THE RATE AND CREDIT VIEW

Bonds Are Back, But Ride May Be Bumpy

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EXECUTIVE SUMMARY

- The future returns prospects of core fixed income have moved materially higher given the selloff in 2022.
- However, the path forward may be bumpy, as it is common for core bonds to have negative returns on a monthly basis.
- The best predictor of long-term returns in core bonds is starting yields. The short-term volatility investors experience due to changing interest rate expectations is just volatility. It has very little bearing on the actual total return if held to maturity.
- The value proposition for core bonds was evident during the Silicon Valley Bank collapse and rally in rates. The rise in core bond yields provide a greater cushion to market volatility.

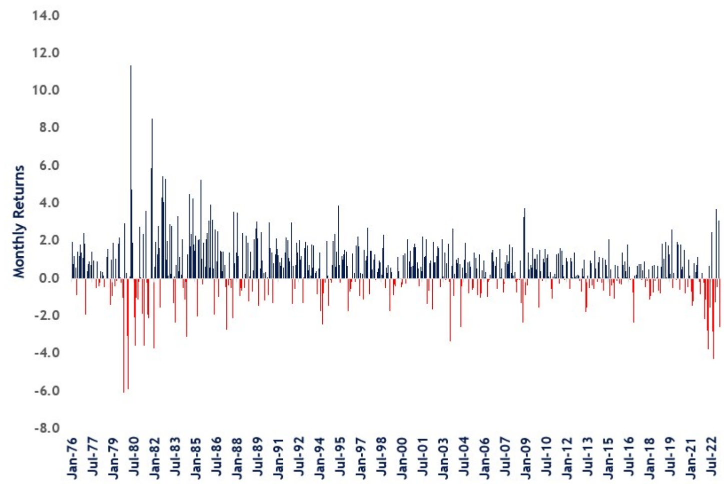
BONDS ARE BACK...BUT IT MAY BE A BUMPY AND THAT IS NORMAL

Bond investors experienced the worst year ever for core bonds last year (as per the Bloomberg Aggregate Bond Index). The prospect of another year like 2022 is unlikely; however, the path forward will not be without market volatility. Despite the higher starting yield levels for fixed income broadly, we could see periods of negative returns. For example, after a strong January for core bonds, February returns were negative. That swing in returns is normal. Since inception of the Bloomberg Aggregate Bond Index in 1975, over 1/3 of the monthly returns have been negative **(see Figure 1)** and close to 1/4 quarterly returns have been negative. Bonds trade daily and interest rates change throughout the day as well, which means the market value of a bond will change daily as well, feeding into swings in monthly and quarterly returns.

However, fixed income instruments are fundamentally different than other financial instruments. Bonds are financial obligations that are contractually obligated to pay periodic coupons and return principal at or near par at the maturity of the bond. That is, there is a certainty with bonds you don't get from many other financial instruments—and that is starting yields (yield-to-worst more specifically, which is the minimum expected yield that can be received from a bond absent an issuer defaulting on its debt).

1 Monthly Returns Are Negative 1/3 Of Time Since Inception Of The Aggregate Bond Index

It is normal for bond returns to swing negative on a monthly basis, which has happened 1/3 of time historically.



Source: Bloomberg. Data as of 2/28/2023. Bloomberg US Aggregate Index.
Indexes are unmanaged statistical composites and cannot be invested into directly. Index performance is not indicative of the performance of any investment

The Aggregate Bond Index has been maintained by Bloomberg L.P. since August 24, 2016. Prior to then it was known as the Barclays Capital Aggregate Bond Index and was maintained by Barclays. From June 1976 to November 2008 it was known as the Lehman Aggregate Bond Index.

Starting yields take into consideration the underlying price of the bond as well as the required coupon payments, therefore, starting yields are the best predictor of future returns. Starting yields and subsequent returns for the Bloomberg Aggregate Bond Index have a very tight relationship. For holding periods as short as five years or as long as ten years, starting yields explain approximately 94% to 95% of returns for the index (**see Figure 2**). That relationship breaks down over shorter periods, with only ~40% of 1-year returns explained by starting yields—there is much more variability (noise) over shorter horizons. But if you buy and hold a fixed income security, the short-term volatility you experience due to changing interest rate expectations is just volatility. It has very little bearing on the actual total return if held to maturity (or if held to the average maturity of a portfolio of bonds).

After the historically awful year for fixed income investors in 2022, it may be disheartening to see another month (or more) of negative returns. We would advocate for a longer-term perspective though. Current yields within many fixed income markets are at generationally high levels. Investors can take advantage of these high starting yields but only if they stay invested and look past the (normal) short-term volatility that happens on occasion.

2 Starting Yields Are The Best Predictor Of Future Returns (Bloomberg Aggregate Index)

Over long-term, starting yields predict future returns 95% of the time.

Source: LPL Research, Bloomberg 2/27/23
Past performance is no guarantee of future results.

FIXED INCOME RETURNS LOOK ATTRACTIVE UNDER MULTIPLE SCENARIOS

We do see the possibility of strong fixed income returns over the next 12 months. The path forward of inflation and interest rates is a key determinant in fixed income returns. Under various interest rate scenarios, fixed income still generates positive returns over the next 12 months. To experience losses comparable to 2022, interest rates (as measured by the 10yr U.S. Treasury note), would need to reach 7%. Said another way, the higher yield earned on bonds serves as an extra cushion from price deterioration if rates continue to rise. If interest rates fall 0.75% from current levels, a core bond strategy could potentially generate double-digit returns. Against this backdrop, we believe bonds allocations should remain a key part of any strategic allocation.

Given the rise in yields during 2022, we see fixed income returns being positive in 2023 under multiple interest rate scenarios.

3 Fixed Income Returns Across Sectors - Interest Rate Scenarios

Hypothetical Returns : Interest Rate Scenario Analysis (As of 2/24)

Change in Interest Rates	-1.0%	-0.5%	No Change	+0.5%	+1.0%
Bloomberg US Aggregate Bond Index	12.3%	9.5%	4.8%	3.7%	0.8%
Bloomberg MBS Index	11.9%	9.1%	4.8%	3.5%	0.7%
Bloomberg US Treasury Index	11.4%	8.6%	4.4%	3.0%	0.1%
Bloomberg US Corporate Index	13.7%	10.4%	5.5%	3.8%	0.6%
Bloomberg Intermediate Corp Index	10.0%	8.2%	5.5%	4.6%	2.8%
Bloomberg US High Yield Corporate Index*	11.6%	10.0%	7.2%	6.7%	5.0%

*Assumes 4% Default Rate and 40% Recovery Rate

Source: LPL Research
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The value proposition of core fixed income became evident after the collapse of the Silicon Valley Bank (SVB). Interest rates moved materially lower as market participants moved to safe haven assets, and core fixed income participated in the corresponding bond rally. Over the course of March 9th to March 15th, 10-year U.S. Treasury yields collapsed over 50 basis points, and the Bloomberg US Aggregate Bond index returned 2.24%. The rise in interest rates over the course of 2022 created the cushion core fixed income is meant to provide during times of market stress moving forward, proving the value proposition for including core fixed income allocations within diversified portfolios.

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US Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Please read the full Outlook 2021: Powering Forward publication for additional description and disclosure.

A mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage, or more commonly a collection ("pool") of sometimes hundreds of mortgages. The mortgages are sold to a financial institution (a government agency or investment bank) that "securitizes", or packages, the loans together into a security that can be sold to investors. The structure of the MBS may be known as "pass-through", where the interest and principal payments from the borrower or homebuyer pass through it to the MBS holder, or it may be more complex, made up of a pool of other MBSs.

Floating rate bank loans are loans issues by below investment grade companies for short term funding purposes with higher yield than short term debt and involve risk.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

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Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

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