Rising Rates and Bond Markets:
Keep Calm and Clip On

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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.

U.S. Treasury yields have risen over the past year, with the yield on 10-year Treasurys climbing by roughly 60 basis points over the 12 months ending December 31. The rise in yields has been driven by several factors, including the rollout of COVID-19 vaccines and reopenings that have supported economic growth. The reopenings, along with sizable fiscal stimulus and supply chain bottlenecks, have contributed to increased inflation, as well as heightened inflation expectations, which have also put further upward pressure on yields.

Because bond prices move inversely to yields, some fixed-income investors are understandably concerned about 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 still at historically low levels, 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 yields on riskier assets are within reason as compared to those of the last 25 years.

With no other consideration than the comparison of current yield levels to historical averages, an investor might conclude that core bonds are overvalued. However, just because core bond yields are at historic lows, they aren't necessarily overvalued owing to where the yields on other asset classes sit (the opportunity cost). An investor who desires greater income might have to take on additional risk/duration/illiquidity. As with any portfolio repositioning, the change in exposure comes with tradeoffs that should be balanced with other goals and objectives. In other words, we think that the current level of core bond yields can be justified given everything else in the current state of financial markets.

Additionally, 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].

[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 interest rates, as shown in Exhibit 1, provided a longstanding boost to bond returns. The broad downtrend in 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. Thus, the more interesting (and perhaps pressing) question is how serious the risk of rising interest rates is to future returns on investors' bond holdings.

EXHIBIT 1: DECADES-LONG DOWNTREND

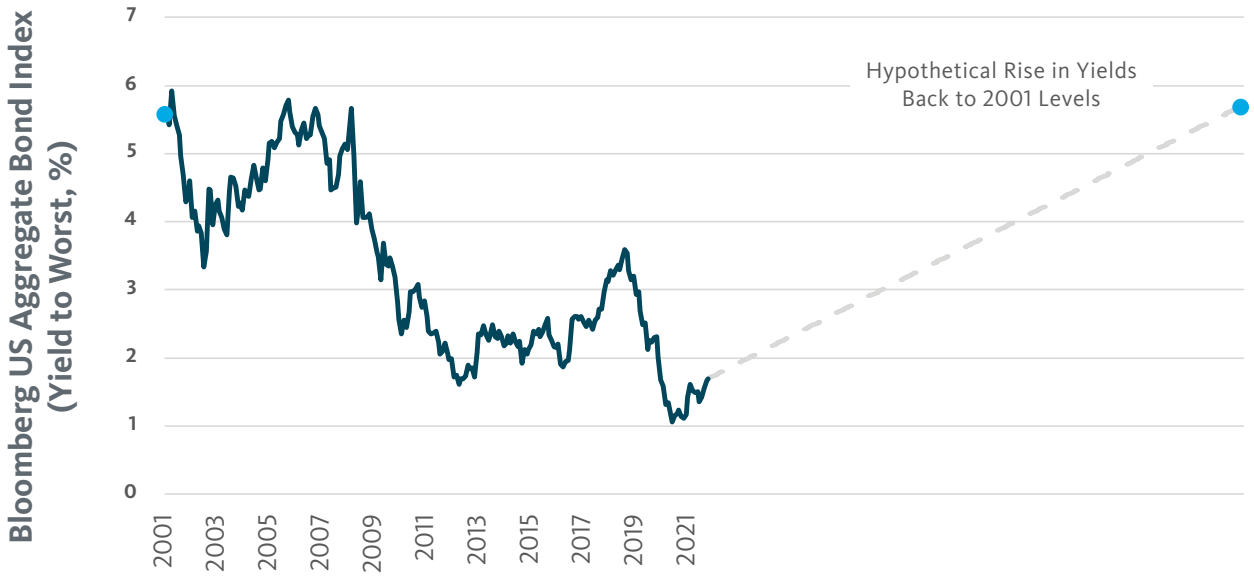
Source: Bloomberg, SEI. Monthly data spans 1/31/1976-12/31/2021. Index returns are for illustrative purposes only and do not represent actual fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results. Performance prior to 1/1/1986 is backtested. Backtested performance, which is hypothetical and not actual performance, is subject to inherent limitations because it reflects application of an Index methodology in hindsight. No theoretical approach can take into account all of the factors in the markets in general and the impact of decisions that might have been made during the actual operation of an index. Actual returns may differ from, and be lower than, back-tested returns. Past performance is no guarantee of future results.

Prices Matter, But Cash Flows Matter More

To help investors observe the possible risk that rising interest rates might pose, we examined the components of U.S. bond returns over the last 20 years. We then analyzed 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 US Aggregate Bond Index. While that's not insignificant, it does highlight that scheduled interest payments are a far more important factor in bond returns.

Please note Exhibits 2 and 3 are projections or hypothetical scenarios based on index data. **These projections or scenarios are purely hypothetical and do not represent all possible outcomes. They do not reflect actual investment results and are not a guarantee of future results. All opinions and estimates provided herein, including forecast of returns, reflect our judgment on the date of this report and are subject to change without notice. These opinions and analyses involve a number of assumptions, which may not prove valid. The performance numbers are not necessarily indicative of the results you would obtain as a client of SIMC.** Index returns are for illustrative purposes only and do not represent actual fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

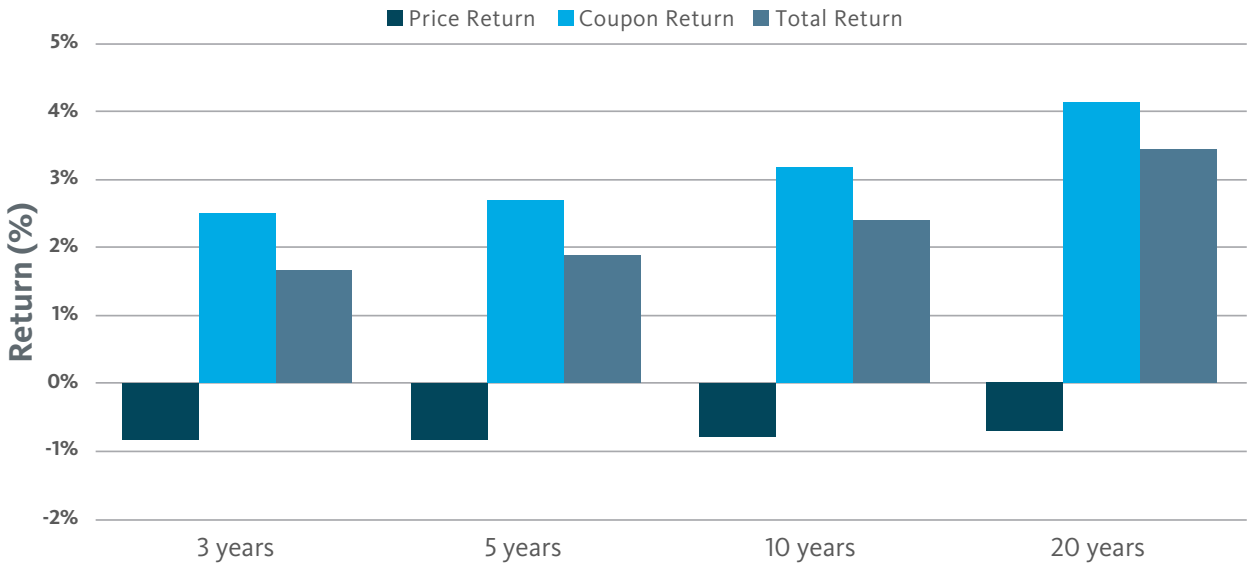
EXHIBIT 2: A BONDHOLDER'S WORST NIGHTMARE?



Source: Bloomberg. Monthly data spans 12/31/2001-12/31/2021.

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, interest payments and principal repayments, into higher-yielding bonds over time could easily overcome this.

EXHIBIT 3: COUPONS COUNT MOST



Source: SEI, Bloomberg, ICE BofA AA US Corporate yield curve. Yield, coupon rate, average maturity and slope of the yield curve are assumed to move from current levels (12/31/2021) 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 US Aggregate Bond Index. Slope of the yield curve is indicative of the AA corporate yield curve (10-year yield minus 5-year yield). Bonds ratings are expressed as letters ranging from AAA (highest grade) to D (lowest grade). Companies rated AA are considered investment-grade and are expected to have a strong capacity to meet their financial requirements.

The takeaway: we believe bonds have a place in a long-term diversified portfolio

To reiterate, SEI does not expect bond yields to fully retrace the decline of the last 20+ years. However, we hope the foregoing analysis will help long-term investors keep their cool as a healthier economy and increasing inflation raise the possibility of a continued rise in longer-term rates. We believe 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

Coupon rate is the annual interest rate that a bondholder receives from the bond's issue date until it matures.

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

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.

Yield to worst is a measure of the lowest possible yield received on a bond that does not default.

Index Definitions

Bloomberg US Aggregate Bond Index measures the return of the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market.

ICE BofA AA US Corporate Index measures the return of AA rated, USD-denominated investment-grade corporate debt publicly issued in the U.S.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.

There are risks involved with investing, including possible loss of principal. Bonds and bond funds will decrease in value as interest rates rise Diversification may not protect against market risk.

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