Key Questions

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Should Bond Investors Be Buying Into a Bond Bear Market?

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When interest rates go up, bond prices go down. This simple investment principle has been the story for fixed income markets in 2022. Interest rates have risen at a staggering pace on the backs of higher inflation expectations, solid economic growth and a turn to a hawkish monetary policy stance from the Federal Reserve (Fed). Bond prices have fallen in accordance, as the returns for the Bloomberg US Aggregate Bond Index and Bloomberg Municipal Bond Index were -5.9% and -6.2%, respectively, in the first three months of 2022 through March 31. Both indices have not seen quarterly losses of this magnitude since 1981.

Consequently, the 40-year bond bull market may soon be coming to an end. Yields of 2-year and 10-year US Treasuries are on the cusp of breaking 40-year downward trends and ushering in a new market cycle for bonds: a bear market. The current set-up in fixed income markets has us asking, “Should bond investors be buying into a bond bear market?”

Bear Market Defined

It’s important to distinguish between a bear market for stocks and a bear market for bonds. Typically, a bear market for stocks is a decline in price of 20% or more from a market high.

There is no real technical definition of what constitutes a bear market for bonds, which is probably attributable to the 40-year downward trend of interest rates starting in 1981. If we refer to a bond bull market as a long-term downward trend in interest rates, then a bond bear market would be a long-term upward trend in interest rates. It’s something we haven’t seen the likes of in quite a while, but is it necessarily a bad thing?

Bond Market in a Rising-Rate Environment

The last broad-based bear market for bonds occurred from 1960-1981, during an increasingly inflationary period in the US. During that time the yield on a 10-year US Treasury rose from 3.9% to 15.8%. Since bond prices fall when interest rates rise, the total return on the 10-year note must have been abysmal during that period, right? In fact, while annual returns ranged from -5.4% to 18.3%, the average annualized return during this period was 4%. How can that be?

Because as interest rates rose, income and principal payments could be reinvested at higher rates. The quoted yield for a bond assumes that any coupon payments received are reinvested at the same yield. Reinvesting coupon payments at higher yields than the purchase yield only enhances total return. The same holds true when reinvesting proceeds from bond maturities. A 2-year Treasury bought in April 2020 at a yield of 0.16% can be reinvested upon maturity in April 2022 at 2.43%. Reinvesting coupon payments and maturities in a rising-rate environment systematically enhances total return.

Bond Investors and Inflation

The key risk for bond investors in a rising-rate environment is inflation. Core inflation averaged 5.3% per year from 1960-1981, peaking as high as 13.6% in 1980. Since then, the annual average has been 2.9%, including a 25-year stretch from 1996-2021, when monthly inflation was never higher than 2.9%. It's important to note that the Fed aims for a 2% inflation target over the long run. Relatively low and stable inflation is desirable for a strong, growing economy.

Conversely, a rise in inflation that persists is detrimental and detracts from the total return for bond holders. Core inflation has risen over the last year and was last measured at 6.4% for February 2022. Whether this recent rise is persistent or transitory, bond investors may see additional negative returns in the short term.

Key Takeaways for Investors

Remaining patient and focusing on forward returns is essential during such times. Continuing to reinvest at higher yields is a sound long-term investment strategy. It just takes time.

The phrase "buy the dip" has become a common mantra among bullish investors. To buy the dip is to simply buy more of an asset when its price goes down. Pullbacks in major stock indices in 2022 have been met with inflows into domestic equity mutual funds and Exchange Traded Funds or ETFs. The total return for the S&P 500 Index was -4.9% through March 31, yet domestic equity funds and ETFs saw inflows of $63 billion. Investors are buying the dip in equities, but not in fixed income.

As mentioned earlier, investment-grade taxable and municipal bond indices are down roughly 6% year to date, yet fixed income mutual funds and ETFs have seen outflows of -$47.0 billion and -$21.9 billion, respectively. These outflows are putting additional downward price pressure as fund managers are forced to sell bonds to accommodate redemptions. As a result, absolute yields are reaching levels not seen since 2019 and may go even higher as the Fed initiates further monetary tightening.

This can be called a bond bear market, but it's an opportunity to invest at higher yields and increase future interest income. The sharp increase in interest rates and coinciding decrease in bond prices to start 2022 resulted in the worst-performing quarter for investment-grade fixed income in over 40 years. Market valuations for bonds have fallen swiftly, but short-term price swings can occur across all asset classes, including fixed income.

The most important aspect of a successful investment strategy is to remain disciplined and rational in times of market volatility. Selling bonds following an increase in rates simply lowers total return and deviates from a disciplined investment strategy. Disciplined fixed income investors are wise not to be overly concerned with price depreciation in the short term and instead focus on their long-term investment horizon, where reinvesting at higher yields enhances total return. A fixed income allocation in a portfolio offers the benefits of capital preservation, steady streams of income and diversification benefits when used in conjunction with other asset classes. If fixed income is part of your overall investment strategy, it's best to stay the course and look forward to the higher yields to come.

For more information, please contact your advisor.

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