# Asset TV Fixed Income in Focus

Gillian Kemmerer:

Welcome to Asset TV. I'm Gillian Kemmerer. Today we are joined again by Andy Sparks, managing director and head of portfolio management research at MSCI, who will put bond returns into perspective. Andy, it's always great to have you in the studio and it's often on Fed decision day, which you say is coincidence but I say it's fate, so it's wonderful to have you in.

Andy Sparks:

Well, thank you, Gillian. Always a pleasure to be here.

Gillian Kemmerer:

So if we recap what happened just about an hour ago, the Federal Reserve maintained rates at their current level, but also maintained its outlook for three cuts this year, which is interesting because US recent inflation prints have run relatively hot. So how have bonds really performed in the last few years in light of both high inflation and high rates?

Andy Sparks:

Well, Gillian, the performance of bonds so far in 2024 has been generally negative. This is true for the investment grade sector. We've had some unexpectedly high inflation readings during January and February. That's fueled concern that the Fed is going to keep rates higher for longer. The result is higher yields, lower prices and negative returns for the investment grade bond sector. High yield has fared a little differently. It's actually generated some positive returns, and it's mainly because bond spreads. So high yield bond spreads have tightened very significantly this year. So 2024 has not really been a particularly good year for bonds.

In terms of recent performance, let me also call out what happened in 2022. I still consider that recent and I think it's very instructive for investors. So we had really, by historical standards, very, very bad returns in the bond sector. So looking at the MSCI US Government Index, returns of about minus 13% for the year. This was driven by 40-year-high inflation, driven by the Fed's extremely aggressive tightening of monetary policy, but it's a year that bond investors would've rather forgotten. But it's there and it's something investors need to consider going forward as well. What might be the ingredients that could cause something like that to happen again?

Gillian Kemmerer:

How can investors evaluate bonds from a long-term perspective?

Andy Sparks:

Well, I think it's useful to look at a lengthy history of returns. I think it's also useful to look at bonds relative to equities. And I think this really helps us better understand how asset allocators might be viewing bonds within a broader portfolio of context. So we looked at returns from 2007 all the way up to the present, and our source for returns were MSCI Equity and Bond Market Indexes. And there were a number of striking patterns. Number one, equities just did generally great, with the US leading the way. Within the bond sector, there were some notable differences in returns, but the real takeaway is that bond returns were a lot lower than equity returns.

And within the government bond sector, returns on the US Government Index were barely ahead of inflation and returns in other government bond sectors were even lower. And so generally, government bonds did among the worst. Corporate bonds did better, with high yield leading the way.

And so it's of course important to look at history, it's important to look at average returns, but historical average returns can also deceive and can mask risk. And so we also looked at a real drawdown event in the market. Specifically we looked at the global financial crisis and how different sectors performed then. And so at one point during 2008, the MSCI Equity Index, one of the leading indexes for global investors, was down almost 50% and bond returns were not down nearly as much. In the case of the corporate bond sector, returns were down, with high yields performing worse than investment grade, but both sectors did have their worst periods during 2008. They were negative returns. Very interestingly and in strong contrast, the US government bond market was up very significantly. So for the year, its performance was almost 10%.

So I think a very important question for investors is what significance do these historical returns hold for the future? Some great sage said, "History may not repeat, but it might rhyme." And so I think one of the takeaways from looking at historical returns is that yes, it is true, maybe expected returns on bonds are lower than other asset classes, but importantly, bonds may also offer very critical at times downside protection against equity market volatility. So I think those were few of the key takeaways from looking at historical returns.

Gillian Kemmerer:

The example you just gave of the global financial crisis reminds me of a conversation we've had a few times here, and it begs the question, are we still observing diminished diversification benefits of bonds as an asset class? And is this a trend that's likely to continue?

Andy Sparks:

Generally, yes, there continues to be less diversification than in prior years. So this diminished diversification's really been observed over the past two to three years. But there are also hints that things may be changing a little bit. So in our analysis of the past two to three years, we did observe that bond returns and equity returns were tending to move in the same direction in strong contrast to the prior 20 years' worth of data. And it turns out even within the bond market, we recently did some analysis looking at movement of credit spreads and government bond returns and we found that, again, over the past two to three years, that it tended to be the case when US government returns were negative, credit spreads tended to widen. And again, that's a little different from what we'd observed in prior years. So even within the bond market, there's been this noteworthy diminished diversification.

Now the hint that things might be changing can be seen in the return pattern that we've seen for 2024. So as I mentioned earlier, for the investment grade sector, we've experienced negative returns so far in 2024. But in contrast, equities have had a really, really strong year. And so there has been this decoupling of returns recently between bonds and equities. I should also say even within the fixed income sector, we've observed, again, as I mentioned, high yield and more generally credit spreads have tightened this year, even though US government yields have gone up. So this sort of diminished diversification we've seen over the past two to three years, there are some hints that this might be changing. And I would also like to underscore that this stands in really strong contrast to 2022 when we had really bad bond returns at the same time that equity returns were hit hard. So they were all this negative returns in 2022, as I mentioned earlier, is really driven by inflation and Fed activity. But this relationship between, this tight coupling that we saw in 2022, it seems to be diminishing in 2024.

So I think a really important issue for investors to focus on is how the market is looking at how economic growth and also how the prospect for improved productivity through, for example, AI, how that may be affecting the different sectors. And so one interpretation of the 2024 returns is simply that growth has been viewed as a positive for equities. And although it may keep bond yields higher because of this idea that the Fed may need to keep rates higher for longer because of concerns about inflation, it may not be affecting the equity market as much because those cash flows that companies may be receiving, those future earnings, may be sufficiently high to offset the impact of higher rates.

Gillian Kemmerer:

So an important consideration, of course, for fixed income asset allocators is bond yields. So what patterns are you seeing there and what are the key takeaways?

Andy Sparks:

The good news for investors is that real bond yields are very high by the standards of the past. And in the case of the US in the 10-year sector, real yields have gone up about 300 basis points since the end of 2021. They're close to their highest levels of the past 15 years. That same statement is also true for many other countries. From an asset allocator's perspective, it's looking tempting. And it's also important, I think, to compare bond yields to forward earnings yields from the equity market. And again, by that criteria, bonds are looking relatively cheap. So it is tempting, it is definitely something that a lot of investors are looking at. But against the background, you do need to take into account that inflation has been unexpectedly high this year. As the Fed mentioned at its March FOMC meeting, it's not going to begin lowering rates until they're quite confident that inflation is headed in the right direction towards its 2% target. So although there are opportunities out there in bonds, yields could still go higher, and those opportunities are offset somewhat by risks as well.

Gillian Kemmerer:

Well, Andy, thank you so much for sharing your view on the fixed income landscape and always offering such a comprehensive historical perspective.

Andy Sparks:

Thank you, Gillian. Always a pleasure to be here.

Gillian Kemmerer:

And thank you for tuning in. From our studios in New York, I'm Gillian Kemmerer for Asset TV.