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2024 Outlook Theme #2: It is Worth Holding Bonds for the Duration

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Q1'24 developments treated the Equity and Fixed Income markets differently. While the Bloomberg Aggregate Bond Index ("Agg") reached a record rolling three month return in January of 8%, the subsequent rise in interest rates pushed that to -1% by the end of Q1'24. Meanwhile, the S&P 500's Q1'24 return of 11% remains in the upper range of rolling 3 month returns, though not an exceptional outlier like the Agg's recent peak. With Q1'24's economic developments focused on better than expected growth, Equities were able to outperform Fixed Income

Even though Q1'24 experienced flat returns due to rising interest rates, offsetting that price risk of duration is the appeal of better yields.

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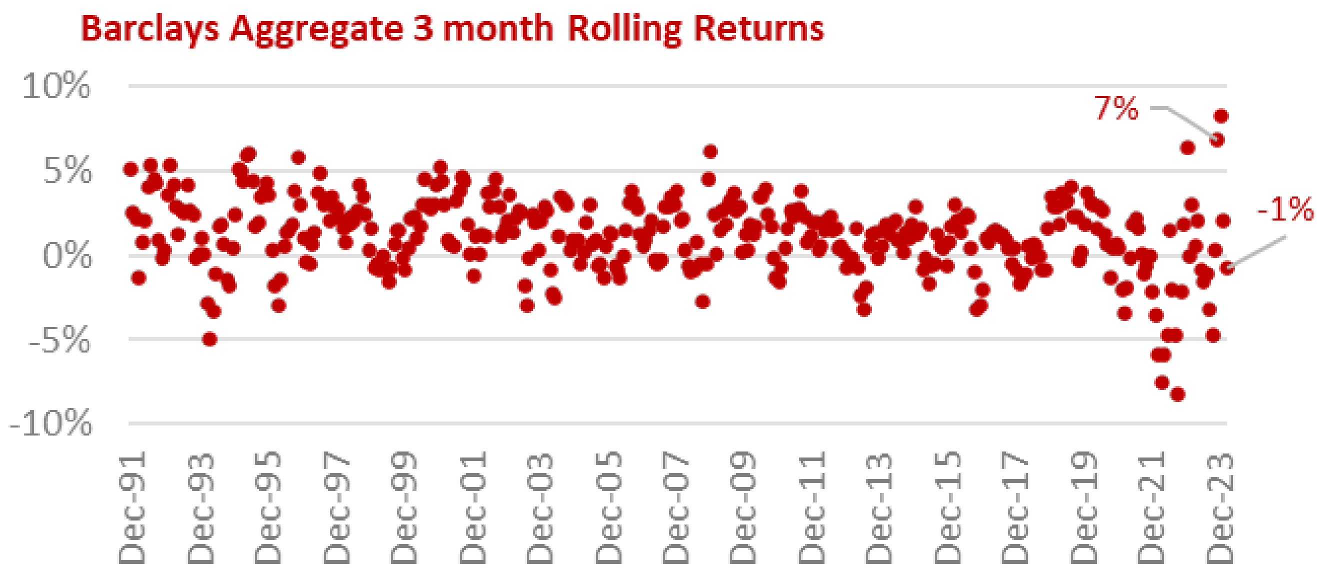

Chart 1

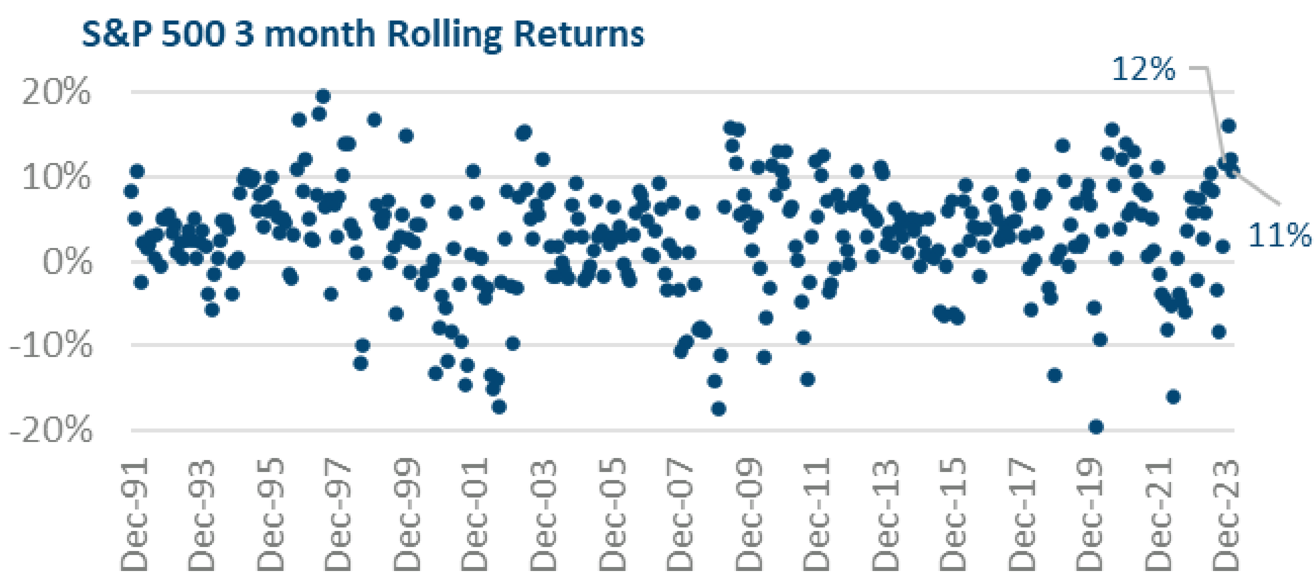

Chart 2

The link between interest rate changes and bond prices is called duration. Duration measures the sensitivity of a bond's price to changes in interest rates, with the value representing the percent change in a bond's price for a 1% change in rates. For example, a bond with a duration of five would lose 5% if interest rates rose 1%.

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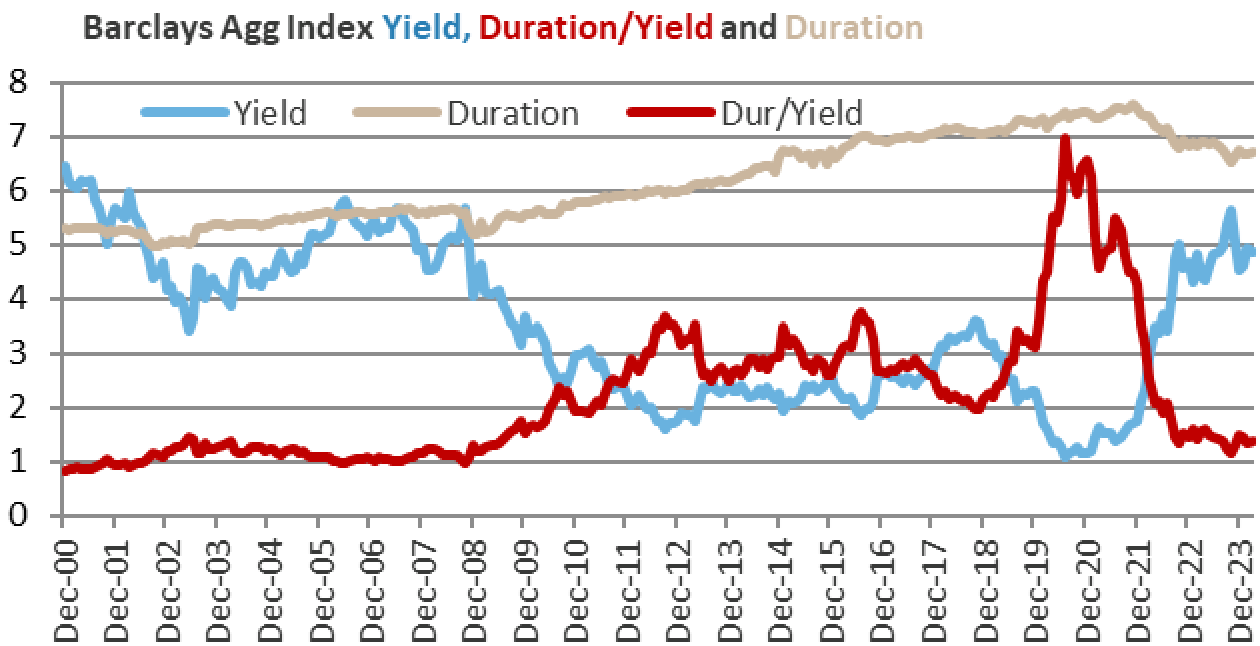

Chart 3

Chart 3 shows the yield, duration and ratio of duration to yield of the Agg back to 2000. Duration to yield is a good metric for Fixed Income risk/reward, because it shows the number of years it would take to earn back the loss in value from a 1% increase in rates.

In previous Outlook Themes, we have noted how the record duration/yield ratio of 7 at the end of 2019 preceded several years of poor fixed income performance.

Today, at the end of Q1'24 and with the Agg yield of 4.8%, the 1.4 duration/yield ratio suggests bonds are reasonably priced, and at least have the potential to offer some portfolio diversification, lower volatility, income, and protection in weakening economic conditions. That said, there is no free lunch, and bonds can tread water when economic conditions are seen to be improving.

As we noted on 12/31/24: *Strong economic growth or stubborn inflation could push rates higher with, for example, the 10yr Treasury heading back towards 5% from 3.88%. A similar 1% move in the Agg's yield would, based on its duration of 6.5, suggest there is price downside risk of about 6%. But the 4.5% yield would allow income to balance that and minimize losses to about breakeven (over a year, to collect that yield) in such a scenario. Should economic growth come up short, rates would decline, and investors would receive some price appreciation to go along with the yield.*

Entering 2024, we noted it would be challenging for both Equites and Fixed Income to continue to post strong returns. Q1'24 illustrated that with a good economy, Equities could still do well, but Fixed Income could be challenged. Yet a more normal interest rate environment still presents the opportunity for portfolio diversification to work, as higher income can balance out short term price volatility, and this is why *It is Worth Holding Bonds for the Duration*.

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-The Standard & Poor's 500 is a market capitalization weighted index of 500 widely held domestic stocks often used as a proxy for the U.S. stock market. The Standard & Poor's 400 is a market capitalization weighted index of 400 mid cap domestic stocks. The Standard & Poor's 600 is a market capitalization weighted index of 600 small cap domestic stocks.

-The NASDAQ Composite Index measures the performance of all issues listed in the NASDAQ stock market, except for rights, warrants, units, and convertible debentures.

-The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 21 emerging markets. The MSCI All Country World Index is a free float adjusted market capitalization index designed to measure the performance of large and mid and cap stocks in 23 developed markets and 24 emerging markets. With over 2,800 constituents it represents over 85% of the global equity market.

-The Barlcays Aggregate Index represents the total return performance (price change and income) of the US bond market, including Government, Agency, Mortgage and Corporate debt.

-The BofA Merrill Lynch Investment Grade and High Yield Indices are compiled by Bank of America / Merrill Lynch from the TRACE bond pricing service and intended to represent the total return performance (price change and income) of investment grade and high yield bonds.

-The S&P/LSTA U.S. Leveraged Loan 100 is designed to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads and interest payments.

-The S&P Municipal Bond Index is a broad, comprehensive, market value-weighted index. The S&P Municipal Bond Index constituents undergo a monthly review and rebalancing, in order to ensure that the Index remains current, while avoiding excessive turnover. The Index is rules based, although the Index Committee reserves the right to exercise discretion, when necessary.

-The BofA Merrill Lynch US Emerging Markets External Sovereign Index tracks the performance of US dollar emerging markets sovereign debt publicly issued in the US and eurobond markets.

-The HFRI Fund of Funds index is compiled by the Hedge Funds Research Institute and is intended to represent the total return performance of the entire hedge fund universe.

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