The case for bonds as interest rates normalize

Federated Hermes

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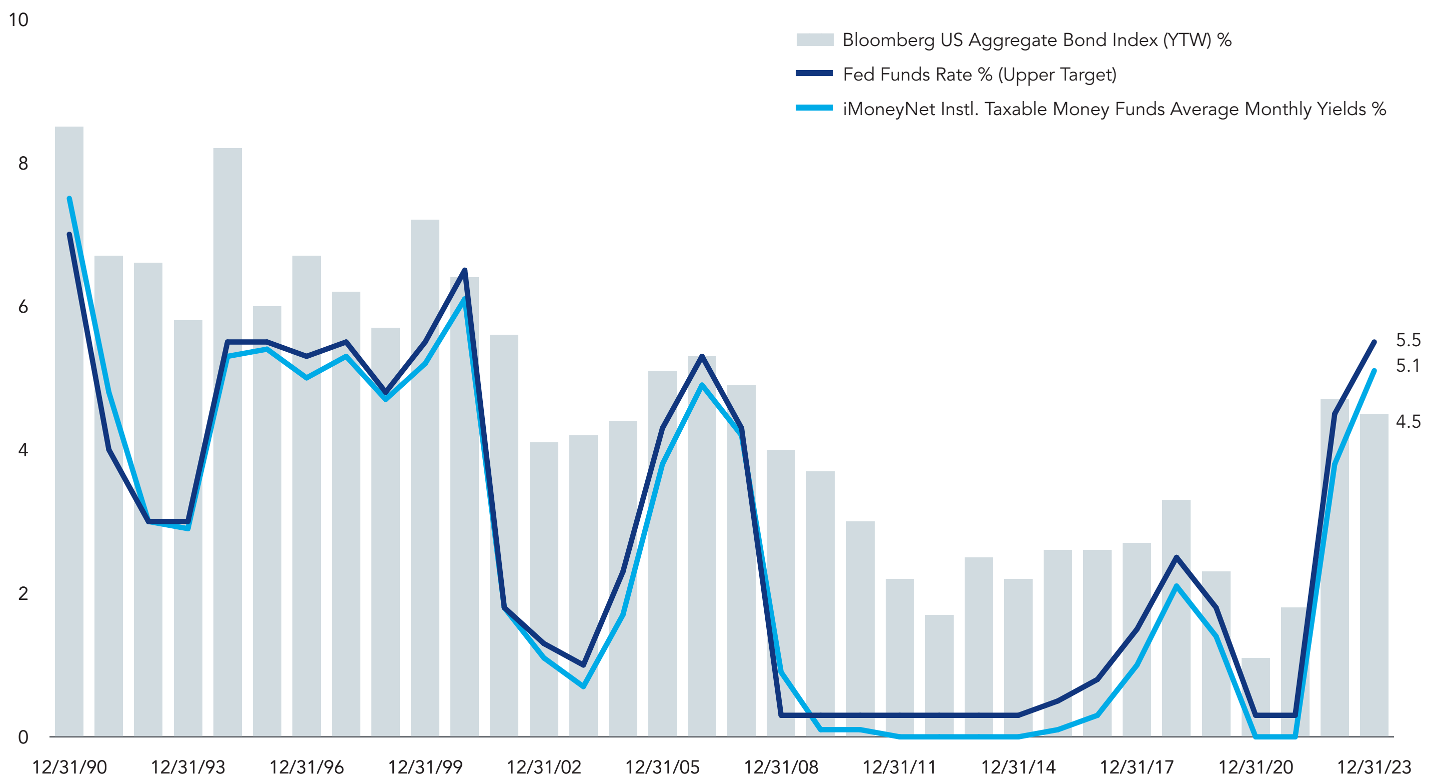
- After a dramatic series of federal funds rate increases, yields appear to have peaked
- Yields across maturities are at the most attractive levels in many years
- Investing in longer maturity bonds has the potential to offer higher income levels over time
- Bond investors may benefit regardless of timing of eventual rate cuts

After a lengthy period of near-zero interest rates, bond markets appear poised to generate income to a degree that has not been experienced since the pre-financial crisis era, the last time the Fed held its policy rate above zero for a sustained period of time.

While short-term yields have been higher than long-term yields since mid-2022, "inverted" yield curves ultimately normalize. And although bond yields have been up and down recently, yields on U.S. Treasuries and other fixed-income investment types are at levels not seen for more than a decade.

Bonds traditionally play a valuable role, providing both portfolio diversification and income, with negative total annual returns a relative rarity.

Bonds historically maintain higher income levels following federal funds rate decreases



Sources: Bloomberg, iMoneyNet 2023.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Past performance is no guarantee of future results. This chart is for illustrative purposes only and is not representative of performance for any particular investment. Indexes are unmanaged and cannot be invested in directly.

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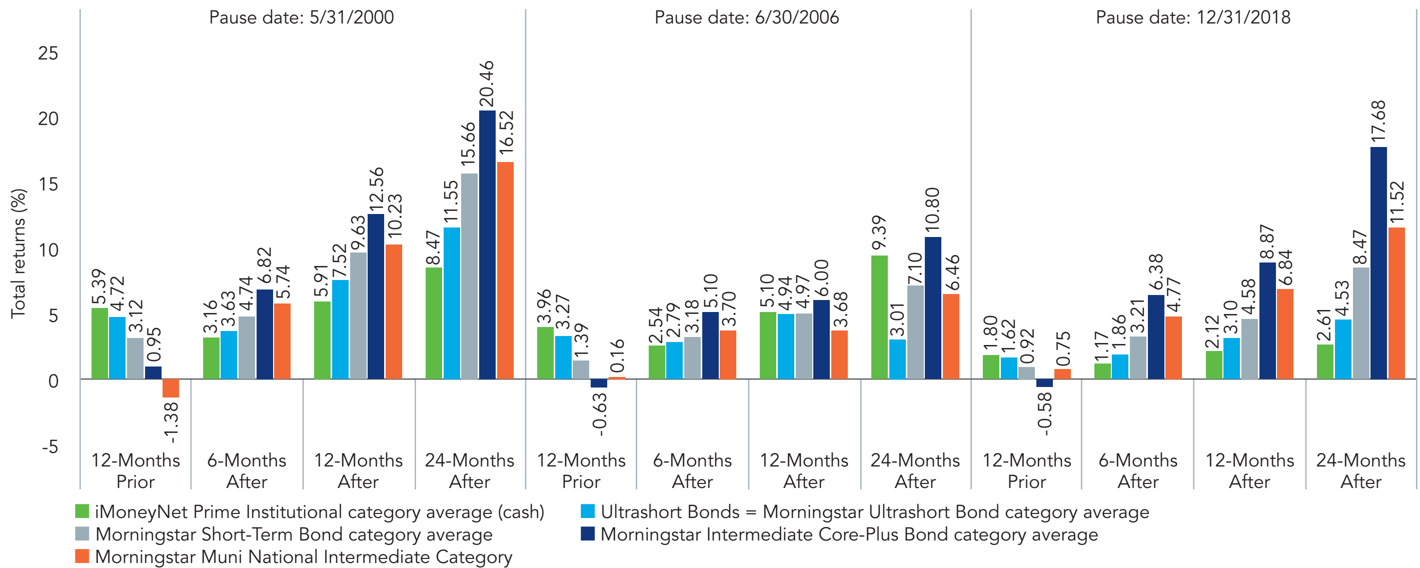
Higher return and income potential

Bonds with longer maturities typically offer a higher yield. Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer maturities have longer durations and are more sensitive to changes in interest rates than securities of shorter durations, but also typically provide a higher return for longer than shorter duration securities.

Performance following Fed pauses



Sources: Morningstar, Inc., iMoneyNet. Performance is cumulative.

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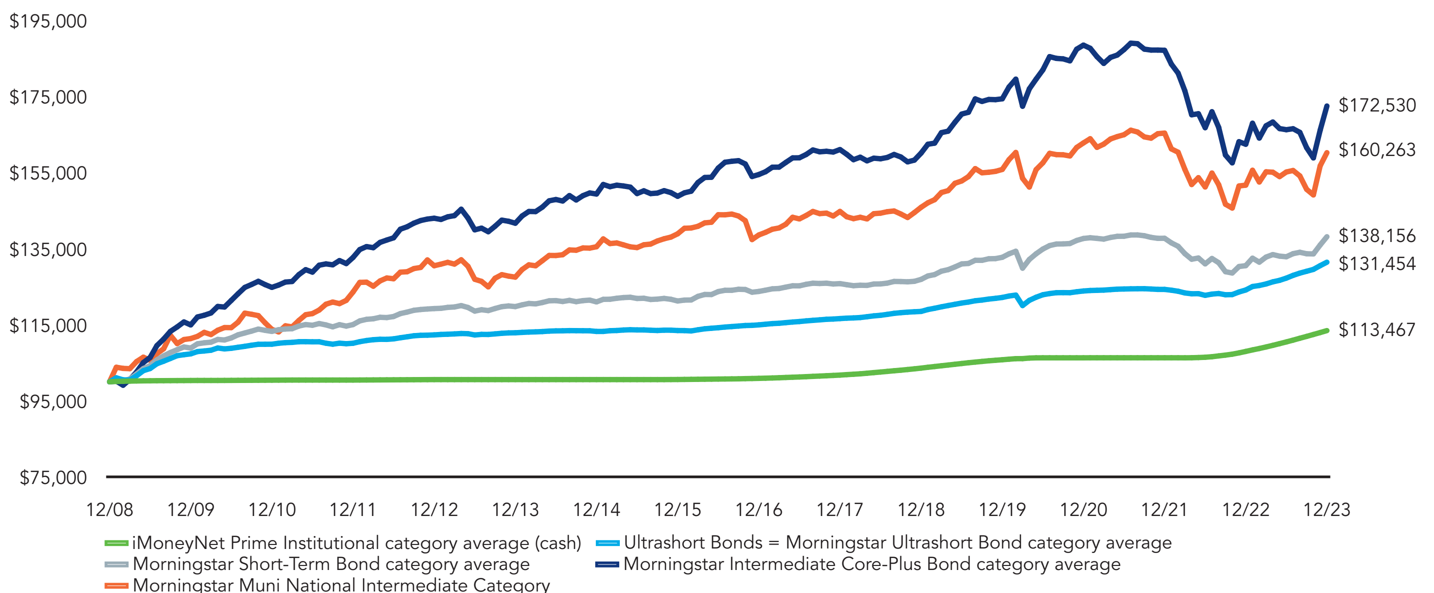
Extending duration can offer a more consistent income stream over time

Bonds can play an important role in a portfolio as a source of income and diversification, but also as a form of portfolio stability during weakening economic conditions and stock market volatility.

Holding bonds of longer duration can benefit investors when:

- The Fed lowers interest rates to stimulate the economy
- Stock markets fall due to slowing earnings
- Bond yields fall (bond prices rise)

Historical total return growth of $100,000 (Trailing 15 years)



Sources: Morningstar, iMoneyNet. Represents the growth of a hypothetical $100,000 investment beginning on 12/31/08 and assuming the reinvestment of all income and capital gains.

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Conclusion

Rather than focusing on timing and perfection, we advocate for maintaining a fixed-income allocation and adjusting durations to meet specific investor and portfolio needs. While the current rate-hiking cycle has been unusual in its scope and rapidity, and in its effect on total returns during 2022, the outlook for bond total returns going forward is positive in our view. This is an important time for investors to reconsider their portfolio allocations.

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Yield to Worst (YTW): On a bond, the yield to worst is the lowest yield that a buyer can expect among the reasonable alternatives, such as yield to maturity, yield to call, and yield to refunding.

Cash = iMoneyNet Prime Institutional category average.

Ultrashort Bonds = Morningstar Ultrashort Bond category average.

Short Bonds = Morningstar Short-Term Bond category average.

Intermediate Bonds = Morningstar Intermediate Core-Plus Bond category average.

Intermediate Munis = Morningstar Muni National Intermediate Category.

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Bloomberg US Aggregate Bond Index is an unmanaged index composed of securities from the Bloomberg Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. Indices are rebalanced monthly by market capitalization.

Indexes are unmanaged and cannot be invested in directly.

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