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Not All Bonds Are Created Equal

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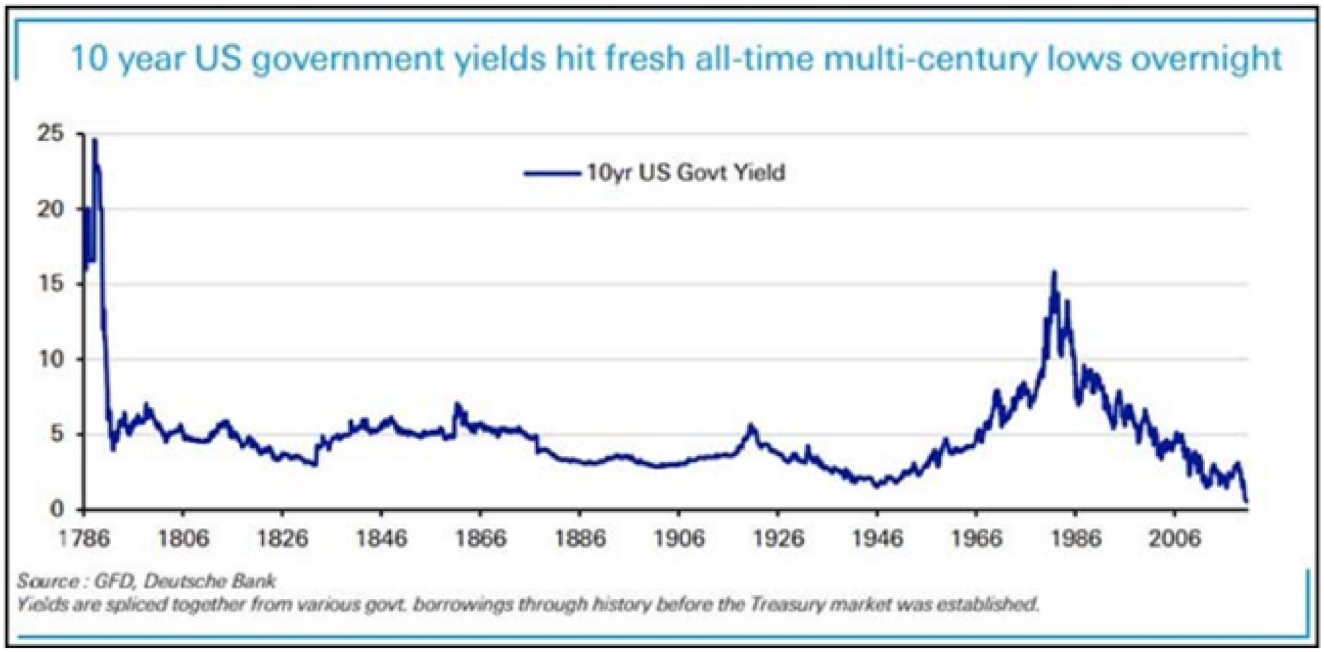
The bond market is incredibly vast and many times the size of the stock market. Treasury bonds are considered riskless and have historically buffered stock portfolios nicely during market declines when investors seek a safe haven – Treasury bonds generally go up in value when markets decline.

The biggest factor for Treasury pricing is interest rates, and as interest rates decline, existing bonds with higher fixed interest payments become more valuable (go up in price) and vice versa. Credit markets can behave very differently since these bonds carry credit risk, and unlike the U.S. Treasury they could default. Like Treasuries, corporate bonds are influenced by interest rates, but they are also influenced by the state of the economy. In a healthy economy the likelihood of default is low, and in a recession the likelihood of a default is higher, and for these reasons they tend to correlate more with stocks than Treasuries, especially as you move down the quality spectrum to more risky borrowers. Risky borrowers pay much higher interest rates than Treasuries, but during times of market stress, High Yield corporate bonds usually decline in price along with stocks, reducing their usefulness as a diversifier or hedge to the portfolio. A recent example, during the first quarter of this year in the peak of the pandemic market mayhem, 10 year Treasuries advanced 10%, while the ML High Yield index declined -13%.



However, Treasuries now have the lowest yields in history by a large margin. Consider the chart below from Deutsche Bank, and you can see we are well below yields experienced during other difficult times when, as is the case these days, the Central Bank kept borrowing costs artificially low, like after the Civil War and even post WW2. As of this writing, the 10 year Treasury yields 0.51%, which is unfathomably low. All things equal this is a fantastic time to be a borrower (time to refinance the mortgage if you have not already), but probably the worst time in history to be a lender. Investors cannot come close to covering the rate of inflation (negative real yields), and can earn four times as much in dividends from an S&P 500 or Dow Jones Industrial Average index fund. Money markets are yielding a number that rounds to zero, and this situation is likely to be the case for the foreseeable future. *The Wall Street Journal* reported that Fed policy is likely to abandon the practice of pre-emptively raising interest rates to curb inflation, instead opting to allow periods of inflation exceeding the target 2% level. Other than cushioning the portfolio during market shocks, we see little logic in adding Treasury bonds to portfolios.

The major bond indices have performed incredibly well this year, benefiting from the flight to quality and historically low rates. The Bloomberg Barclays Aggregate (74% of which is AAA rated and mostly government debt) has advanced almost 8% for the year, while the Bloomberg High Yield Index is still negative. But one must ask “where do we go from here?” Recently, investment managers looking to generate income have found it impossible to keep pace with the Aggregate Bond index. However, unless rates go negative, a highly unlikely but possible event, then little return can be expected from here. On the other side of the spectrum, high yield bond funds are generating yields over 5.5% but carry risk and higher volatility. It seems that the Aggregate Bond index may have already enjoyed its best days relative to other areas of the bond market that still offer some opportunity.

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