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You Snooze, You Lose? The Case for Bonds

Waiting too long to rotate from cash into bonds could significantly diminish your returns.

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With US 10-year yields close to 5% and the end of the year approaching, it may be time to consider whether to move from cash to bonds. In my August commentary, I showed the potential benefit of bond investments even when it's uncertain how long the Federal Reserve (Fed) will remain in interest-rate-hiking mode. Today, there's a bit more clarity on the Fed, with markets expecting the central bank to remain on hold and begin cutting rates by mid-2024 as of this writing. Still, we don't know for sure that the Fed is done. So I've taken a fresh look at why it may be better to invest in bonds before the last rate hike rather than after it.

Key Points

- While we don't know for certain if the Fed is done hiking, investors have historically benefited by buying bonds up to 12 months before the end of the Fed's hiking cycle.
- Factors such as falling inflation and tighter financial conditions could mean the Fed is done hiking.
- An incremental approach to rotating out of cash into bonds may be less risky than some investors expect.

What We Can Learn from Past Rate Hiking Cycles

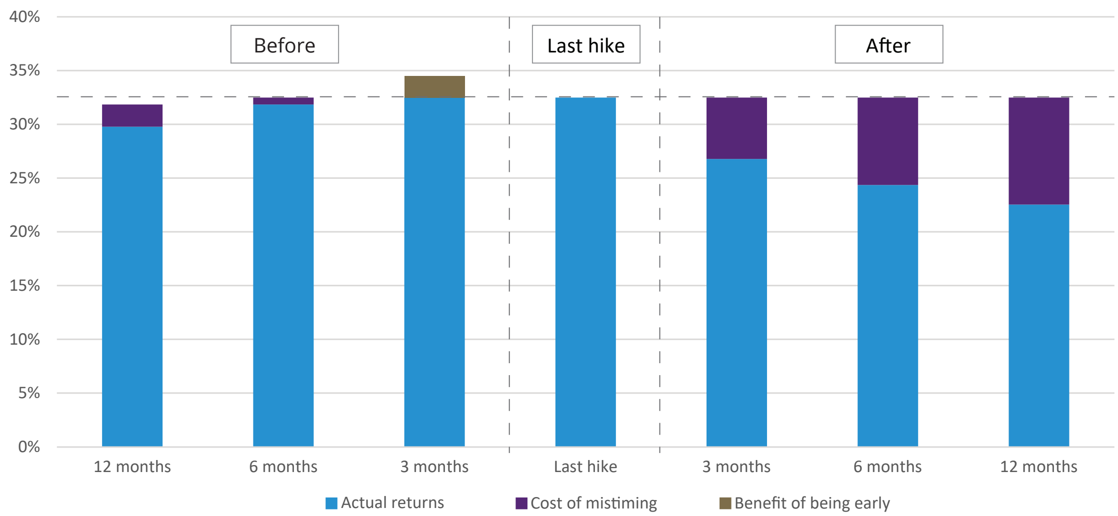
Using data from the past six Fed rate-hiking cycles, **FIGURE 1** shows the average three-year total-return advantage of being in the Bloomberg US Aggregate Bond Index[1] if an investor was three, six, or 12 months early relative to the last hike (left side of the chart), and three, six, or 12 months late relative to the last hike (right side of the chart). The purple shaded areas represent the lost total return compared to timing the last hike perfectly, shown in the middle bar, or the "cost of mistiming" the last hike. The gold shaded area is the additional total return earned compared to timing the last hike perfectly.

The key takeaway? It was better to be early than late. Investors don't have perfect foresight and, therefore, tend to price in expectations ahead of the actual event. Being three months early achieved the maximum return, and being six months early was not far off and was very similar to being "on time." Finally, being late was costly: The opportunity cost of being just three months late was an average of six percentage points, and the cost rose for being even later.

FIGURE 1

Don't Be Late

Average Three-Year Cumulative Returns for US Bonds Before, At, and After the Last Fed Hike



As of 10/25/23. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Each bar represents the average cumulative monthly return for three years at various intervals around the last hike of each tightening cycle. Tightening cycles: March 1983–August 1984, March 1988–May 1989, February 1994–February 1995, June 1999–May 2000, June 2004–June 2006, and December 2015–December 2018. US bonds are represented by the Bloomberg US Aggregate Bond Index. Source: Bloomberg and Wellington Management.

Why the Fed May Give Hiking a Rest

Rising bond yields have repeatedly surprised markets over the past year, so why do I feel more confident that we're nearing the end and moving into bonds may be a prudent strategy now? Inflation is declining. Core consumer price inflation has moved steadily down from 6.6% to 4.4% over the past 12 months. The spike in bond yields is tightening financial conditions by making it more costly to borrow. As the Fed's recent statement alluded, higher bond yields are doing some of the tightening work for them—a view that will likely factor into the Fed's rate decisions over the coming months. Finally, I see evidence the Fed's cumulative 550 basis points[2] of rate hikes are feeding into the real economy but with a longer lag than usual. Banks' lending conditions are tightening, US equity markets are less buoyant, and wages are coming off the boil.

Where could I be wrong? Labor markets are still very tight and while wages have come down, they're still inconsistent with 2% inflation. Unemployment may need to be meaningfully higher than the Fed's forecast of 4% to bring wages and inflation down sustainably enough to achieve its target; that would mean more tightening may be necessary. Even if that's the case, however, having a three-year investment horizon could still bring a total-return advantage to bonds relative to cash, as more tightening would also revive fears of recession—a good thing for bonds as it would turn the Fed's focus to rate cuts.

Finally, a longer-term concern is the term premium (the additional yield investors require as compensation for holding longer-term bonds), which has risen recently in response to a myriad of factors. If the term premium on US Treasury bonds rises further due to increasing US government deficits and bond supply, that could inhibit any meaningful bond rally.

The Risk of Owning Bonds vs. Cash

As with any investment, there are relative risks to be considered. Cash, CDs, and money-market funds generally involve the least amount of risk but also offer the least potential return.

Bonds tend to carry greater risk than cash equivalents, including the risk that a bond's lender may be unable to make interest or principal payments on time (credit risk). Bonds with longer maturities (e.g., 10 years or more) can offer higher returns but can lose value when interest rates rise (interest-rate risk). Some bonds (in particular, corporate bonds) are also subject to the risk that the lender may choose to pay off the bond early, which could deprive investors of potential interest income (call risk). When rates are falling, lenders sometimes choose to pay off bonds ahead of maturity in order to reissue bonds at lower prevailing rates.

Investment Implications

- **Investors may want to consider moving out of cash and into longer maturities.** Bonds now have comparable yields to cash and have benefited materially more than cash in the past six Fed interest-rate-hiking cycles, on average, over a three-year horizon. Since the market anticipates the last hike, much of the positive return has historically accrued before that.
- **An incremental step out of cash into bonds may not be as big a risk as some expect.** Even if the Fed keeps hiking, the market can't have perfect foresight about the timing of the last hike. The key is that the cycle is likely either over or close to the end, in which case yields will likely stabilize or rally.
- **Investors can make this move incrementally by moving into the intermediate part of the yield curve.**[3] As markets anticipate the end of the Fed's tightening cycle, the yield curve steepens, which could benefit the intermediate part of the curve as much or more than the long end.

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

[1] 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.

[2] 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.

[3] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

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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