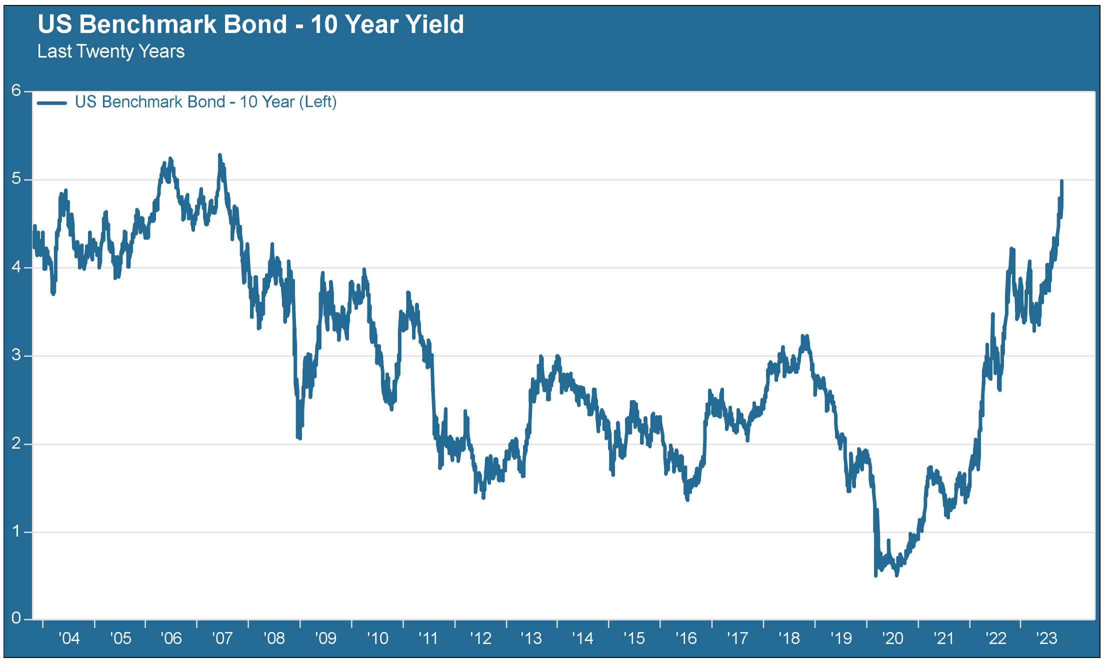
Weekly Market Flash

So Much for Bond FOMO

October 20, 2023

Sometimes it seems like we do nothing around here but write about bonds. Unfortunately, what is normally the dullest category in the pantheon of portfolio assets is where all the action has been this year. Where the action is, attention must be paid. Here's a twenty-year picture of the 10-year Treasury yield, which this week has been bellying up to the five percent level last seen in the summer of 2007.



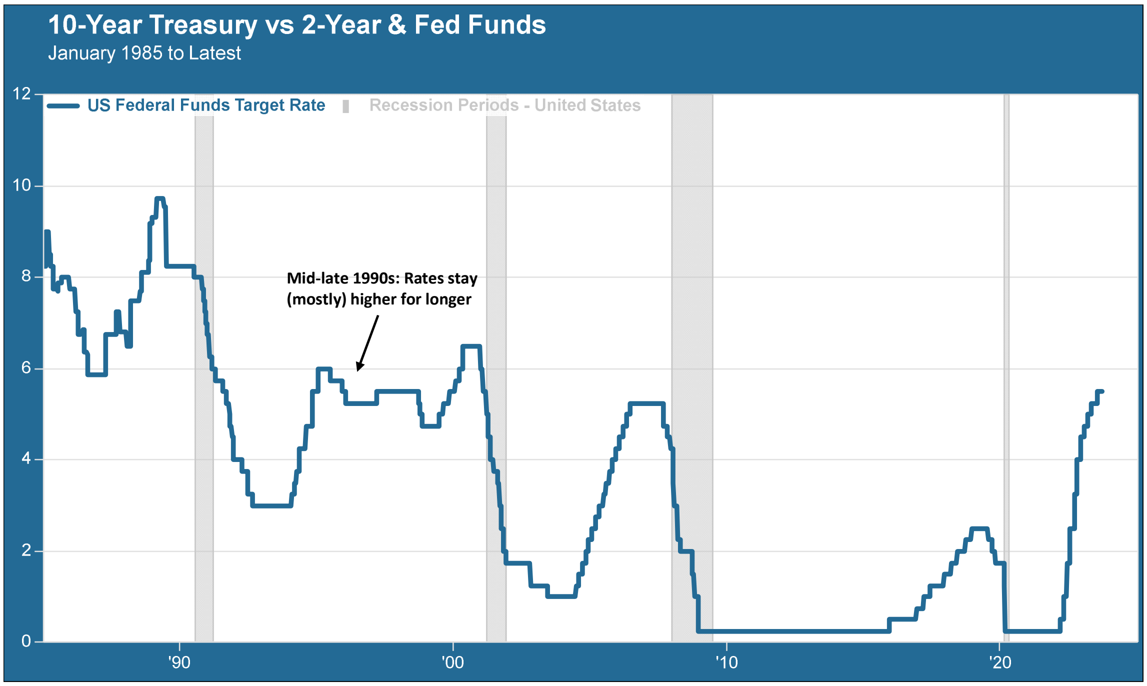
Source: MVF Research, FactSet

Year of the Bond

Let's cast our minds back to about one year ago, when the 10-year yield was hurtling towards four percent (a level that at that time had also not been seen in over a decade). This was a "once in a lifetime opportunity" said just about anyone with a bond strategy to sell. Investors got the message. Suddenly, the FOMO (fear of missing out) that had recently been the dominant vibe in areas like cryptocurrencies and loss-making tech companies with improbable growth scenarios was now making itself felt in the staid, buttoned-down world of fixed income. As buyers rushed in, prices went up and yields fell, giving an even more urgent sense of scarcity value to the yields on offer. Financial media outlets rang in the New Year in January 2023 as the "year of the bond."

Lessons From History

The rush to lock in yields when the 10-year was around 3.5 percent, which is where it was at the start of this year, was not irrational. The Fed funds rate was at 4.5 percent, and many economists were of the opinion that the tightening cycle would come to an end before short-term rates got to five percent. Investors with an eye for history looked back at several decades of Fed monetary policy and concluded that, usually, rates start coming down pretty quickly after the Fed funds hits its peak. Moreover, the rate cuts normally happen because a recession is looming on the horizon – and the widespread assumption at the beginning of this year (including by us) was that a recession was likely in store for 2023 as well. The chart below illustrates this pattern – notice how the rates start coming down right at the doorstep of the recessions in 1990, 2001 and 2008 (2020 is a different case, since the rate cuts happened for different reasons and before anyone knew there would be a recession caused entirely by a global pandemic).



Source: National Bureau of Economic Research, MVF Research, FactSet

So far so good. But there were two things missing in the rationale of rate cuts and historical precedence. First, the time period shown in this chart does not include any period in which inflation was an actual, clear and present, top-line economic problem. The Fed's credibility as a central bank rests primarily on its willingness to do whatever it takes to keep inflation under control. In the 1970s it lost a lot of its credibility for that very reason – constantly bouncing back and forth between fighting inflation and fighting recessions, ultimately leading to stagflation. Jay Powell, the current Fed chair, is astutely aware of the history of the organization he leads. His insistence from the beginning of the current tightening program that rates would stay high until inflation was under control again should have been taken more seriously by the bond market. It wasn't, and a year later, with the Fed funds at 5.5 percent and the 10-year at the five percent Rubicon, investors are feeling the pain.

The second missing part of the rate cut rationale was asking what happens if the recession doesn't materialize. For this, consider what happened in the second half of the 1990s. The Fed had raised rates starting in February 1994, a move which took the market by surprise and was seen as a pre-emptive move by the bank to head off a potential return of inflation. Rates eased a bit after the July 1995 peak, but stayed at an elevated level for the remainder of the decade. Recall that the economy was growing during this period, there was no recession, and the Fed decided it was prudent to keep rates higher for longer to ensure that the strong economy didn't run so hot as to bring back inflation.

All of which is to say that markets are subject to millions of things happening all the time that can upend what may seem like the most compelling of cases. Yes, bonds looked attractive twelve months ago when the 10-year was at four percent. We had many spirited discussions in our investment committee meetings at the time, not to mention a barrage of enticements by various money managers trying to sell us on FOMO. We also believed that a recession was more likely than not. But we also listened closely to Powell and his colleagues at the Fed, and took seriously their insistent repeating of the higher for longer mantra, and thus took slow and cautious steps rather than rushing pell-mell into longer durations. The good news, such as it is, is that bonds generally may be able to supply something they have not for a long time, namely a stable source of income for clients at a stage of life where income is important. Neither we nor anybody else knows what is going to happen with yields in the coming days or weeks or months. But we do not see the income opportunity going away any time soon.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research