	14.80	5.55	6.50
MSCI Emerging Markets	1.42	24.93	8.81	4.99

Fixed Income	Total Return Q1 2018 (%)	Total Return 1-Yr (%)	Total Return 3-Yr (Annlzd) (%)	Total Return 5-Yr (Annlzd) (%)
Bloomberg Barclay's US Aggregate Bond	-1.46	1.20	1.20	1.82
Bloomberg Barclay's US Corporate High Yield	-0.86	3.78	5.17	4.99

Source: Morningstar
The Standard & Poor's 500 Index, often abbreviated as S&P 500, is an American stock exchange market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The S&P 500 index components and their weightings are determined by S&P Dow Jones Indices.
The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. and Canada.
The MSCI Emerging Markets Index is an index designed to measure equity market performance in global emerging markets.
The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.
The Bloomberg Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.
The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

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