ENVESTNET PMC

The New Fixed Income Regime

How Higher Interest Rates May Revitalize Bond Portfolios

- Historical insight into interest rate cycles
- Analysis of the current bond market
- Review of recent fixed income and cash management trends
- Opportunities for future portfolio positioning

PREPARED BY ENVESTNET | PMC

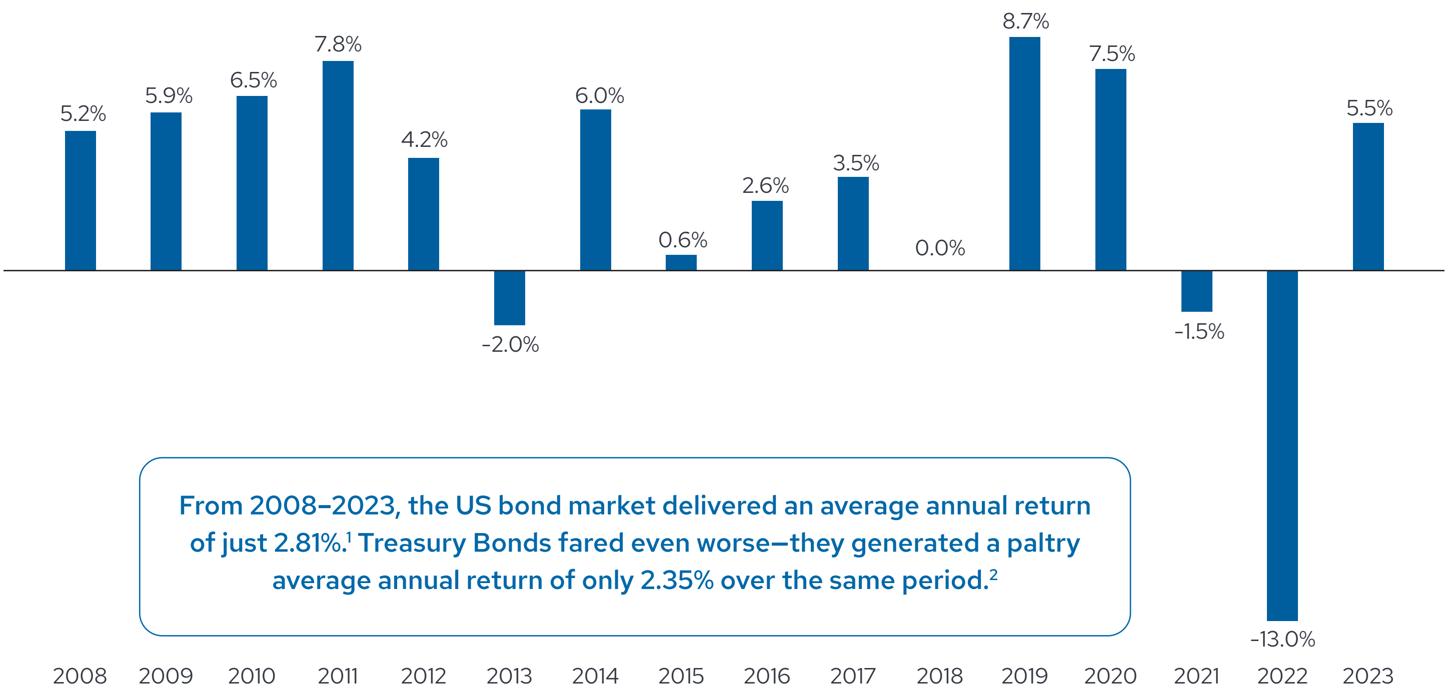
2024 REPORT

INTRODUCTION

US fixed income investors endured years of low yields after the Great Recession of 2008–09, followed by widespread bond market declines in 2021–22. This environment limited the appeal of fixed income securities for many investors. In fact, many Wall Street strategists and financial journalists used the acronym TINA (There Is No Alternative) to describe how portfolios were almost forced to overweight equities for the entire decade of the 2010s and into the early 2020s. Tapping into reliably solid bond returns just wasn't an option during this TINA period.

Figure 1.

US Bond Market Returns



US Bond Market represented by the Bloomberg US Aggregate index.
Total returns data from YCharts.

TINA DUMPED FOR TARA?

While the Federal Reserve interest rate hiking campaign (since March 2022) brought short-term pain and frustrating losses to bond investors, this effort also elevated yields from historically meager levels. (Remember that bond prices and yields have an inverse relationship.) One fixed income expert even declared that TINA—the acronym that suggests "There Is No Alternative" to stocks—has been ditched for TARA (There Are Realistic Alternatives).[3] The alternatives referenced by TARA are fixed income securities. This change could invite a potential shift in investor allocations, so we want to explore the possibility of a new environment for bonds and answer key questions, namely:

- *What's the historical evidence to indicate that bonds may be revitalized now that the Federal Reserve has likely stopped raising interest rates for this cycle?*
- *Why do certificates of deposit (CDs), savings accounts, and money market not offer the upside return potential of bonds when interest rates fall?*
- *Can duration and convexity create risk/return asymmetry in fixed income markets?*
- *What are the investment opportunities available for advisors to help their clients navigate the new fixed income regime?*

This paper will provide useful background information, insightful illustrations, and practical portfolio management insights.

1 US Bond Market represented by the Bloomberg US Aggregate index. Total returns data from YCharts.

2 Treasury Bonds represented by the Bloomberg US Treasury index. Total returns data from YCharts.

3 Naomi Rovnick. January 11, 2023. *Move over TINA, it's time for TARA. Reuters.*

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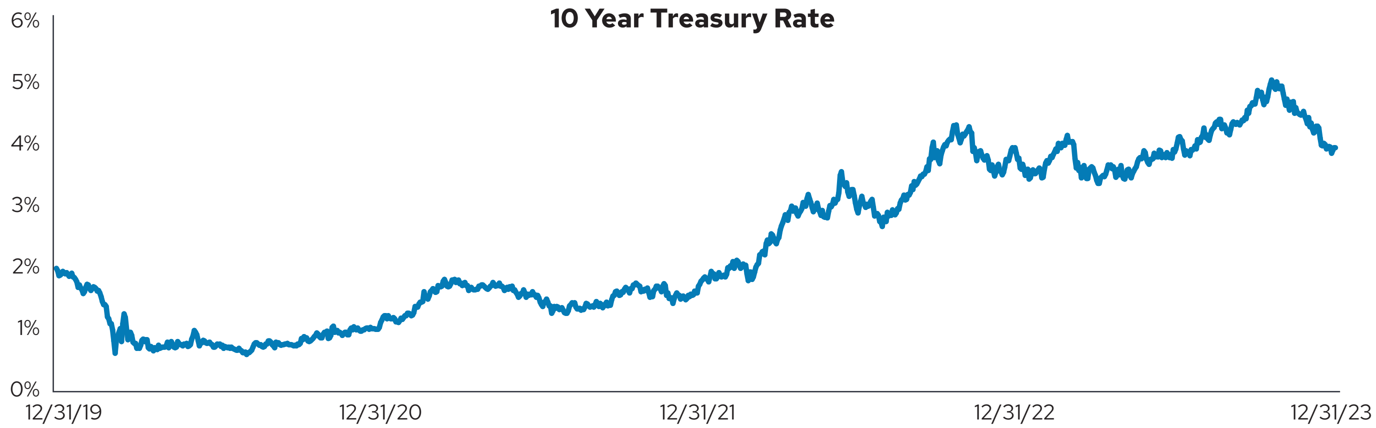
INTEREST RATE ENVIRONMENT

To better understand how quickly and how significantly US interest rates have climbed since the Federal Reserve started hiking rates on March 15th, 2022, let's look at the 10 Year Treasury yield, considered one of the most important interest rates in finance. As displayed in Figure Two, the 10 Year's yield hit an all-time low of 0.52% in August of 2020 and rose to around 5% in October 2023.

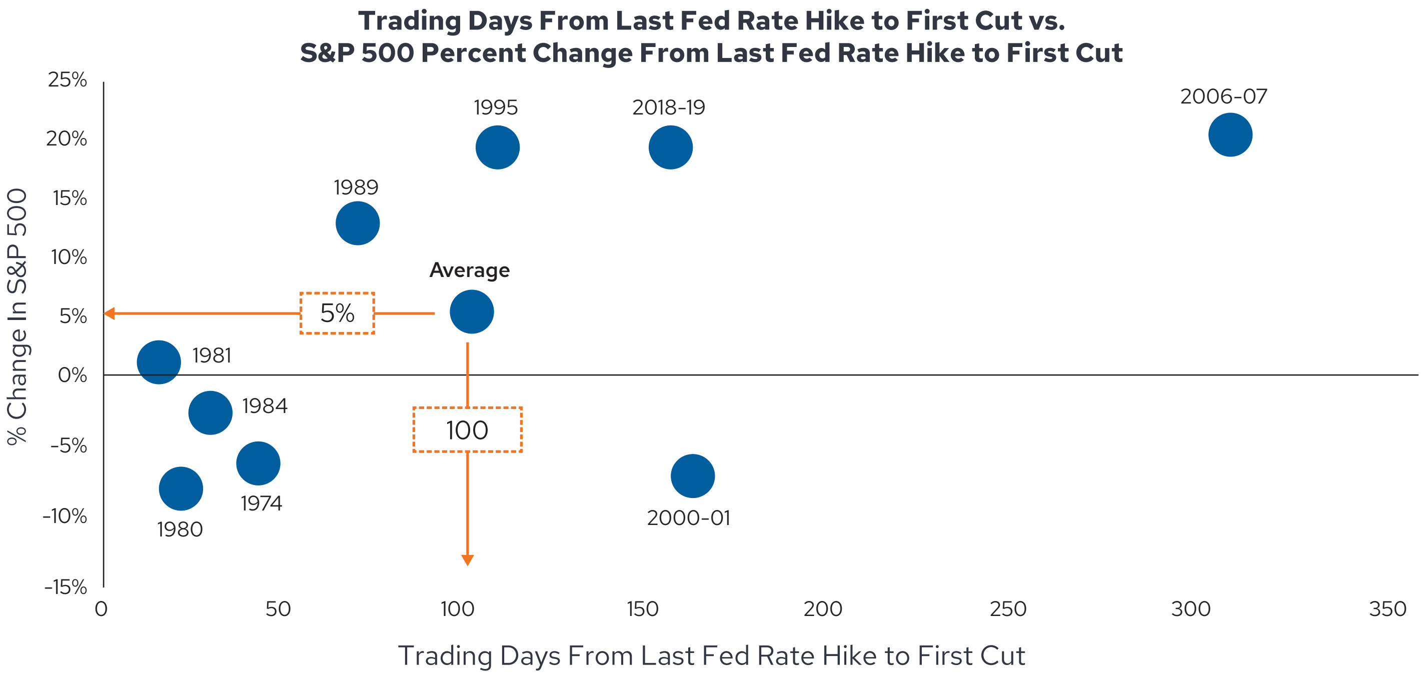
Figure 2.



Data from YCharts.

When examining a rate directly controlled by the US Central Bank, we see that the Federal Funds Rate plummeted to 0–0.25% in March of 2020 and didn't increase for two years.[4] As of December 31st, 2023, the Federal Funds Rate had jumped sharply to 5.25–5.50%.[5] This monetary policy tightening was necessary to combat inflation, and its effects have reverberated across the financial system. Based on the Fed's own economic projections and policy commentary on December 13th, 2023, the current tightening cycle is complete unless high inflation reignites. As such, the Federal Reserve projects multiple interest rate cuts in 2024. As displayed in Figure 3, historically, the Fed started loosening monetary policy following fairly brief pauses after the final hike of a cycle. (Note that the last Federal Funds Rate hike in this current cycle likely occurred on July 26th, 2023.)

Figure 3.



Data and calculations from Strategas.

4 Bloomberg Terminal data

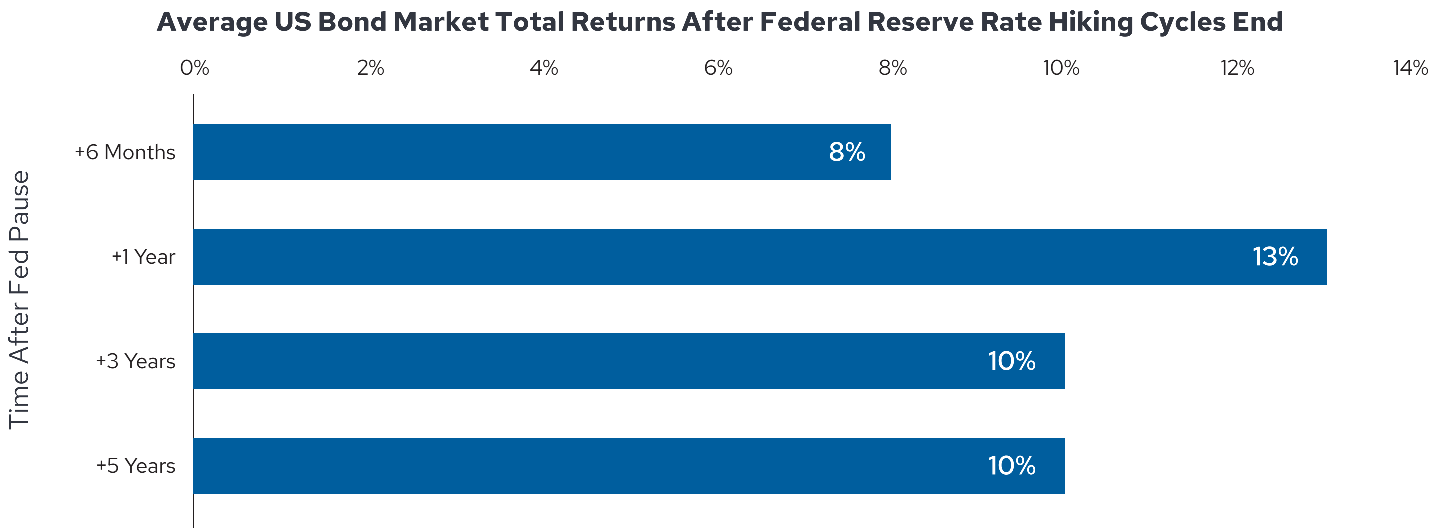
5 Bloomberg Terminal data

6 PGIM Investments. (2023). *Bonds Historically Provided Consistent Positive Performance After Fed Pauses.*

THE PIVOT

Now let's investigate how US bond markets have historically responded to Federal Reserve pauses and interest rate cuts. While every policy cycle is unique, we can identify useful generalizations from the past. As Mark Twain (allegedly) quipped, "History doesn't repeat itself, but it does rhyme."

Figure 4.



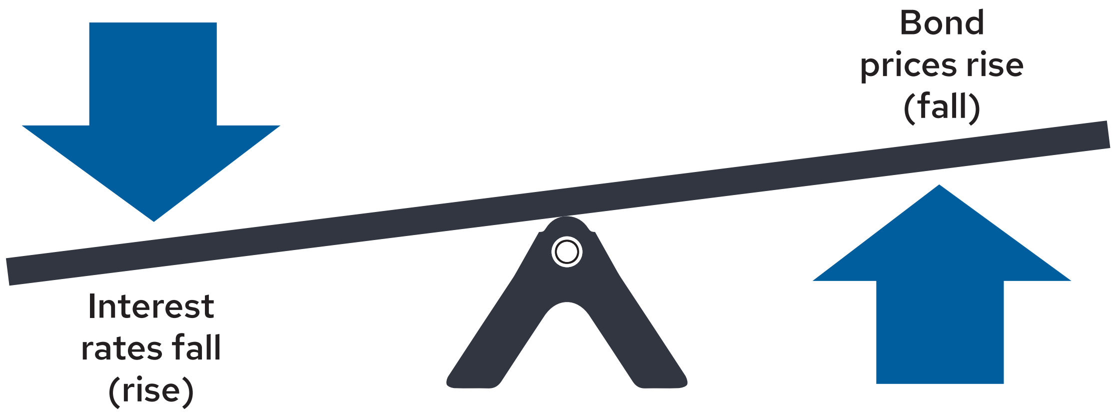
Data and calculations from PGIM Investments. Data from 8/1/1984 to 12/31/2021.
"US Bond Market" represented by the Bloomberg US Aggregate index.

A PGIM Investments data analysis found that US bonds have delivered positive returns 100% of the time in the subsequent six-month, one-, three-, and five-year time periods after the last hike in the previous seven Federal Reserve tightening periods.[6] Bonds have historically performed well following the end of Federal Reserve tightening because, as noted in Figure 3, Fed pauses have generally led to interest rate cuts in relatively short order. This transition to looser monetary policy has been a positive environment for fixed income investors even as CDs, money market funds, and savings accounts typically offered reduced interest rates. To better understand these dynamics, let's explore how falling interest rates have impacted bonds and cash in the past.

BONDS VS. CASH WHEN RATES FALL

Before digging into the data, we need to recall a couple of fixed income fundamentals. First of all, remember that interest rates and bond prices have an inverse relationship, with rates driving prices (not the other way around). Figure 5 illuminates this linkage.

Figure 5.



Educational illustration only and does not imply any guaranteed positive return.

When we think about this illustration, it's quite intuitive: If you could buy a new bond for $1,000 from Company A paying 6% interest, you wouldn't give another investor $1,000 for a bond issued by the same company if it only paid 3% interest, *ceteris paribus*. (The Latin phrase *ceteris* paribus means "holding other things constant.") You'd pay less for the 3% bond in this situation, thus showing how higher interest rates depress bond prices. The reverse is also true: Falling rates boost prices for existing bonds, *ceteris paribus*.

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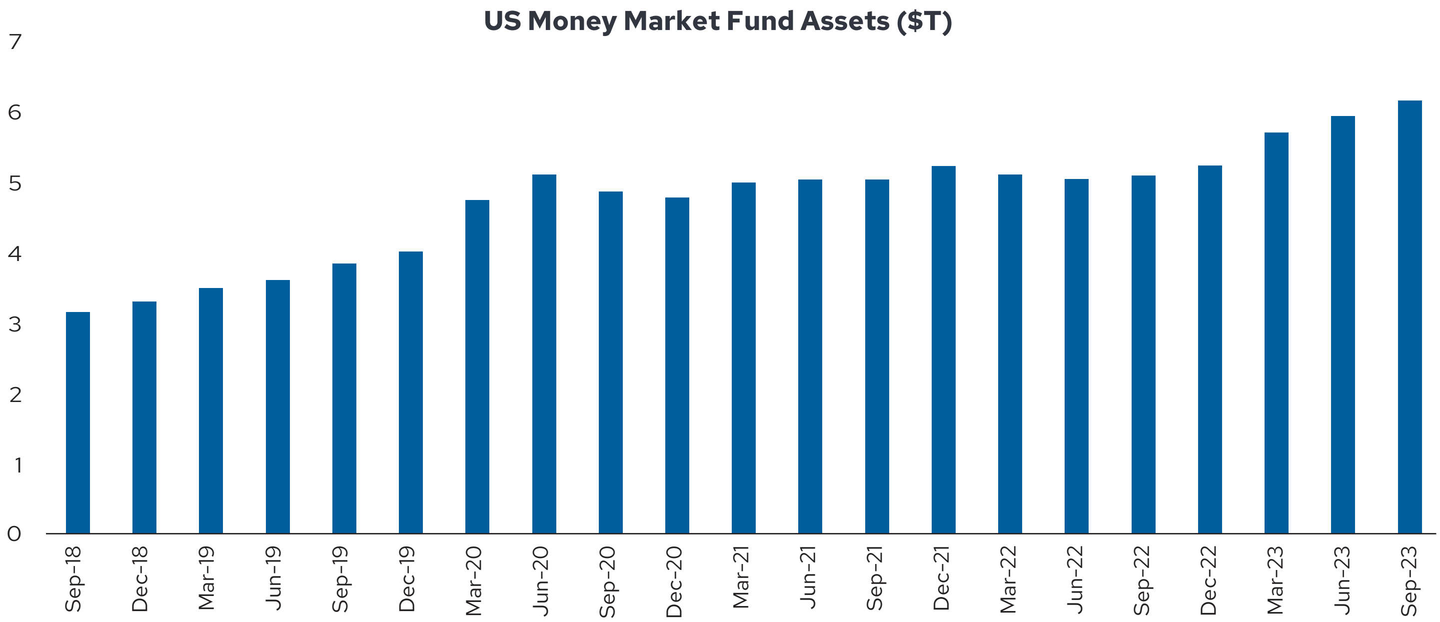
Secondly, remember that long-term bonds are more sensitive to interest rate fluctuations than shorter-term. Duration and convexity are the formulas used to assess fixed income interest rate sensitivity, but we'll spare you from the mathematical details. For now, just know that longer maturities generally correspond with greater duration and convexity.

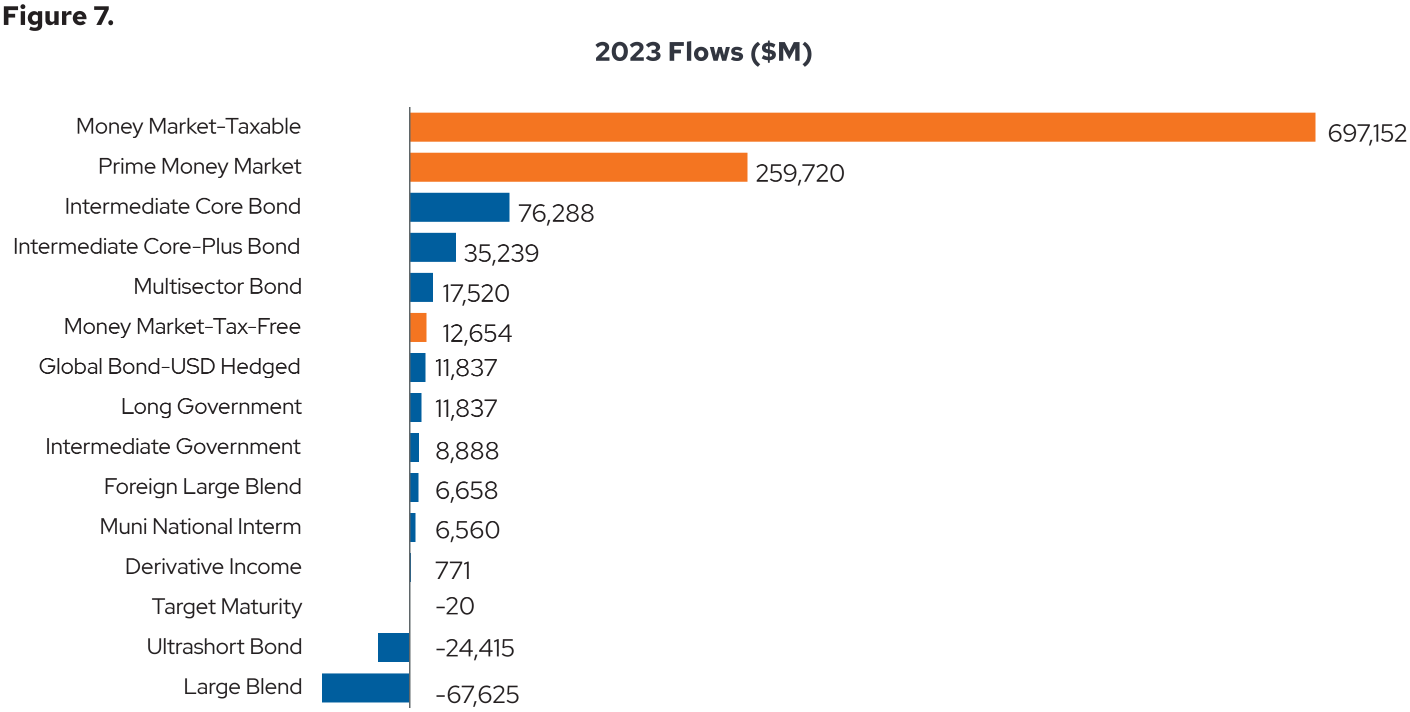
Because money market funds, savings accounts, and other bank deposit products (what we'll collectively refer to as "cash") have a duration of zero, they aren't in danger of losing money when interest rates rise. In fact, higher rates have swelled money market fund balances to a record $6.1 trillion as of September 30th, 2023. Figures 6 and 7 show this growth very clearly.

Figure 6.



Data from YCharts.

Figure 7.

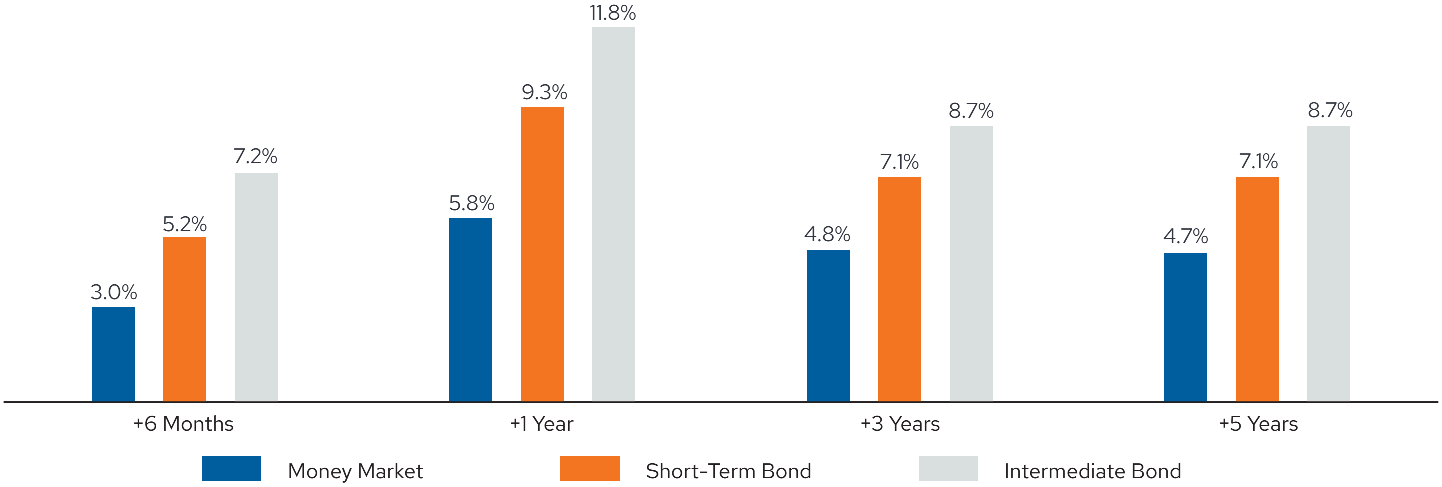


Data from Morningstar through December 2023.

While cash offers downside protection when interest rates rise, it also fails to provide opportunities for capital appreciation when interest rates decline. Traditional bonds do offer the potential for price gains when rates drop, plus they enable to lock in hefty yields. Cash doesn't let investors secure higher rates for twenty or thirty years, but long-term bonds do. CD returns have also fallen behind bond returns following a Federal Reserve pivot. Figures 8 and 9 quantify how cash and CDs have lagged bonds in previous cycles of rate cuts.

Figure 8.

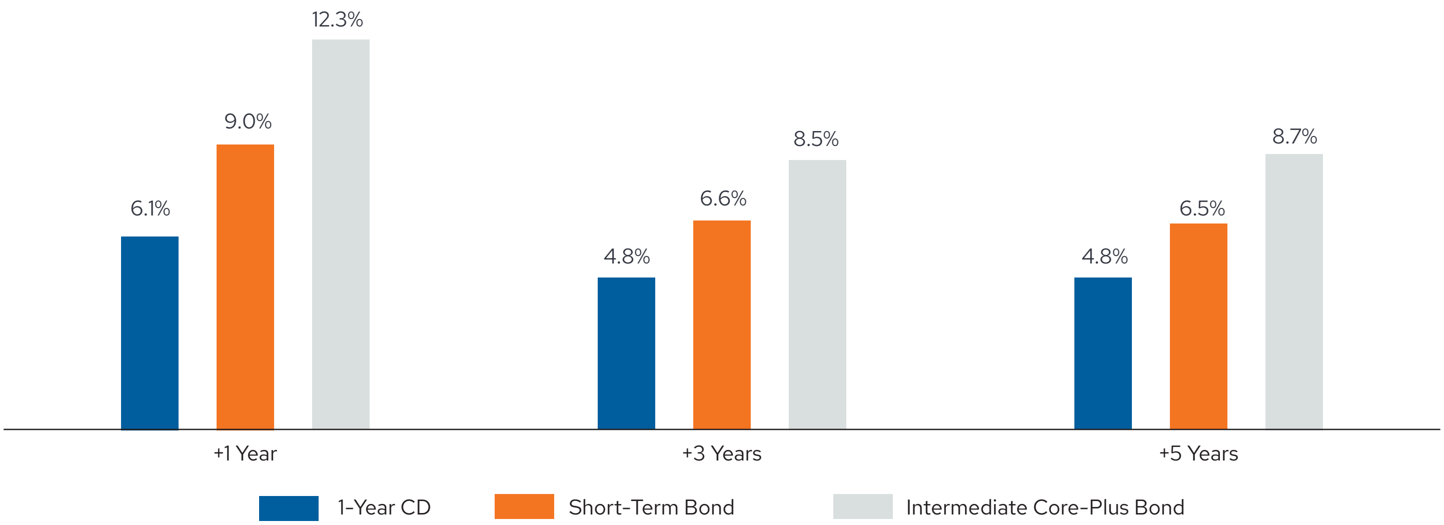
Average Returns Once Rate Hiking Campaigns End



Data and calculations from PGIM Investments. Morningstar category averages used. Average returns between the end of each of the past seven Fed rate hike cycles and the first cut of the following Fed rate cycle using monthly data since 12/31/1982. Returns for periods longer than one year are annualized.

Figure 9.

Average Returns After CD Rates Have Peaked



Data and calculations from PGIM Investments. Morningstar category averages used for bonds. CD returns from Bankrate.com. Data since 12/31/1982. Returns for periods longer than one year are annualized.

Importantly, we see in these illustrations that, historically, longer-duration asset classes have outperformed short-term bonds and cash, as well as CDs, once rates peaked. If you have one takeaway from this paper, this should be it: While extended bond duration is undesirable as interest rates climb, it has historically benefited investors when rates drop.

ASYMMETRY IN BOND RISKS/RETURNS

If bond prices responded to interest rate shifts in a linear fashion, a 100-basis point (or bp) hike in rates would lower bond prices exactly as much as a 100 bp rate cut would lift bond prices. (Note that 1 bp is equal to 0.01%.) Happily for investors, there's generally an asymmetry in the relationship between rates

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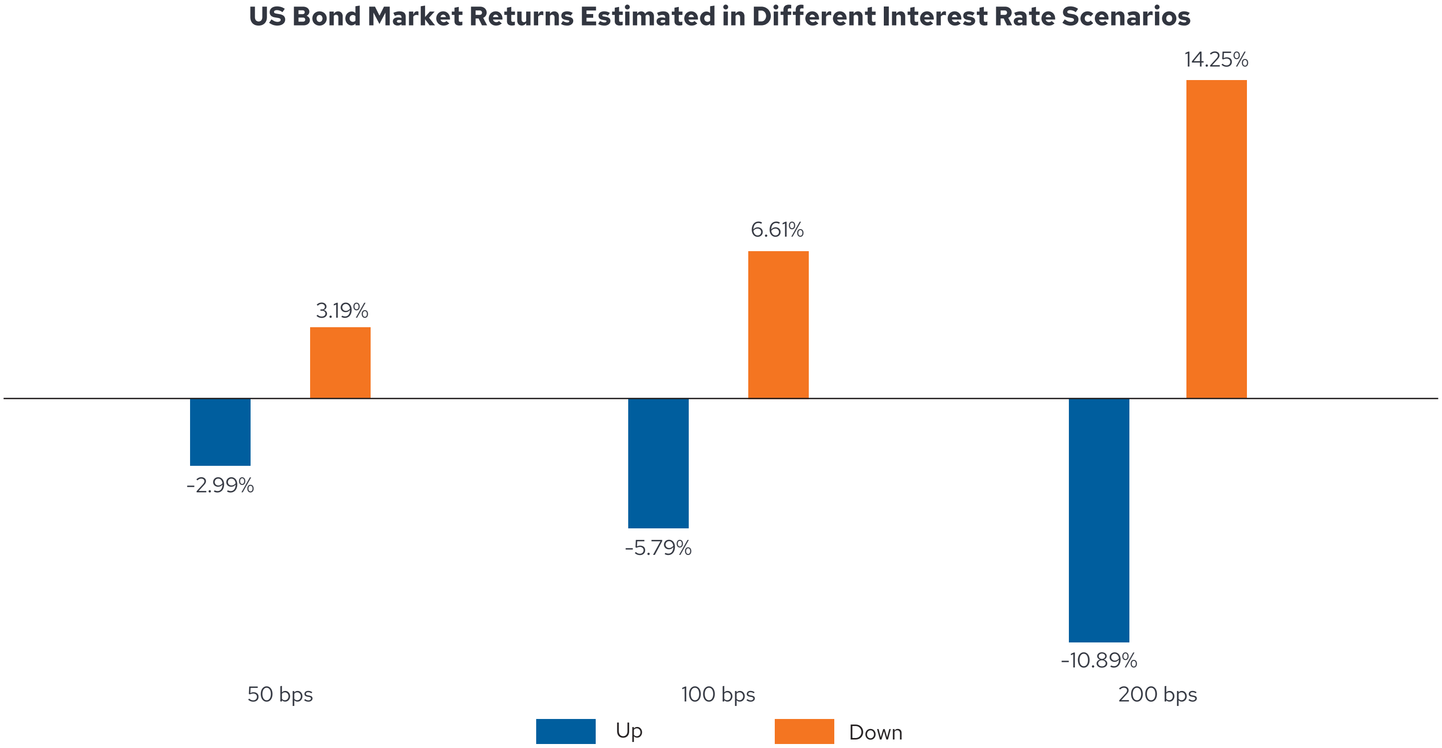
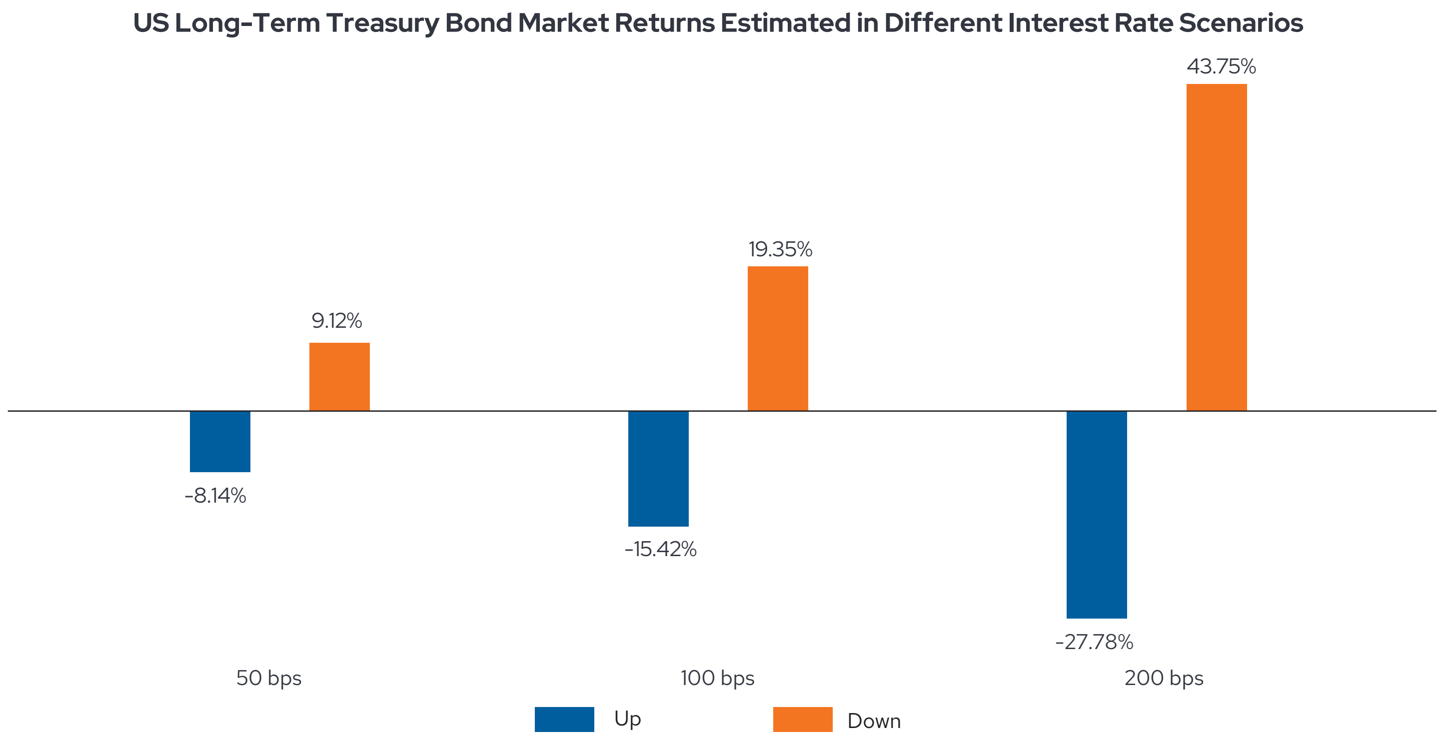
and bond prices. This non-linearity becomes especially significant for long-term bonds. It causes interest rate cuts to potentially be more rewarding than rate hikes of the same magnitude dent bond returns. In short, falling rates may help bonds more than rising rates hurt them. (Note, however, that this risk/return asymmetry doesn't apply to money market funds or CDs.) Figures 10 and 11 depict these concepts using market data.

Figure 10.



Bloomberg total return data as of December 19th, 2023. "US Bond Market" represented by the SPDR® Portfolio Aggregate Bond ETF (SPAB) which tracks the Bloomberg US Aggregate index.

Figure 11.



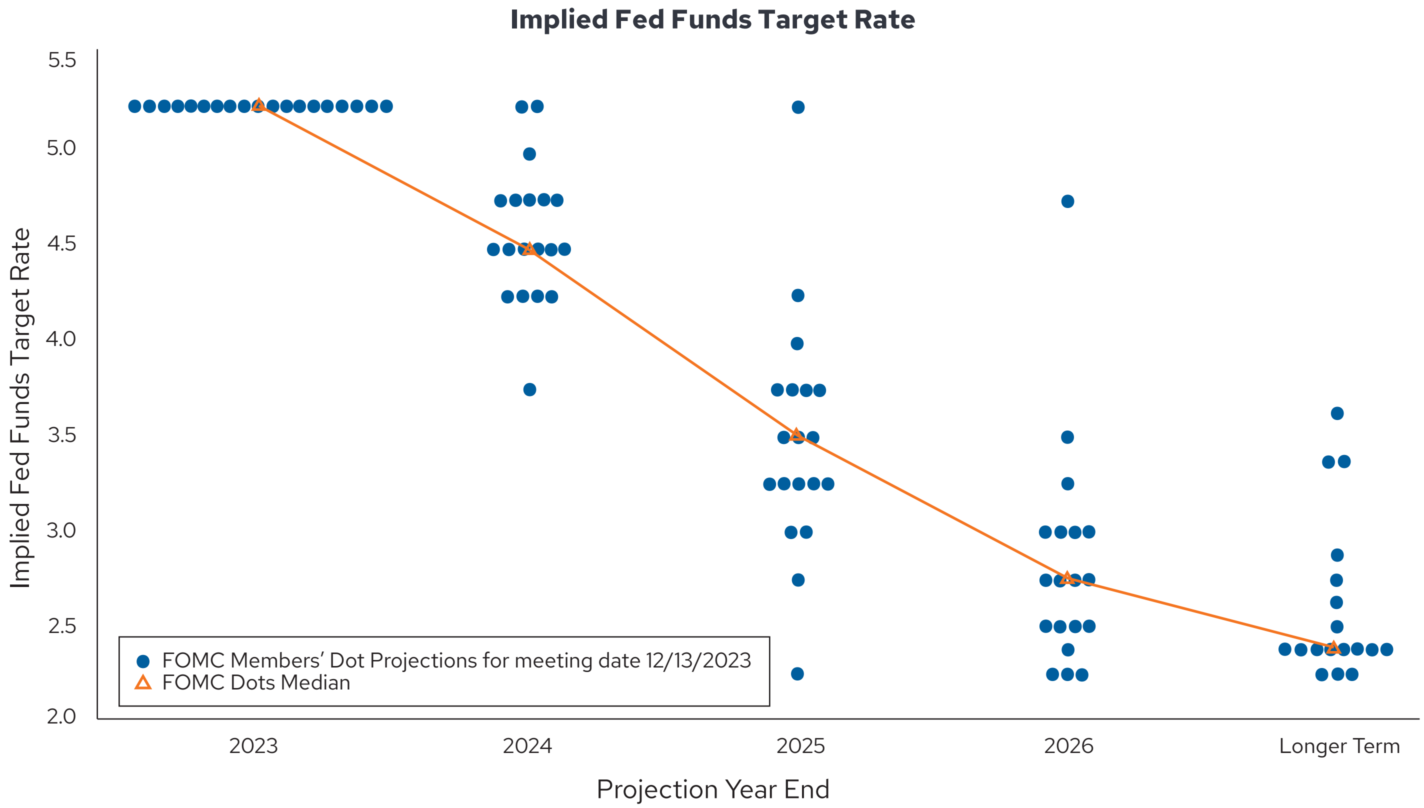
Bloomberg total return data as of December 19th, 2023. "US Long-Term Treasury Bond Market" represented by the iShares 20+ Year Treasury Bond ETF (TLT) which tracks the Bloomberg US Government Long index

While falling interest rates are forecast to boost US bond market returns noticeably more than Bloomberg predicts a return to hikes would harm them (see Figure 10), the risk/return asymmetry is far more pronounced in Figure 11. Long-term Treasury bonds have high duration and convexity, making them very sensitive to interest rate shifts. This sensitivity is a liability when rates climb but should be a tailwind if, and when, the Federal Reserve loosens monetary policy to drive rates down.

PORTFOLIO IMPLICATIONS

Now that we've waded through interest rate history, delved into money market flows, explored a range of quantitative estimates, and touched upon complicated mathematics, you're probably wondering, "How should I utilize this research in actual portfolios?" That's a great question, so we've distilled our analysis into three key ideas you may consider for your clients. All of these strategies are based on Figure 12, which illustrates how Federal Reserve Open Market Committee members expect the Federal Funds Rate to move in the future. (This visual is the Fed's famous "dot plot.")

Figure 12.



Created on the Bloomberg Terminal.

Based on the Fed's own predicted ability to cut the Federal Funds Rate this year by 75 bps, with further reductions in the following years, investors may want to consider these thoughts on fixed income portfolio positioning:

1. *Floating rate securities have historically underperformed as monetary policy is loosened. Their interest rates would ratchet down in the Fed's baseline scenario, and the prices of these securities wouldn't be expected to rise materially. History suggests floating rate securities will struggle when rates dip.*
2. *Investors were wise to utilize money market funds, cash in the bank, and short-term bonds as US interest rates rose very steeply. Now that the Fed is forecasting a pivot toward rate cuts in 2024, investors may want to consider reducing overweighted cash and short-term bond positions. Locking in higher yields with longer-term fixed income investments may be prudent before rates fall.*
3. *Increasing bond portfolio duration has historically been wise when rates peak. Fixed income securities with distant maturities have greater potential for capital appreciation at these pivotal times. The Bloomberg data we cited in Figures 10 and 11 support this assessment.*

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CONCLUSION

We hope this paper has helped you develop a game plan for this new fixed income regime of higher, but potentially falling, interest rates. In many ways, though, we view the current rates environment as historically normal. (The yield curve remains inverted, however.) Rates aren't actually high when viewed through a long-term lens. From this perspective, the 2009–2021 period was the outlier due to extremely low yields in the US and much of the world. Today's market has made fixed income securities more attractive for many investors and their financial advisors, which is a positive. We appreciate the opportunity to share our insights on potential bond market strategies and welcome your questions on anything discussed in this paper.

Please email pmcconsultingsales@envestnet.com for more information.

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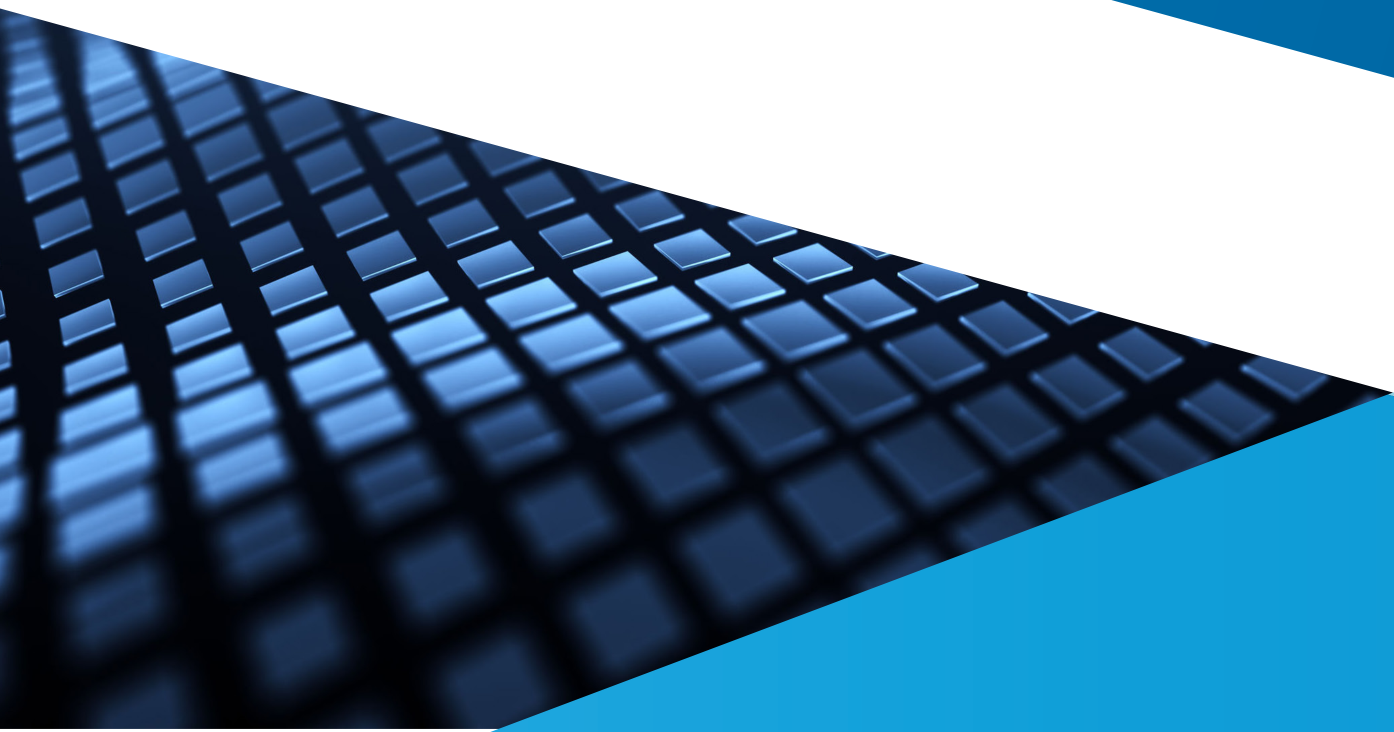

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