Investment Insights
Bond Yields Hit Multi-Decade Highs & the Israel Conflict Intensifies: Our Investment Views

Key Takeaways
- The serious attack on Israel and subsequent global reaction is likely to add to investor risk aversion.
- On top of that, a strong jobs report has caused bond yields to jump to multi-decade highs.
- Given the confluence of issues, we assess the “safe haven” status of Treasuries. It depends on the risk in question, but we believe Treasuries still play a prominent role in risk management.
- Moreover, we like Treasuries in today’s environment, with a preference for shorter-dated bonds where we can get over 5% yields.

Bonds are a core part of most investor toolkits. They come in different shapes and sizes, but have historically offered two strong propositions:

1. Lower-risk bonds, such as U.S. Treasuries, can act as a ballast against stock market volatility, balancing the risk/return pendulum.
2. Bonds generally offer positive returns above inflation, typically beating cash over the long run.

This is not the recent experience. With the sudden rise in interest rates and surprisingly strong jobs reports, we’ve seen a big move in U.S. Treasury yields. This has left many investors with bond allocations in the red again for 2023, following declines in 2022.

The narrative gets more confused in the wake of the horrid attack on Israel. It’s not unthinkable that an advisor or client may wonder whether we can still count on Treasuries as a safe haven in times of geopolitical crisis. (By “safe haven” we mean that U.S. Treasuries are one of the few asset classes investors turn in broad market selloffs.)

So, do bonds still deserve a place in a portfolio? Should investors maintain their long-standing rationale for mixing bonds and stocks together? And what can we expect from bonds, given the tragic developments in the middle east? While it may be difficult to swallow, there are reasons for optimism for the future of fixed-income returns.

Are bonds a safe haven in the midst of the recent attack on Israel?
Given the sudden and continuing travesties in Israel, let’s tackle the “safe haven” status first. In recent months, the safe haven status of U.S. Treasuries has been a topic of debate. With concerns about the U.S. government’s huge deficits and the Fed’s higher-for-longer narrative (which could mean the U.S. needs to pay more to cover its debt payments) some have speculated on whether Treasuries’ safe haven status is intact.
We believe it depends on the risk in question. If U.S. equities or credit declines because of concerns surrounding interest rates, then Treasuries may not provide the ballast investors would like. That’s indeed what we saw in 2022.

However, in the case of geopolitical conflict, the focus is on risk aversion generally. In this case, relative safety in an unstable world matters most, so we expect Treasuries to act as a store of value.

The trouble comes from the confluence of events, as these geopolitical risks occur at the same time as rate rises. In those instances, our preference is for the shorter end of the curve. This generally means Treasuries with a maturity date of less than five years, which have yields in excess of 5%, with the backing of the U.S. government and limited interest rate risk.

**Do we still think bonds are a good investment?**
Looking forward, our outlook for fixed-income returns remains optimistic. Yields are resetting at higher levels, while prices are declining, creating attractive opportunities in fixed income from a valuation perspective.

Particularly, areas like short-term Treasuries, boasting yields of 5% or higher, present an opportunity for investors. It is possible to bolster portfolios with substantial income without exposing excessive duration risk (a measure of interest rate risk).

Conversely, the longer-term debt market faces persistent pressure due to expectations of prolonged Federal Reserve policy and the enduring strength of the economy. With the sell-off in long-term Treasury bonds, we are cautiously optimistic about the better prospects for higher returns and income, though we still advise investors to carefully consider their overall exposure to duration.

**Why are Treasury yields still rising?**
Reflecting on the beginning of the year, the financial landscape and consensus projections unanimously painted an optimistic picture for a soft landing with interest rate cuts. Namely, inflation was moderating, coupled with a slowing economy due to the assertive measures taken by the Federal Reserve. Subsequently, we have witnessed a rollercoaster of developments that have notably yielded a remarkably resilient U.S. economy, seemingly impervious to the policy maneuvers of the Fed. Furthermore, certain aspects of the economy suggest that attaining the Fed's 2% inflation target may require more time than initially envisaged.

**Does the jobs report matter?**
The labor market remains the driving force behind unexpectedly high demand and wages, despite a 5% increase in interest rates over the past 18 months. A lower-than-average supply of workers, coupled with persistent demand for goods and services, has maintained hiring at a pace that surpasses typical expectations in a rising interest rate environment. Additionally, fiscal policy, characterized by increased spending and widening budget deficits, is acting as a stimulant for the economy, contrary to the Fed's objectives in its battle against inflation.

**Is the Fed's “higher for longer” message the main catalyst?**
Taken together, this backdrop has fostered the notion that interest rates will remain elevated for an extended duration. Consequently, long-term Treasury yields have surged significantly within just a few months, as markets brace themselves for this scenario — an outcome that was not accounted for just half a year ago. As long as the labor market retains its resilience in the face of monetary policy actions,
fiscal policy remains accommodative, and overall demand remains on a steady course, the Federal Reserve lacks a compelling motive to shift away from its hawkish stance. An untimely shift toward a more accommodating position poses the risk of inflation rekindling, reminiscent of the Volcker era in the 1980s.

To reiterate, the concept of enduring higher interest rates was not factored into market forecasts earlier this year. Now, we are witnessing markets adapt to this new reality in real-time, as it becomes evident that the economy is stronger than anticipated.

**Any new risks we need to think about? What are the consequences of higher rates?**

As financial markets continue to absorb the implications of prolonged elevated interest rates, the practical consequences in the medium term may face challenges. We are already witnessing the impact on the housing market, where we observe declining prices and subdued demand. Furthermore, consumers who had previously been buoyed by stimulus measures during the Covid era have now depleted their surplus savings, which had been a driving force behind the remarkable demand surge in 2020 and 2021. With diminished savings and higher interest rates affecting credit cards and loans, as well as increased prices for everyday essentials, the risk of reduced consumption looms large.

If demand erosion becomes widespread, it could jeopardize the revenue and cash flows of companies across the board. This, in turn, could lead to a reversal in hiring trends or even sustained job cuts across various sectors of the economy. These same businesses are also susceptible to higher debt costs when they need to refinance or raise capital. Many of these companies have outstanding low fixed-rate debt issued during 2020 and 2021. However, if the Federal Reserve maintains its commitment to prolonged higher rates, these companies will be compelled to refinance in a substantially higher interest rate environment, adding pressure to their ability to manage their debt.

**What’s the likely impact on the economy?**

In summary, elevated interest rates have a tightening effect on the overall economy. Some repercussions manifest suddenly, as seen in the housing market, while others have a delayed impact and take time to materialize, such as in labor markets. There is reason to believe that the Federal Reserve may stick to its higher-for-longer policy, and history suggests that recessions (hard landings) occur more frequently than smooth economic transitions (soft landings). However, predicting when or if such an event will occur remains challenging. Therefore, it is advisable to construct investment portfolios with a range of potential outcomes in mind, avoiding undue bias towards a single scenario.

**Do Treasuries still offer the same diversification?**

As a core holding among many investors, owning longer-term Treasuries usually offers a twofold benefit:

- First, it mitigates the opportunity cost of remaining invested in short-term debt. In the event of a Fed policy reversal and interest rate cuts, short-term debt could experience a sharp decline in yields, forcing investors to refinance at significantly lower rates. Maintaining exposure to long-term bonds secures higher yields both today and for an extended period, thereby reducing opportunity costs.
- Second, long-term Treasuries have historically served as effective diversifiers in the face of credit and equity risks during market downturns.

While we acknowledge the possibility of continued economic resilience, the potential for a conventional downturn should not be discounted. In such a scenario, long-term Treasury exposure could still offer a hedge against riskier segments of your investment portfolio. Nevertheless, it’s important to note that...
during this cycle, the diversification benefits of long-term Treasuries have been less pronounced, primarily due to a higher inflation environment. If inflation proves to be more persistent than anticipated, the traditional negative correlation between long-term Treasuries and equities may not be as robust.

**Does the “inverted yield curve” mean anything in today’s context?**
The current shape of the yield curve could pose a challenge for long-term Treasuries potentially mitigating equity risk. Our studies have demonstrated that in instances of an inverted yield curve, long-term Treasuries have shown a diminished ability to shield against declines in equity markets. Conversely, in situations when the curve is steep (with long-term interest rates surpassing short-term rates), long-term debt has exhibited the ability to garner substantial returns amid periods of declining equity markets.

**What do we think of corporate bonds in this environment?**
While corporate bonds still have a place, we find credit to be relatively overpriced. Whether examining investment-grade or high-yield debt, we are unable to justify an overweight position at present. The spreads investors receive for holding this debt are currently at or slightly below long-term averages. In other words, taking on risky debt like high-yield bonds offers limited yield advantages relative to risk-free alternatives. Additionally, given the heightened likelihood of a recession, relatively speaking, we are uncomfortable with current valuations.

**Final Thoughts**
In the near term, further volatility is possible, so managing risk is important. But Treasuries offer positive forward-looking prospects after inflation (especially for long-term investors) and we continue to see merit in these holdings.

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