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Rising Rates and Bond Markets: Keep Calm and Clip On

AUGUST 2021

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Snapshot

- We believe the global economic recovery from COVID-19 will be one of the strongest in living memory.
- Accordingly, it's not surprising that investors are thinking about the risk of meaningfully higher interest rates and, as a result, falling bond prices.
- We believe core, investment-grade bonds have a role in a diversified portfolio regardless of market conditions.

Pent-up demand from households and businesses, bolstered by historic levels of fiscal and monetary accommodation, should make for a historically robust economic recovery in the coming quarters as the global economy continues to recover from COVID-19. This could push global bond yields meaningfully higher. Because bond prices move inversely to yields, some fixed-income investors are understandably concerned about the possibility of falling bond prices. While seeing a price decline can be disconcerting, we believe investment-grade bonds should continue to provide important diversification benefits for investment portfolios and positive returns over both intermediate and longer time horizons (even in the unlikely case of a longstanding move to significantly higher bond yields).

Why Own Bonds?

With interest rates so low, some investors are asking whether there is still a role for core, investment-grade bonds in a diversified portfolio. We believe there is. First, bonds can provide meaningful income generation. While the current income received from bonds is quite low compared to history, we believe the relationship to cash and implied returns on riskier assets are within reason as compared to those of the last 25 years. In other words, we think that the current level of core bond yields are justified given everything else in the current state of financial markets.

Second, bonds still provide valuable diversification benefits. Because the returns on high-quality bonds tend to behave differently than the returns on riskier, growth-oriented assets like stocks, they can help lower the volatility of an overall portfolio. In other words, in an optimal investment portfolio, some assets should rise when other assets fall—which is often what happens in the relationship between stock and investment-grade bonds[1]. Bonds can reduce portfolio volatility and serve a role as a deflationary hedge when stocks might suffer to a larger extent than the corresponding "rise" in purchasing power.

[1] For a deeper look at the strategic asset allocation case, see our January 2021 commentary, "Are Investment-Grade Bonds Still Worth Holding?"

A Multi-Decade Tailwind

A nearly four-decade-long downtrend in global interest rates, as shown in Exhibit 1, has provided a longstanding boost to bond returns. Thus, the more interesting (and perhaps pressing) question is how serious the risk of higher interest rates is to future returns on investors' bond holdings.

Exhibit 1: Decades-Long Downtrend

Source: Bloomberg, SEI. Monthly data from 1/31/1990 through 6/30/2021.

The broad downtrend in global rates continued into mid-2020, falling to record lows in many countries as the global pandemic took hold. Interest rates have since moved higher, thanks to the stronger growth and inflation outlooks fostered by forceful policy measures and the arrival of effective vaccines. Interest rates have modestly fallen as of late, but there are significant expectations of rising rates in the future.

Prices Matter, But Cash Flows Matter More

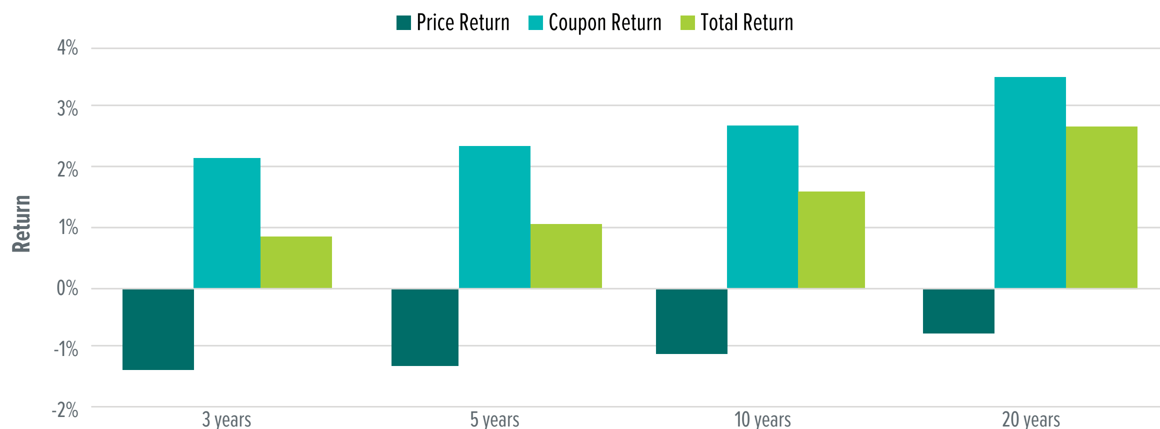
To help investors observe this risk, we examined the components of global bond returns over the last 20 years. We then analysed what returns might look like if we saw the last two decades of falling interest rates reverse course over the next 20 years (Exhibit 2). Interestingly, the additional boost to core bond returns from rising bond prices (falling interest rates) was just over one-tenth of the total annualized return on the Bloomberg Barclays Global Aggregate Bond Index. While that's not insignificant, it does highlight that scheduled interest payments are a far more important factor in bond returns.

Exhibit 2: A Bondholder's Worst Nightmare?

Source: Bloomberg. Monthly data from 12/31/2001 to 6/30/2021. Yield to Worst of the Bloomberg Barclays Global Aggregate Bond Index.

Courtesy of those recurring interest payments, simulated bond returns on the same index would still likely be positive even if interest rates reversed course in a straight line for the next 20 years. As shown in Exhibit 3, the impact of rising interest rates on bond prices would impose a small drag on overall returns, but the benefits of reinvesting cash flows into higher-yielding bonds over time could easily overcome this.

Exhibit 3: Coupons Count Most



Source: SEI, Bloomberg Barclays. Yield, coupon rate, average maturity and slope of the yield curve are assumed to move from current levels (6/30/2021) back to 2001 levels (12/31/2001) linearly over 20 years for this hypothetical analysis. Yield, coupon rate, and average maturity are indicative of the Bloomberg Barclays Global Aggregate Bond Index. Slope of the yield curve is indicative of the AA corporate yield curve (10-year yield minus 5-year yield).

Active portfolio management helps automate the reinvestment of principal from maturing bonds into new bonds at higher coupons during rising-rate environments. So while investors might need to "reinvest" the coupons to achieve the total return in this example, the bond fund they own or the laddered-bond strategy they employ will still reinvest principal and may be able to offer higher coupon rates (higher income generation potential) during a rising-rate environment.

The Takeaway: Hold onto Your Bonds

To reiterate, SEI does not expect bond yields to retrace the decline of the last 20+ years. However, we hope the foregoing analysis will help investors keep their cool next time the risk of higher interest rates comes into focus. Investment-grade bonds should not only be able to produce positive returns in a multiyear period of rising interest rates, but they should continue to provide valuable diversification and income benefits as well.

Glossary

Active portfolio management *is an investment strategy that attempts to outperform an investment benchmark index or target return.*

Fiscal policy *refers to the use of government spending and tax policies to influence economic conditions.*

Hedge *is a financial instrument or investment strategy that attempts to offset to risk of adverse price movements in a portfolio.*

Monetary policy *refers to the actions undertaken by a country's central bank to control money supply and promote economic growth.*

Yield *is the amount that a bond pays each year in interest as a percent of its current price.*

Yield curve *represents differences in yields across a range of maturities of bonds of the same issuer or credit rating.*

Index Definitions

Bloomberg Barclays Global Aggregate Bond Index *measures the return of the global, investment-grade debt market.*

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210623.02 IMU (08/21)