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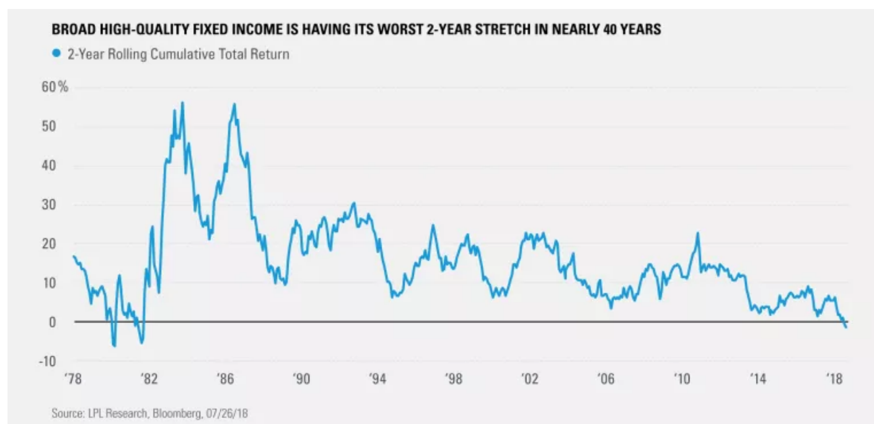
A Tough Stretch for High-Quality Bonds

Posted by lplresearch

It’s been a difficult stretch for fixed-income investors since yields bottomed in the summer of 2016.

As shown in the LPL Chart of the Day, the 2-year cumulative total return for the broad high-quality bond market (as represented by the Bloomberg Barclays Aggregate Index) is negative for the first time in nearly 40 years.



As the business cycle has normalized, the economy is relying less on monetary policy and is transitioning to more typical drivers like corporate fundamentals and fiscal stimulus. As a result, interest rates have risen to more normalized levels. Although this is ultimately a positive sign that reflects a strengthening economy, it has made for a challenging two years in high-quality fixed income.

“Economic growth, deficit spending, rising inflationary pressures, and expectations for future rate hikes have lifted rates over the past two years,” according to LPL Chief Investment Strategist John Lynch. “Although interest rates may likely move higher in the year ahead, we believe the pace of the last two years will not be replicated.”

Investors have felt the pain of higher interest rates in the form of lower bond prices. However, investors may stand to gain over time as they generally receive more interest than they pay. Two years ago, yields across the globe were extremely depressed, with the 10-year Treasury yield reaching its all-time low of 1.36% on July 8, 2016. The 10-year yield has more than doubled since then. Investors can take solace that we do not believe the next one or two years will be as challenging for fixed income investors as the past two have been. Long-term interest rates currently reflect meaningfully higher levels of growth and inflation than they did two years ago.

We have already seen indications that the pace of interest rate increases has slowed, which was reflected in the quarter-over-quarter performance of the Barclays Aggregate. Though the second quarter return was negative, it was much less so than the first quarter, pointing to a rate environment that reflects the economic realities of a strengthening U.S. economy.

Although investors may be questioning the worth of high-quality fixed income in their diversified portfolios, we maintain that it is vital to help manage equity market risk in the face of higher volatility. As the business cycle ages, we believe high-quality fixed income becomes more important for suitable investors.

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