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BOND iQ
Intra Quarter Update

The Role of High-Quality Bonds in a Low Interest Rate World (Part 1 of 3)

It's hard to believe that it's been over a year since the seismic impact of COVID-19 was first felt around the globe. As the world retreated into lockdown, economic shockwaves sent financial markets into a tailspin. Policy makers responded quickly and powerfully, unleashing a tidal wave of fiscal and monetary stimulus that ultimately helped stabilize the economy and markets. Within only a few short months, equity markets recovered most of their March losses, fueled by optimism for a swift economic recovery. Bond yields, however, still remain well below pre-COVID levels. As a result, many investors have been left questioning what role high-quality bonds play within diversified asset allocations in light of the persistently low interest rate environment. In this three-part series of "BondiQ," we explore the three most common questions that we hear from investors regarding the outlook for high quality fixed income.

Question #1: With interest rates so low, will high-quality bond portfolios still provide a reliable "hedge" against economic or market volatility?
Answer: Yes, we believe that high-quality bond portfolios will still offer a reliable portfolio offset during periods of economic or market volatility. In fact, interest rates have slowly but consistently risen since reaching all-time record lows last August. While the short end of the yield curve remains tethered to the Fed's easy monetary policy, longer-term bond yields now offer bond investors a reliable cushion against future risk asset volatility. To help quantify this "hedge" potential, consider the results of a simple scenario analysis. In this hypothetical example, we assume that market volatility helps drive interest rates back to August 2020, lows (for reference the 10-Year Treasury was around 0.50%) with a total return horizon of 3 months. In this scenario, the approximate total return of the Bloomberg Barclays Aggregate Bond Index is around 3.9% according to Bondedge. Almost 4% total return might not sound overly compelling, but as the table below illustrates, that is modestly above the average return for the AGG during the 11 worst quarters for equities going back to 1994- including periods when interest rates were much, much higher. While that total return figure may be softened by widening corporate bond spreads, this simple exercise does helps illustrate that the "bond hedge" remains very much alive and well, despite persistently low interest rates.

Performance during the Worst Quarters for Stocks since 1994*

QUARTER ENDING	S&P 500 INDEX	BARCLAYS HIGH YIELD	BARCLAYS AGGREGATE
DEC-08	-21.9%	-17.88%	4.58%
MAR-20	-19.6%	-12.68%	3.15%
SEP-02	-17.3%	-2.93%	4.58%
SEP-01	-14.7%	-4.23%	4.61%
SEP-11	-13.9%	-6.06%	3.82%
DEC-18	-13.5%	-4.53%	1.64%
JUN-02	-13.4%	-6.41%	3.69%
MAR-01	-11.9%	6.36%	3.03%
JUN-10	-11.4%	-0.11%	3.49%
MAR-09	-11.0%	5.98%	0.12%
SEP-98	-10.0%	-4.55%	4.23%
AVERAGE	**-14.4%**	**-4.28%**	**3.36%**

In the next edition of this 3-part series, we take a deeper dive into our outlook for interest rates. Growing government debt, a $7 Trillion Fed Balance Sheet, and the prospect of additional fiscal stimulus has sparked increasing anxiety among investors over the outlook for future inflation. We take a closer look at our fundamental outlook for inflation and provide a simple roadmap to help formulate a likely range for interest rates throughout the coming years.

As always, please don't hesitate to reach out to any member of the Johnson team and be on the lookout for the second installment of our 3-part series on high-quality fixed income during a low interest rate environment.

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