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What's Next for Bonds?

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After the worst bond market in history, what can we expect going forward? Looking at the Bloomberg Aggregate Bond Index at the end of the second quarter, the total return for bonds over the past five years rounds to zero. Five years of no return where historic price declines offset five years of yield. This has been a terrible experience for bond investors, but these moves are in the rearview mirror. Bonds should help portfolios from here, whether it is soft landing or recession for the economy, and should cushion future periods of stock market turbulence.

The Fed has started the next easing cycle, cutting rates by half a percent in September. The Bloomberg Aggregate Bond Index advanced 5% in the third quarter, anticipating the well telegraphed change in Fed policy. Very interestingly, the yield curve normalized – the yield on the 2 Year Treasury is now back below the yield on the 10 Year Treasury. Investors in money markets and CDs may need to find a new place to park assets (we have some great ideas, just ask our Wealth Managers).

As we have been saying for well over a year, our base case going forward is a soft landing, with the economy cooling enough to bring inflation down but still avoiding recession. We expect the Fed to continue to lower short-term rates through next year, but longer-term yields should level off or even go higher from here, as the yield curve steepens if the economy can keep its head above water. A simple, rule-of-thumb model we use for roughly calculating where 10 Year Treasury yields should be is expected inflation plus expected GDP growth. Expectations of 2% to 2.5% for both inflation and growth would imply 4% to 5% 10 Year Treasury yield. At the current yield of 3.75%, the 10 Year is actually a little low, and this probably reflects downward bias of inflation and growth expectations and a little exuberance for the start of the rate cut cycle. Do not expect lower bond yields from here unless there is a recession. This means that, in the soft landing scenario, you should be a buyer of bonds based on yield levels and not for expectations of price increases from here (bond prices move inverse to yields and decline when yields rise and vice versa).

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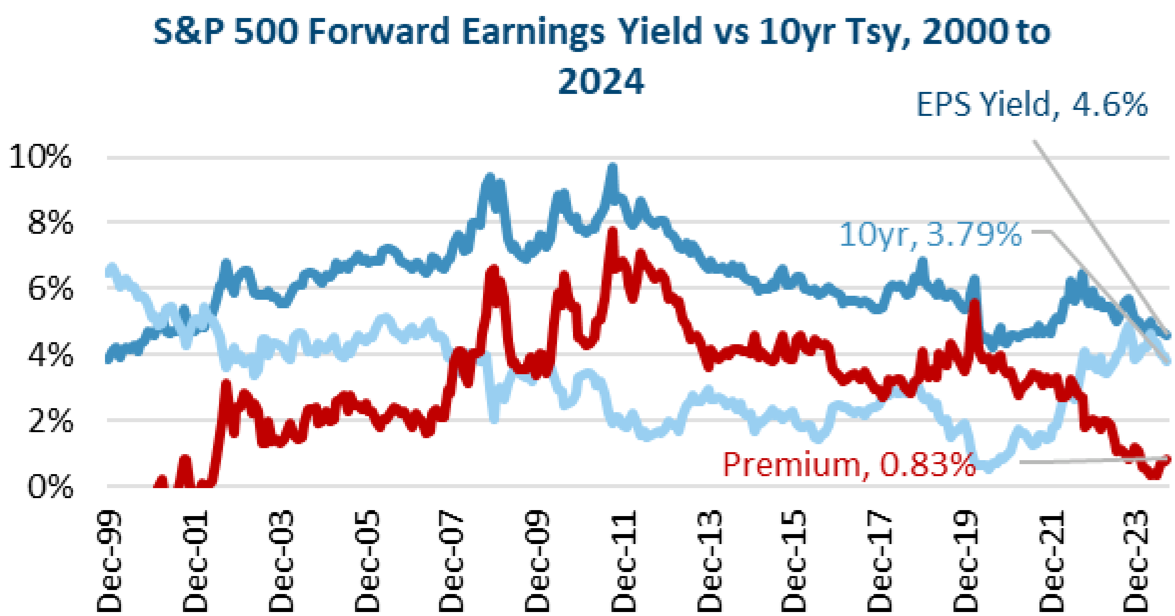

Chart 1

With some of the more attractive yields in two decades for investment grade bonds, investors are now getting reasonably compensated, especially relative to the earnings yield of the S&P 500, as seen in Chart 1. The post pandemic inflation scare period was unique in that both stocks and bonds declined, a phenomenon that we wrote plenty about. But these days, with higher yields to absorb price moves and inflation subsiding, we should expect a return of normal behavior between stocks and bonds, in that bonds should help when stocks experience a panic. In fact, this was the case during the brief summer correction in stocks when market threw a tantrum after some mildly weak economic data. The S&P 500 declined 8.5%, while the Aggregate Bond index rallied over 2% from 7/16 to 8/5 (and bonds are currently at their high for the year). If the economy were to head toward recession (not the base case scenario), then it would be reasonable to expect more of this – stocks down and bonds up.

High quality bonds should do well and cushion portfolios in the case of recession as a flight to quality and as expectations for lower yields in the future fuel price advances for bonds. An inverted yield curve has been a fairly accurate warning sign of a future recession because it is the bond market expecting lower yields in the future, most likely in response to recession. Now that the yield curve is normalized, should we all take a victory lap and stop worrying about recession? Absolutely not – check out Chart 2 below from the St. Louis Fed website. This charts the difference between the 10 Year and the 2 Year yield. When the line is below zero, the yield curve is inverted. The shadowed regions indicate recession. In every recession since 1990, the yield curve started to normalize (rose above zero on the chart) before recession finally hit. While recession is not our base case expectation, it is the second most likely scenario behind a soft landing, and bonds would help portfolios in this scenario.

Chart 2

So, both the soft landing scenario and the recession scenario are good environments for bonds going forward. The scenario where bonds continue to do poorly would be a resurgence of inflation. Fortunately, this is the least likely scenario at this point. That said, if inflation were to reignite, then investors would have even higher yields to take advantage of. Do not let the historically bad returns for bonds over the past five years scare you away from allocating to the asset class. Consider it instead a potentially solid set up for fixed income going forward. Grimes & Company has compelling bond investment strategies that could offer unique opportunity in this uncertain economic environment.

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