Markets in a Minute: Should I Own Bonds While Interest Rates Are Rising?

The sometimes-sleepy bond market has been anything but this year. With inflation at its hottest level in decades and the Federal Reserve beginning to raise interest rates, the U.S. Treasury index had its worst-ever start to the year, falling by 6% through March 22. Adding to the list of concerns: bonds declined in tandem with stocks, meaning that bonds didn't provide portfolios the cushion in volatile times that investors have come to expect.

With more rate hikes on the horizon, investors may be tempted to avoid fixed income investments altogether. But historical precedent suggests that, even with these headwinds, bonds can still provide positive returns and serve an important role in a diversified portfolio.

What's Caused Bond Prices to Slump?

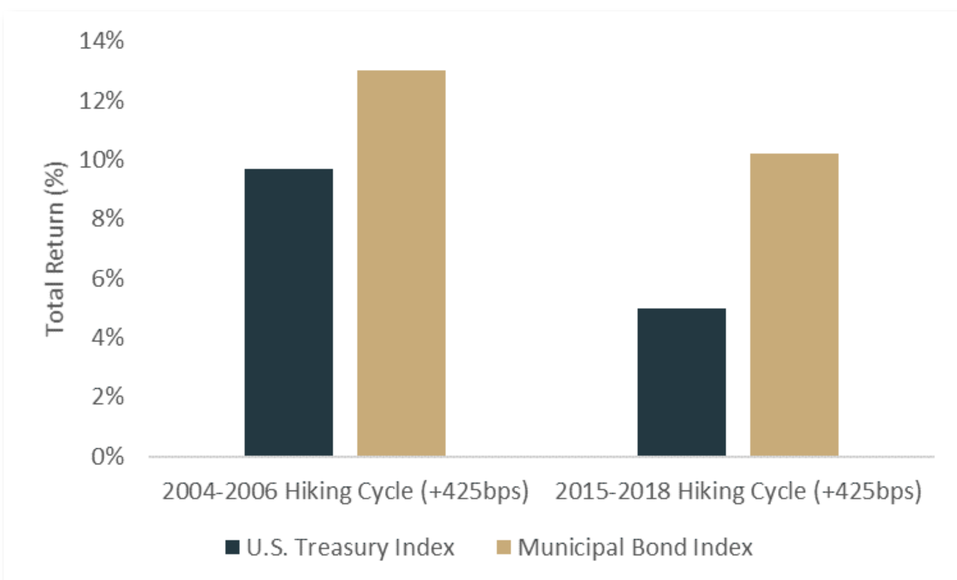
- Bond prices tend to fall when interest rates rise and/or inflation runs hotter than expected, as has been the case this year.
- One closely followed measure of forward inflation has risen dramatically since mid-February. That's due in part to concerns that Russia's war with Ukraine could keep energy prices elevated and drive up prices for other commodities.
- To keep inflation from jeopardizing economic growth, earlier this month the Federal Reserve raised the Fed-funds rate for the first time since December 2018. It kicked off its rate-tightening cycle with a modest quarter-point increase, but the central bank is widely expected to move more aggressively in the coming months.
- In fact, the Fed-funds futures market is anticipating additional rate hikes this year, with investors assigning a high probability to half-point rate increases in both May and June, according to the CME Group's FedWatch Tool.

Against Such Headwinds, Why Bother With Owning Bonds?

- Bonds have typically provided an important buffer for portfolios during stock-market corrections, such as the pandemic-induced downturn in 2020. During February and March 2020, the S&P 500 index fell by nearly 33% in just 23 trading days. As stocks sank, the Bloomberg U.S. Aggregate Bond Index trended higher, ultimately finishing the year up by more than 7%.

- More than just providing a buffer, bonds have often provided positive returns even as rates were rising. During two of the most-recent Fed rate hike cycles – 2004-2006 and 2015-2018 — both U.S. Treasuries and municipal bonds saw strong gains on a total return basis.
- That said, the initial months of a Fed rate hike cycle can be choppy as stocks and bonds start to price in slower growth. But six months to a year after the Fed has begun raising rates, markets tend to be broadly higher.

How Have Bonds Performed During Fed Rate Hike Cycles?



Past performance is no guarantee of future results. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index. Indexes: U.S. Treasury Index, U.S. Municipal Bond Index. Source: Bloomberg

It's important to keep in mind that long-term bonds — or those with maturities of more than 10 years — are more sensitive to changes in interest rates than short-term bonds. So, diversification across maturities (as well as sectors and credit risk) can help to mitigate portfolio risk during periods of market volatility.

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For long-term investors, rising rates may even present an opportunity for investors whose fixed-income holdings are diversified across different maturities. In such an environment, as individual bonds with lower yields mature, the proceeds can be used to buy bonds with higher yields. Those new bonds bring with them higher levels of interest income and potentially greater total returns. In other words, rising rates may create some short-term pain but ultimately translate into longer-term gains.

So, while investors may worry about owning bonds in a rising-rate environment, there may be risks in forgoing fixed-income entirely. For a better understanding of how bonds play a role in your portfolio, don't hesitate to reach out to your financial advisor.