

Bonds in 2023: Keep calm and clip the coupons



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Higher income has reduced near-term risk and is setting up the bond market for a run of attractive long-term returns.

Highlights

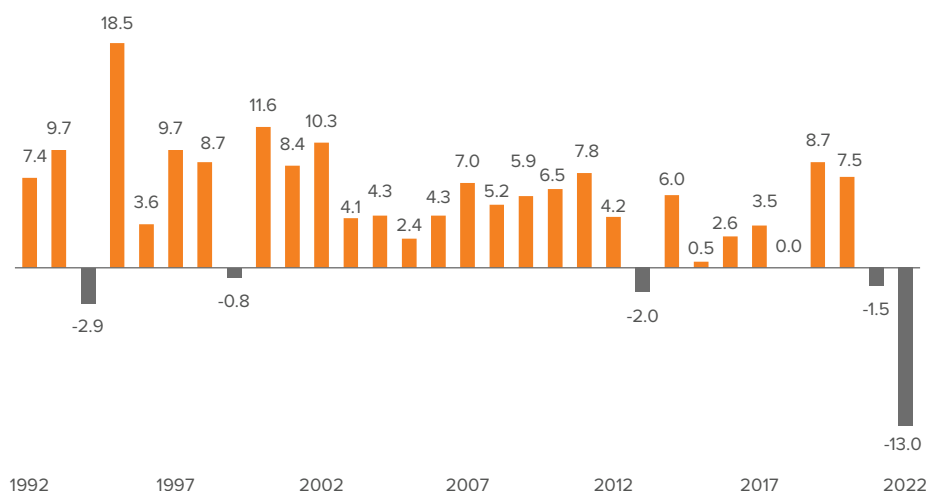
- **Poised to get back on track:** Bond returns have typically been strong in the year following a selloff.
- **More reward for less risk:** At current yields, the income earned on bonds provides a return buffer even if rates continue to rise.
- **Bonds are well positioned for the long term:** Historically, there has been a strong correlation between starting yield and future returns.

2022 bond rout sets the stage for strong returns

Bonds, often thought of as the anchor of a broader portfolio, posted a 13% loss in 2022, the worst calendar year for the Bloomberg US Aggregate Bond Index (the “Agg”) in at least 30 years (Exhibit 1).

Exhibit 1. 2022 bucked the bond market’s longer-term trend of steady performance

Bloomberg US Aggregate Bond Index calendar year returns (%)



As of 12/31/22. Source: Bloomberg. Investors cannot invest directly in an index. **Past performance does not guarantee future results.**

For some investors, the fallout in fixed income markets has raised questions about the role bonds play in strategic asset allocations. However, we believe this is a time to consider adding to bonds, not stepping away. In fact, the broader bond market has historically delivered strong returns in the year following a selloff. In addition, current market dynamics have significantly enhanced the risk profile of bonds. Here’s why.

Higher income means less risk in the near term

Rising interest rates are generally bad for bonds, especially for those with longer-dated maturities. But not all rate increases have an equal impact on a bond's total return. If rates are very low to begin with, the impact of rising rates on bond returns will be much larger, because the starting yield provides less of a buffer, and the change in relative terms is much larger, as shown in Exhibit 2. And that is exactly what happened in 2022. The yield for the Agg started 2022 at 1.75%. By the end of 2022, the yield on the Agg had jumped to 4.68% — a staggering increase in percentage terms, with little income to offset the price decline.

Exhibit 2. When rates rise from already high levels, bonds suffer less

Rate increases are like driving a car: zero to 60 mph can knock you back in your seat, but once you're going fast, speeding up is less noticeable.

Interest-rate move from 1% to 2%

= **+100% change**

= larger price decline

Interest-rate move from 4% to 5%

= **+25% change**

= smaller price decline

Source: Voya Investment Management. For illustrative purposes only.

As rates increase to more normalized levels, the negative impact from additional rate moves higher starts to wane — which is the environment we are in today. The higher yield earned on bonds serves as an extra cushion from price deterioration if rates continue to rise.

As illustrated in Exhibit 3:

- The Agg could absorb an 88 basis point increase in its yield and investors would still break even — meaning that the income generated would fully offset the decline in price (scenario 1).
- Even if rates rose to their peak level from the past 20 years, the total return loss would be relatively modest (scenario 2).
- If rates fall back to their 20-year average, it would translate to a total return of more than 10% (scenario 3).
- And if the Fed were to unexpectedly cut rates due to a hard economic landing, the total return would be more than 15% (scenario 4).

Exhibit 3. Expected returns for the Agg in different interest rate scenarios¹

Bloomberg US Aggregate Bond Index

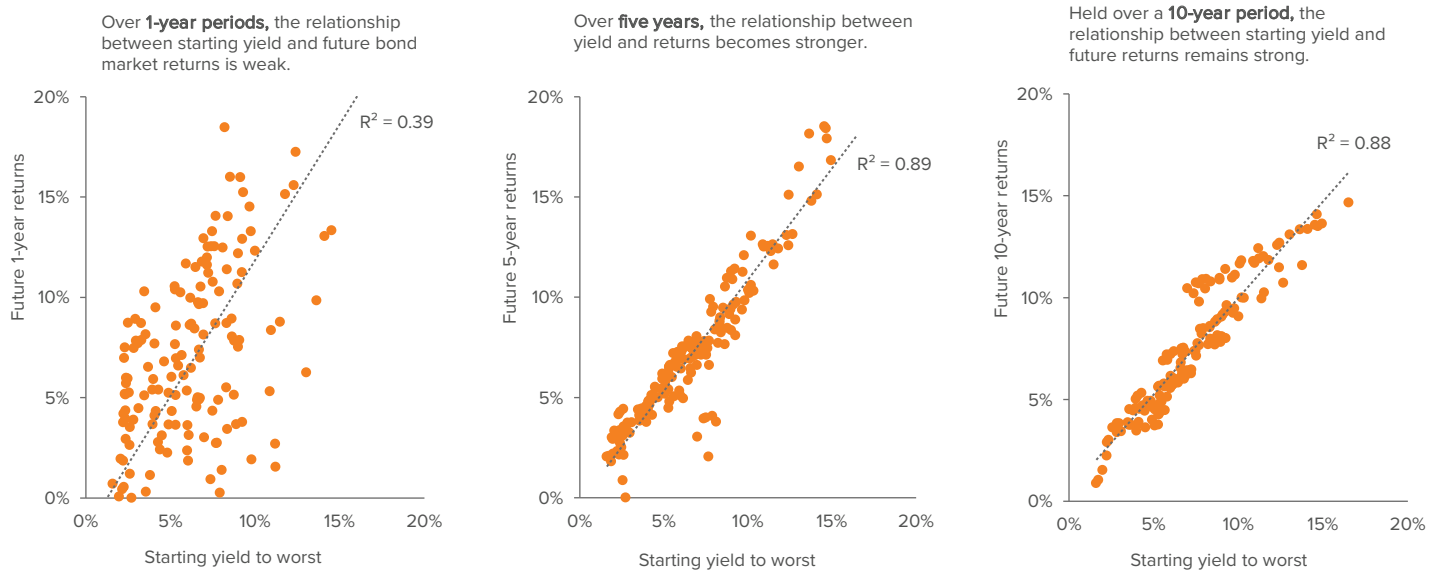
	Scenario 1 Investors "breakeven"	Scenario 2 Rates rise to 2-decade high	Scenario 3 Rates revert to long-term average	Scenario 4 Fed cuts rates due to hard landing"
A. Starting yield	4.64%	4.64%	4.64%	4.64%
B. Yield change	0.88%	1.26%	-1.42%	-2.00%
C. New yield (A + B)	5.52%	5.90%	3.22%	2.64%
D. Price return	-5.52%	-7.94%	8.95%	12.60%
E. Total return (C + D)	0.00%	-2.04%	12.17%	15.24%

As of 02/15/23. Source: Bloomberg. 1) Calculations based on the Agg's current duration of 6.3 years and assume immediate parallel shift in yield curve and the new yield is then earned for the 12-month period. **Investors cannot invest directly in an index.**

The strong correlation between starting yield and future returns

Rates were extraordinarily low for a very long time. Given this environment, many advisors likely forgot the important role that income plays in long-term total returns for bonds. Historically, the starting yield of the Agg has been a good indicator for long-term returns. Exhibit 4 shows relationship between starting yield and rolling returns over various time horizons.

Exhibit 4. Starting yield has been a good indicator of long-term future returns



Rolling periods from 1976 to 2022. Source: Bloomberg. Information shown is for the Bloomberg US Aggregate Bond Index. Investors cannot invest directly in an index.

A key reason to own core fixed income is to diversify equity and credit risk. While that assumption didn't hold up well in 2022, the great news for bond investors is that interest rate normalization has returned us to a world in which income is a meaningful component of return. In addition, if recession risk increases, core bonds could rally due to their safe-haven status. Against this backdrop, we believe there is a wider range of scenarios that can lead to positive returns for bonds. In our view, The asset class should remain a key part of any strategic allocation.

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The **Bloomberg US Aggregate Bond Index** is a widely recognized, unmanaged index of publicly issued investment grade US government, mortgage-backed, asset-backed and corporate debt securities. The Index does not reflect fees, brokerage commissions, taxes or other expenses of investing. **Investors cannot directly invest in an index.**

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