With the Fed on Hold, Is the Case for Bonds Kaput?

While the market anticipates future rate cuts, bonds could stand to benefit.

As inflation data has come in higher than expected recently, the number of Federal Reserve (Fed) rate cuts expected by the market in 2024 has fallen from six at the beginning of the year to just one or two. By the end of April, the 10-year US Treasury yield had risen more than 80 basis points[1] year to date and the Bloomberg US Aggregate Bond Index[2] had returned around -3%.

While the Fed decision to hold off on rate cuts for an extended period (it's been nine months since the central bank stopped hiking rates) may be disappointing to the market, it doesn't necessarily scuttle the case for owning bonds. We saw a similar situation following the Fed tightening cycle of 2004–2006. The Fed hiked rates 17 times during that cycle (vs. 11 in the current cycle) and then was "on hold" for 15 months before delivering the first rate cut in September 2007.

Despite the lengthy delay, bonds outperformed cash over the one-, two-, and three-year periods following the last hike in June of 2006 (**FIGURE 1**). Over the two years after the last rate hike, cash returned 9%, but government bonds returned 16%, the aggregate index 14%, and corporate bonds 11%. In **FIGURE 2**, we can see that yields bounced around in the year following the last rate hike and then declined the following year as the Fed's cutting cycle began (in September 2007), producing capital gains for bonds.

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Key Points

- Market expectations for Fed rate-hikes have been adjusted down from six at the beginning of the year to just one or two.
- Following the rate-hiking cycle in 2004-2006 and a lengthy pause, bonds went on to outperform cash over the one-, two-, and three-year periods.
- Though uncertainty and risks remain, investors may want to consider moving out of cash and into bonds.

FIGURE 1

Even With the Fed on a Lengthy Hold After the 2004 Tightening Cycle, Bonds Still Outperformed ...

Cumulative Returns After Last Hike in 2006 (%)

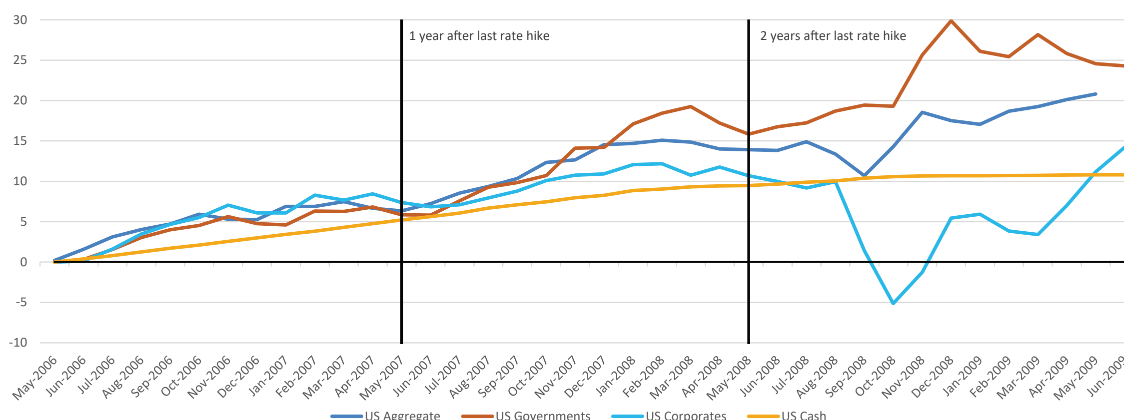
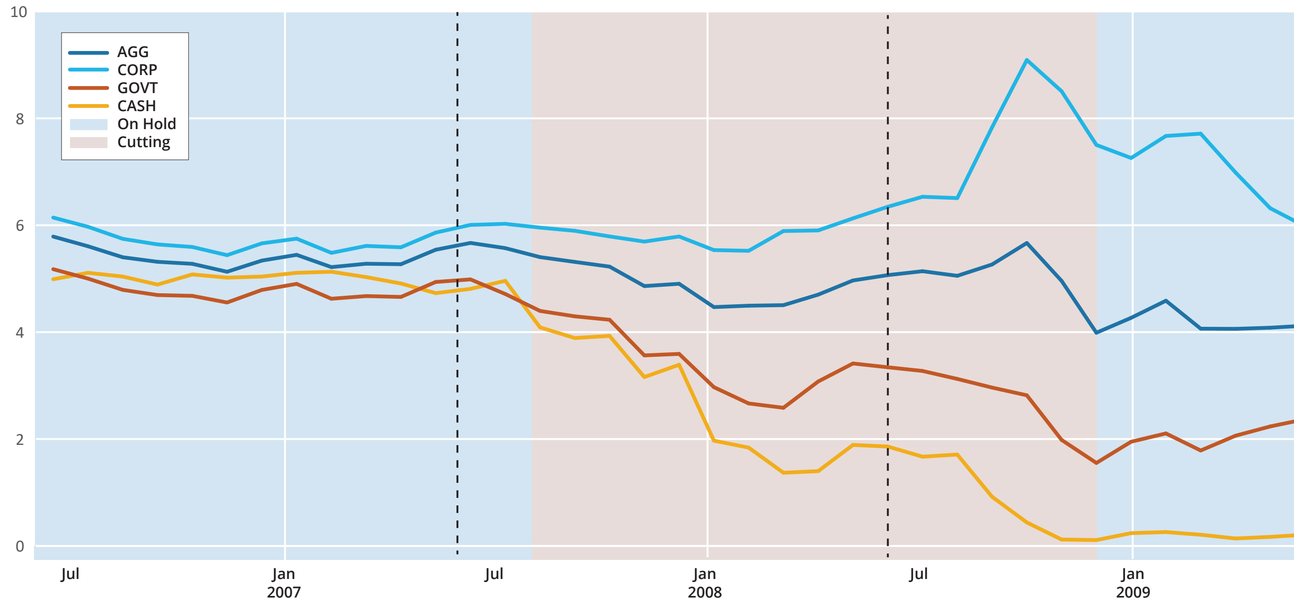


Chart data from 2006-2009. **Past performance does not guarantee future results**. Indices are unmanaged and not available for direct investment. Each data series represents the cumulative monthly return for the three years after the last hike of the June 2004–June 2006 tightening cycle. Aggregate bonds are represented by the Bloomberg US Aggregate Total Return Bond Index; corporate bonds by the Bloomberg US Corporate Total Return Index; US government bonds by the Bloomberg US Treasury Total Return Index; and cash by the Bloomberg US Treasury 3-Month Total Return Index. For illustrative purposes only. Source: Bloomberg, 5/24.

FIGURE 2

… As Yields Anticipated the Fed's Eventual Easing Cycle Prior to the Global Financial Crisis

Yield Level After the Last 2006 Hike (%)



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Three Takeaways for Investors to Consider

1. So long as the next move is expected to be a rate cut, markets should eventually anticipate this by driving yields lower and prices higher.
2. When the wait for rate cuts is longer, the investment horizon may also need to lengthen to pursue meaningful outperformance vs. cash.
3. Even though economic growth has proven resilient recently, there are early signs it may be slowing, including in employment and service sector data (in April, the services Purchasing Managers' Index[3] fell below 50 for the first time since December 2022), which could prompt the Fed to ease this year.

There are risks, of course. Not long after the 2004–2006 tightening cycle and the rate cuts that followed, we saw the Global Financial Crisis emerge and corporate bond spreads[4] blow out due to liquidity strains in the financial system. Today, while not impossible, it's difficult to envision rate cuts against a backdrop of a severe recession, given that economic growth and employment are solid and there are few excesses in corporate or consumer balance sheets.

We think the more likely risk is the potential for the Fed to pivot back to rate hikes if inflation remains stubbornly above its 2% target. But in his May 1 press conference, Fed Chair Jerome Powell said the Federal Open Market Committee's working assumption is that the next move will still be a cut given restrictive policy and signs of labor-market softening. He did say that it will take longer than expected to get to rate cuts, as policy tightening and other post-pandemic adjustments are working their way through the economy with a lag. That being said, he was more explicit about possible paths to a rate cut than a rate hike.

Investment Implications

- **Investors may want to consider moving out of cash and into bonds.** The Fed being on hold for a long stretch isn't unprecedented. Even with the Fed on hold for 15 months after the 2004–2006 tightening cycle, bonds outperformed cash over multiple time periods.
- **The Fed's next move still seems more likely to be a rate cut than a hike.** While the Fed is far from all knowing, it has pointed to softer labor data and signs of continued post-pandemic normalization.
- **Yields appear to be fair.** The market is pricing in about one or two rate cuts by year end—a much more reasonable expectation than the six rate cuts priced at the beginning of the year.

Your financial professional can help you decide the appropriate amount to hold in bonds and cash.

[1] A basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

[2] Bloomberg US Aggregate Bond Index is composed of securities that cover the US investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

[3] Purchasing Managers' Index is a monthly indicator of US economic activity based on a survey of purchasing managers at more than 300 manufacturing firms.

[4] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

Bloomberg US Corporate Total Return Index is a market-weighted index of investment-grade corporate fixed-rate debt issues with maturities of one year or more.

Bloomberg US Treasury Total Return Index is an unmanaged index of prices of US Treasury bonds with maturities of one to 30 years.

Bloomberg US Treasury Bill 1-3 Month Total Return Index is designed to measure the performance of public obligations of the US Treasury that have a remaining maturity of greater than or equal to 1 month and less than 3 months.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed-income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • US Treasury securities are backed by the full faith and credit of the US government as to the timely payment of principal and interest.

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