THE CASE FOR BONDS

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AGENDA

Brief History

Bond Yields’ Long Decline

Post-Financial Crisis

Post-COVID

The Pain Trade

The Future

WHY DO INTEREST RATES MOVE?

Interest rates are constantly changing, for various reasons:

- Changes in inflation, or changes in inflation expectations
- Fed policies—including adjustments to Fed funds rate and (more recently) QE
- Demand for credit—e.g., homeowners and businesses may need to borrow $$
- Shifting demand and risk preferences among investment options
- Changes in demographics

DISTINCTION: YIELD VS. TOTAL RETURN

Bonds, like stocks, generate total returns through a combo of income and price change

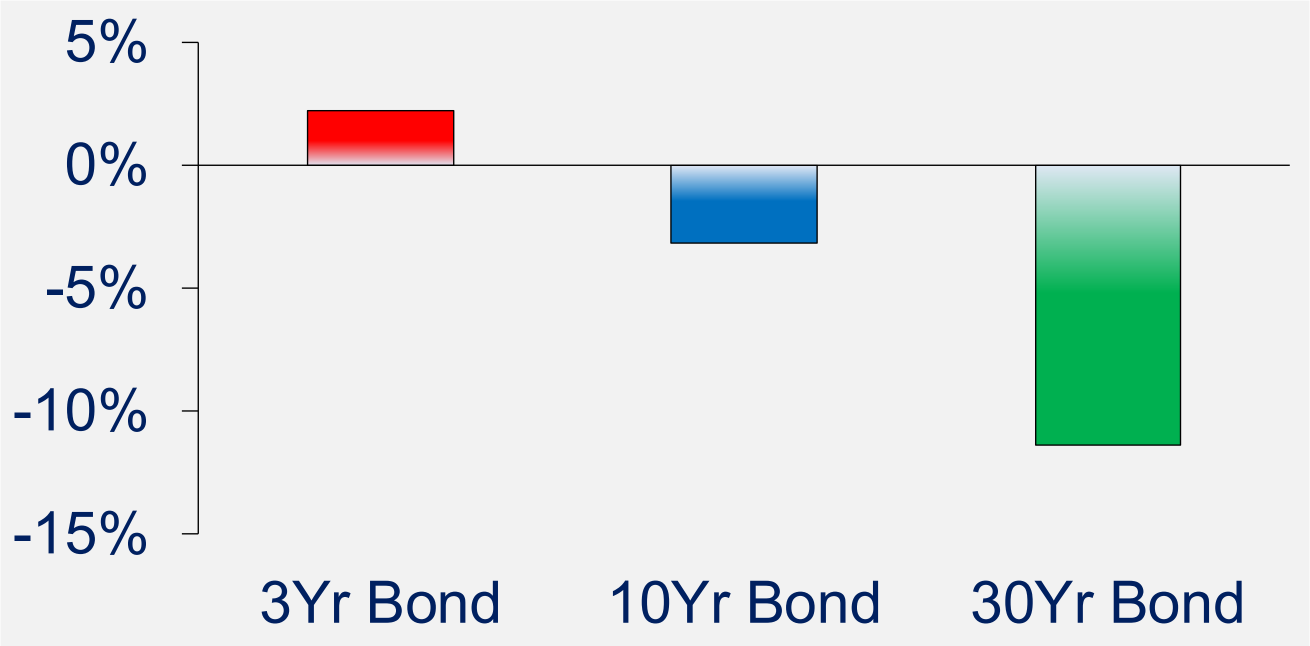
- For stocks, dividends are the income component
- For bonds, coupon provides the income

Yields are related to but not the same as returns

- Yield to maturity is the expected return of a bond from purchase date to maturity
- But bonds are marked to market every minute of every day, same as stocks
- When yields rise, bond prices fall (and vice-versa)
- The longer the bond's maturity/duration, the bumpier the re-pricing

SIMPLE EXAMPLE: BOND RETURNS

"Total return" for bonds due in 3, 10, and 30 years (each with 4% coupon), if rates rise by 1% (over a one year horizon):



Coupon Return =	4.0%	4.0%	4.0%
Price Return =	-1.8%	-7.2%	-15.4%
Total Return =	2.2%	-3.2%	-11.4%

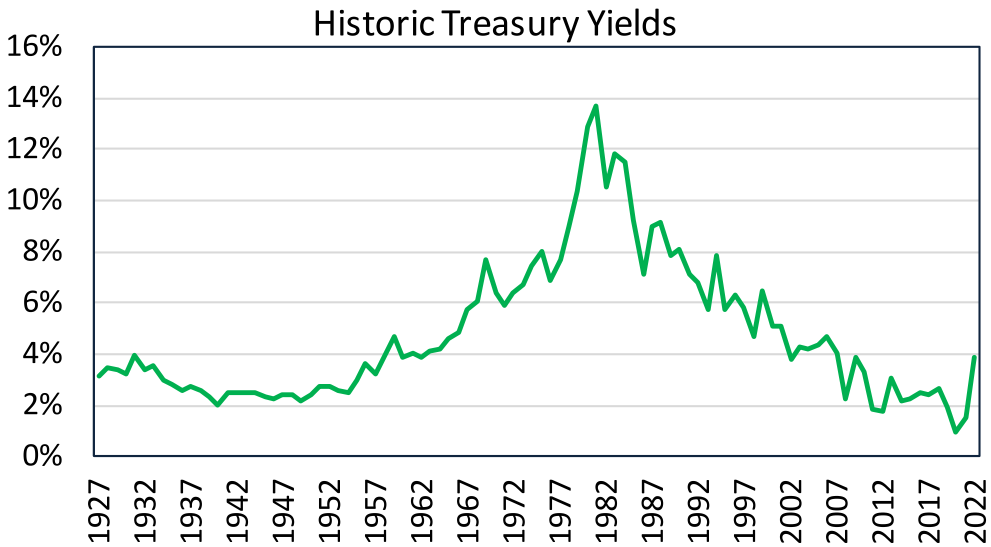
These numbers flip when rates fall!

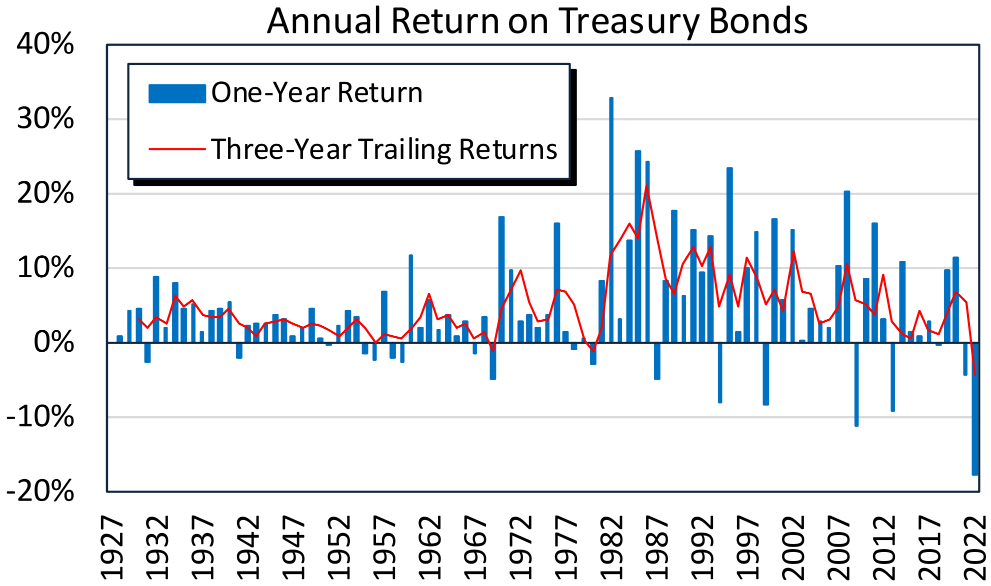
A LONG LOOK BACK…

US interest rates began rising in the 1960's as debt-financed war and "Great Society" spending increased, spurring inflation.

Inflation—and interest rates—peaked in the early 1980's, and began a long trend of falling rates.

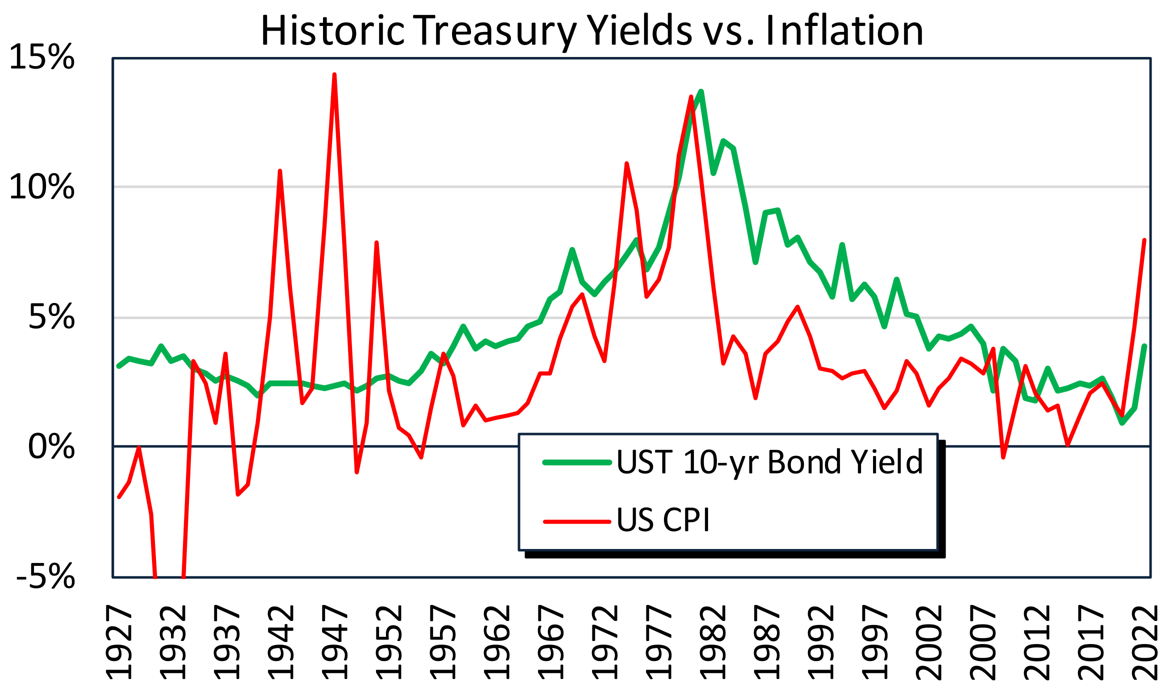
Returns were boosted throughout the 1970s due to higher yields—in the bond market, "yield wins over time."





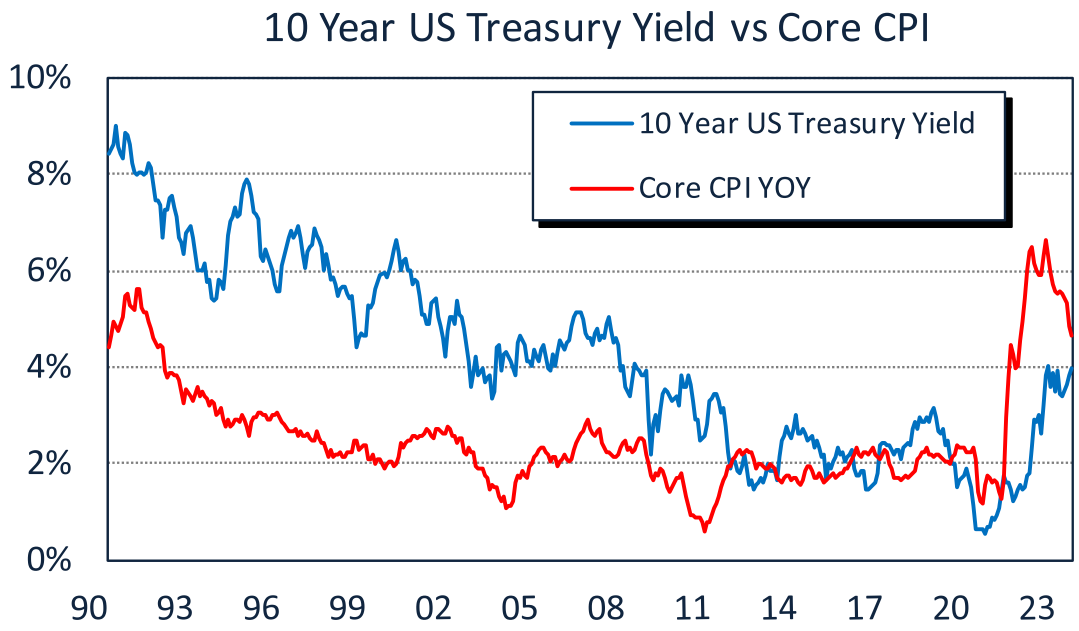
INTEREST RATES AND INFLATION

- Inflation experienced heightened volatility during the Great Depression and through the WWII period
- Interest rates remained suppressed due to strong demand for bonds vs. other assets
  - Stocks were considered to be too risky for many households in the first half of the 20th century
- Inflation pressures rose throughout the 60's and 70's due to heavy spending on Viet Nam war, OPEC price hikes and misguided monetary policies.
- Finally, the Federal Reserve "broke the back" of inflation in 1981, leading to a long decline in the CPI and interest rates



MORE RECENTLY...

- This chart shows why investors were caught off-guard by the sudden upturn in inflation, post-pandemic
- Inflation expectations continued to fall throughout the 90s and into the 2010’s
  - In fact, the Fed was forced to put a more expansive “playbook” in place in 2020 (the timing was terrible!)
  - The dreaded “lower bound” of 0% Fed funds rate meant the Fed had to implement QE when rates policies maxed out
  - The Fed’s 2% inflation goal was looking more like a ceiling than a target



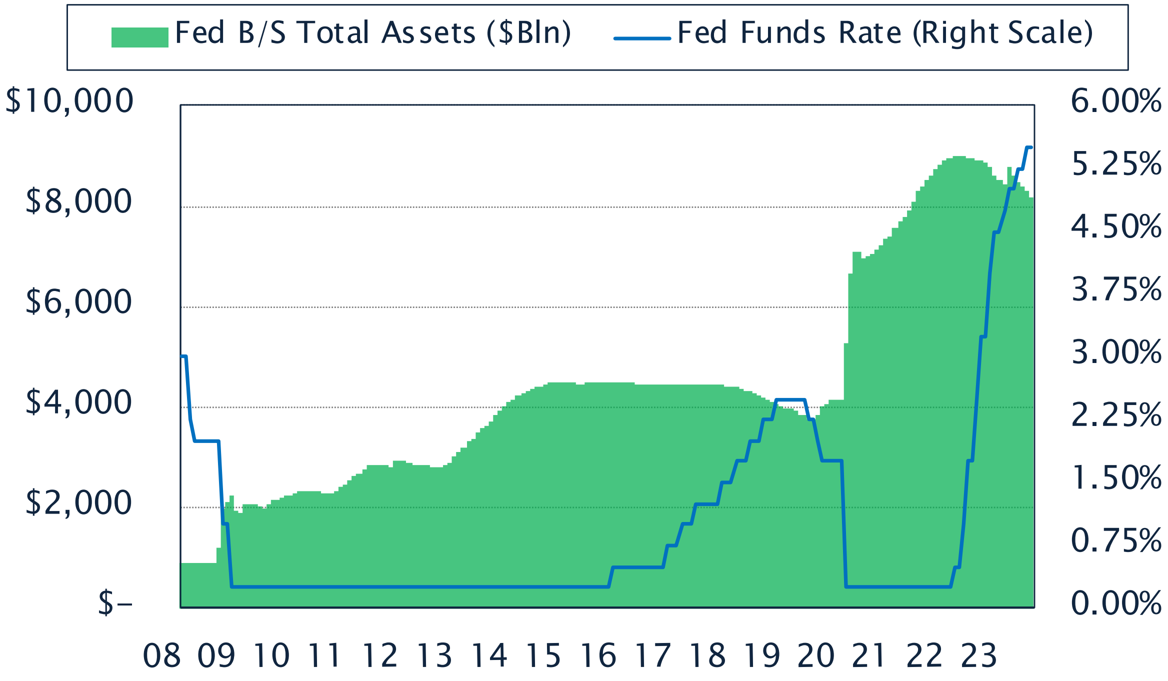
THE FED'S QE PROGRAMS

In the wake of the global financial crisis, the Fed was forced to implement previously-unused policies in order to stimulate the economy

Enter "quantitative easing," AKA large-scale asset purchases

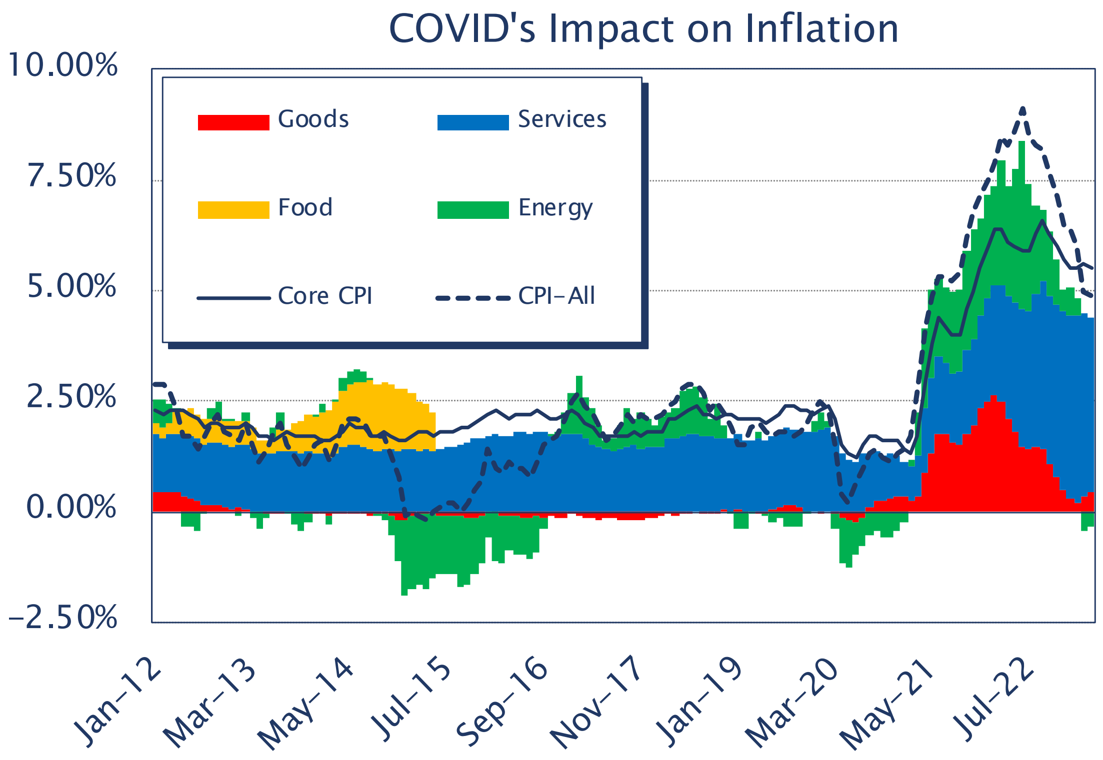
The Fed bought trillions of Treasuries and agency mortgage-backed securities (MBS)

The COVID QE program was even bigger than the GFC QE



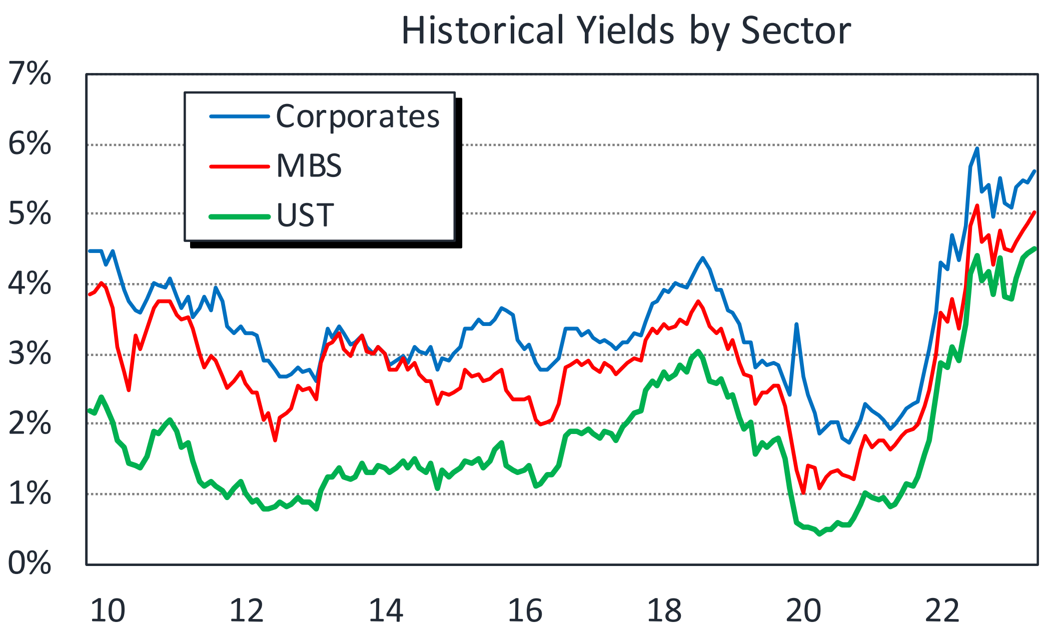
INFLATION MAKES AN UNTIMELY RETURN

- COVID brought inflation back to its highest level in more than four decades
- Initially fueled by supply chain-induced shortages and energy costs
- More recently, spending on service-related items has remained strong, propping up prices in this sector
  - Services represent ~70% of US economy, and prices are far “stickier” than for goods
  - This is why the Fed may have to keep the funds rate “higher for longer”



CURRENT YIELD LEVELS

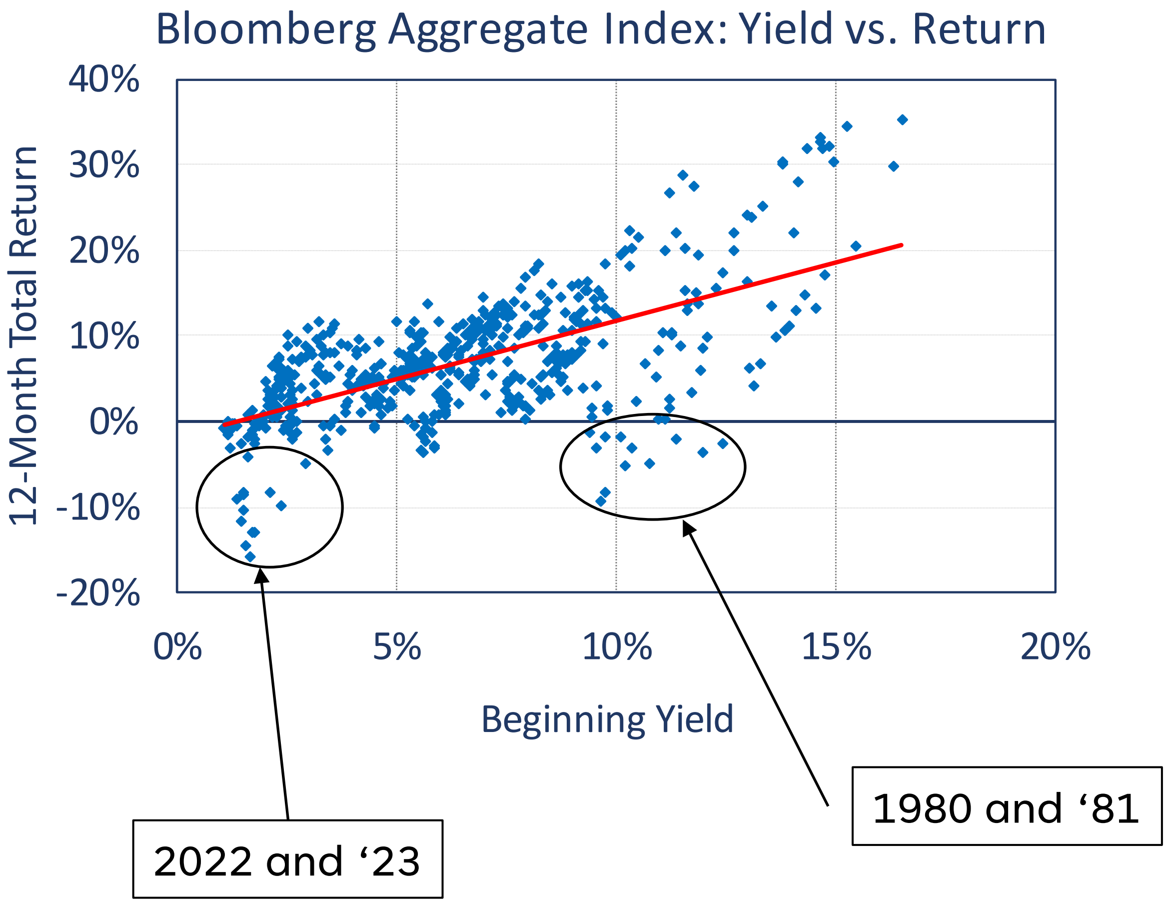
- In the post-GFC world, yields have been held down both by policy and by stubbornly low inflation
- But current yield levels—even Treasury yields—provide a solid basis for portfolio building
- History has shown that yields above 5% have been a good entry point



	Current	Average
←	5.61%	3.38%
←	5.02%	2.84%
←	4.58%	1.74%

NOW THAT WE'RE AT THESE HIGHER RATE LEVELS…

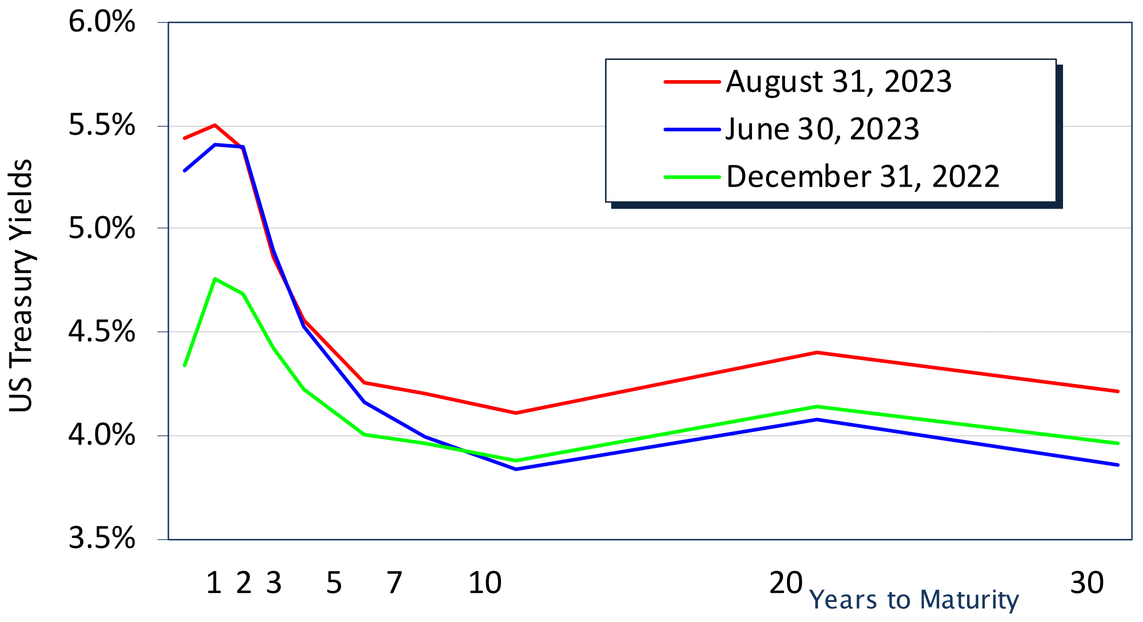
- The process of moving from low to high rates has been brutal:
- 2022 Aggregate Index return = -13.01%
- The two worst periods of performance in the bond market coincided with inflation spikes.
  - 2022 was far worse, since there was insufficient yield (income) to offset the price declines
- In short, the higher your yield, the better your return prospects are—and vice versa



WHERE ALONG THE YIELD CURVE?

- The current Treasury yield curve is inverted, with short rates above longer rates
  - Very tempting to load up on short maturities
  - Staying short = defensive; little price risk

- But if rates head back down, you forego any price gains
  - And any maturing bonds will have to be invested at lower yields
  - Investors who have suffered over the past couple of years will want to make back those losses



WHICH SECTORS?

Treasuries:

- Benchmark for US investors, ultimate defensive play
- No credit risk; likely to outperform in a severe recession
- Liquidity always there, even in crisis periods

Negatives:

- Lots of supply coming down the pike + ongoing QT
- Potential for more political shenanigans

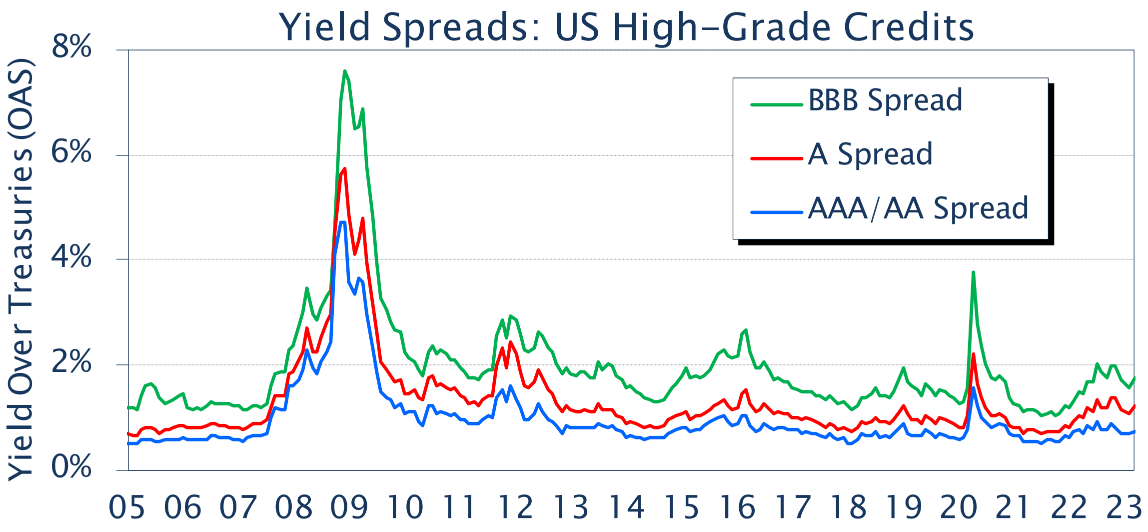
WHICH SECTORS?

High-Grade Corporate Bonds:

- Offer better-than-average yield spread vs. Treasuries currently
- Fundamental credit quality very solid; upgrades > downgrades
- Little appetite for companies to pursue debt-fueled M&A activities

Negatives:

- Will be under pressure in recession; cash flow and profits suffer
- Liquidity can dry up in crisis scenarios



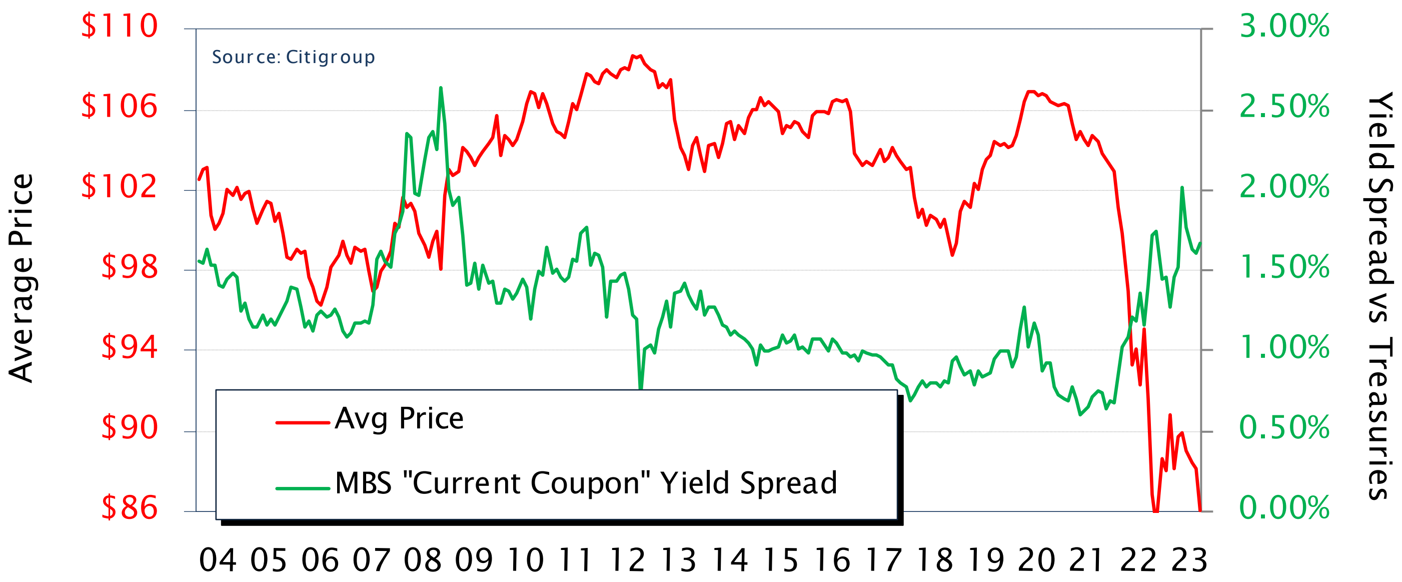
WHICH SECTORS?

US Agency Mortgage-Backed Securities

- Excellent combination of yield and price “headroom”
- US government credit quality; no real credit risk
- New supply is way below normal

Negatives:

- Banks aren’t buying now, and no Fed buying
- Duration is a moving target
- Good analytics necessary to manage MBS



SUMMARY

- With yields at multi-year highs, bonds offer the best total return potential in decades
- The Fed's tough monetary policies are bringing inflation down, albeit at a slow pace
- We only need for rates to stabilize—not fall—to achieve good returns
  - But there are excellent capital appreciation opportunities if rates do fall
- Bonds have the potential to outperform stocks, depending on macro conditions
- Biggest risk to bondholders isn't recession, it's inflation moving back up
- The MBS sector is the "sweet spot" among high-grade bond sectors