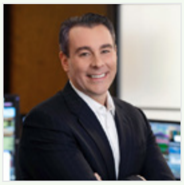
HIGHER RATES ARE CREATING OPPORTUNITIES IN FIXED INCOME



CHRISTOPHER IOVANNA, CFA

Vice President
Taxable Bond Client Portfolio Manager

Fixed income markets endured their worst year on record in 2022. The key catalyst for the poor performance was the Federal Reserve (Fed), as it ceased its pandemic-induced bond purchases and raised interest rates significantly and quickly in its battle against the highest inflation in 40 years. However, with yields much higher now, we see opportunity in fixed income, and believe allocating to this asset class is an important part of a diversified portfolio.

HIGHER YIELDS CAN MAKE FUTURE RETURNS MORE ATTRACTIVE

Higher yields allow investors to purchase bonds more cheaply and generate higher income. The last time yields for the Bloomberg Aggregate Bond Index were as high as they were at the beginning of June 2023 — around 4.60% — was March 9, 2009. The 1-, 3-, and 5-year returns from that point were 9.51%, 7.55% (annualized), and 5.10% (annualized).

Additionally, the Fed may now be nearing the end of its hiking cycle. **Figure 1** shows returns for the Aggregate after the Fed paused hiking in previous cycles.

WHAT ARE THE RISKS TO STAYING SHORT?

While short-term rates on cash and cash-like investments such as US Treasury bills may seem attractive today, avoiding intermediate and longer-term bonds may not be optimal for long-term returns. Bonds have outperformed cash in 18 out of the last 25 years. We believe it is prudent to allocate to multiple bond sectors and maturities, and there are many reasons to consider an allocation to longer-term bonds, including:

Reinvestment Risk

Reinvestment risk is the possibility that an investor will be unable to reinvest cash flows received from an investment, such as coupon or principal payments, at a rate comparable to their current rate of return. A short-term Treasury will come due in a brief period. The investor will then need to determine what to do with it, while dealing with prevailing market rates that may not be as attractive. Read more about this in our article, Reinvestment Risk is a Coin Toss, with Higher Stakes Now.

Capital Appreciation

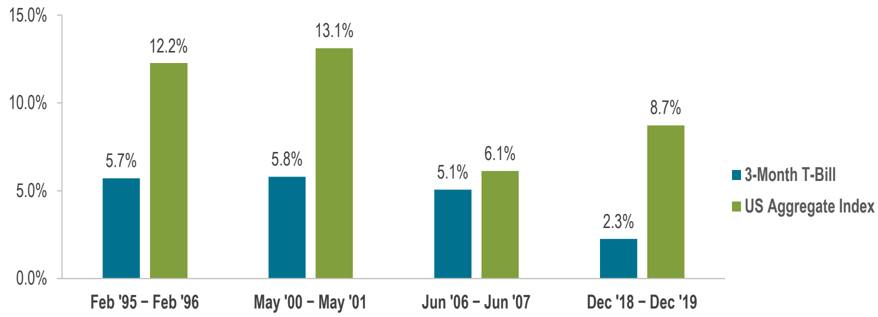
Purchasing a T-bill allows for little opportunity to generate capital appreciation since the duration is so short and Treasuries do not have a spread. Investors will achieve roughly the yield on the instrument at purchase. Additionally, the yield is quoted on an annualized basis, so the actual return for a bond with less than a year to maturity would be lower. An active fixed income manager will likely be able to generate a total return above the yield on their portfolio.

FIGURE 1

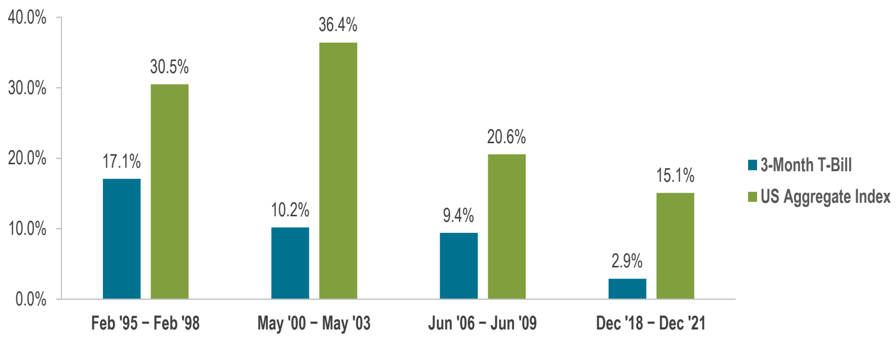
Bond Returns Have Been Strong Post Rate Hike Cycles

Bloomberg US Aggregate Performance Versus 3-Month T-Bills

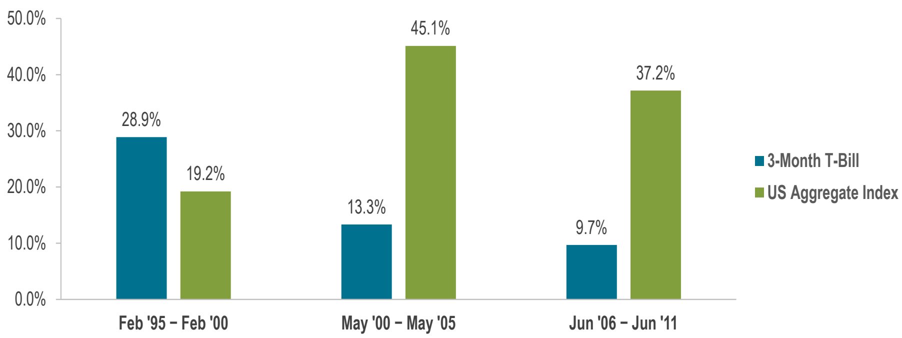
1-Year Cumulative Returns



3-Year Cumulative Returns



5-Year Cumulative Returns



Source: Federal Reserve and FactSet. Cumulative returns shown above were calculated on a monthly basis. The Investment Grade Corporate Bond and US Treasury Index represent components of the Bloomberg Aggregate Index. The High Yield Corporate Index performance represents the Bloomberg High Yield Corporate Index. Past performance is no guarantee of future results.

CONCLUSION

Fixed income assets can play an important role in an investor's portfolio. We believe having a diversified fixed income allocation that includes intermediate- and longer-duration investments can help mitigate reinvestment risk and help investors participate in capital appreciation opportunities.