Confluence INVESTMENT MANAGEMENT

Fixed Income Quarterly

March 2024

Have bonds become more important because of inflation?

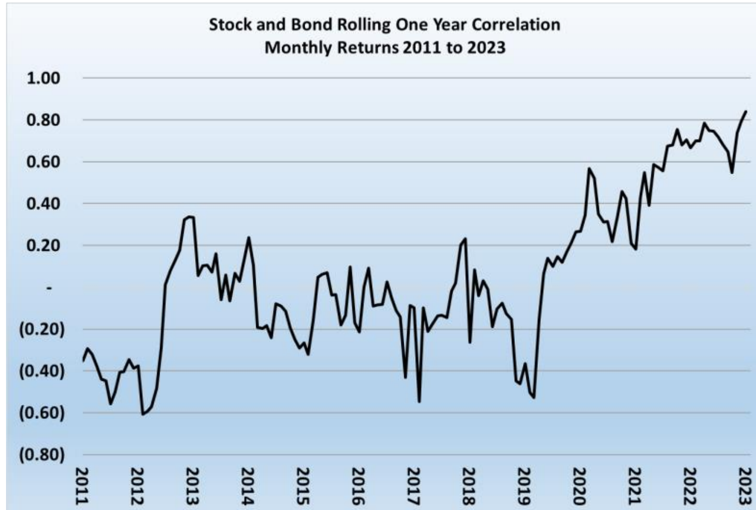
- Although inflation may decline cyclically in coming quarters, we expect the longer-term trend to involve higher inflation as well as heightened inflation volatility.
- Higher inflation will tend to increase volatility across financial markets, and stocks and bonds may become more highly correlated.
- Increasing allocations to bonds may be an effective way to address rising financial market volatility and rising correlations. However, the nature of how bond exposures are positioned may be as important as, if not more than, the overall proportion.
- We favor a duration slightly shorter than broad benchmarks, including more exposure to intermediate maturities, while limiting exposure to very long and very short maturities.
- We suggest a modest overweight to Treasuries and MBS, with an underweight exposure to the corporate sector.

Inflation is a bane to financial assets, and bond investors are keenly aware of this risk. This perspective is shaped by the fixed coupon structure of most bonds. If inflation unfolds higher than expected, the value of those fixed coupons declines. Of course, inflation takes a heavy toll not just on bonds, but also on most asset classes, including stocks. And given that we expect inflation to shift higher (after a cyclical decline in 2024), it's important to consider how to address this headwind. Ironically, part of the solution may involve having higher allocations to bonds. Bond volatility tends to be a fraction (around one-third to one-quarter) of equity asset class volatility, with the exception of very long maturity bonds.

Over the past 40 years, bonds have paired well with stocks, often providing a safe haven when stocks decline. Thus, bonds brought lower volatility to portfolios and important diversification. However, much of this relationship existed during periods of disinflation, when inflation was in secular decline. In the post-pandemic era, when inflation has been higher, stocks and bonds have more frequently been moving in the same direction. In portfolio parlance, this means stocks and bonds have had low or negative correlations in the past, but more recently their correlation has turned positive.

In our first chart, we illustrate the return correlations between stocks (S&P 500) and bonds (Bloomberg Aggregate) in the period following the financial crisis of 2008. Most of the time, the correlation has been around zero (stock and bond returns are unrelated to each other) or negative (stock and bond returns moved in opposite directions), creating a high level of portfolio diversification when combining the two asset classes. However, in the post-pandemic time frame, we can see that stocks and bonds have become positively correlated, a trend that eroded some of the benefit of combining the two.

What is the driver of rising positive correlations between stocks and bonds? From our vantage point, it appears to be inflation and, by extension, Fed policy. After decades of disinflation, investors were caught off-guard by the pandemic-induced inflation. So, too, was the Fed. After dismissing the early inflationary trend, the Fed rapidly raised rates in 2022, driving down both stocks and bonds. Then, late in 2023, the Fed quickly shifted away from its tighter policy, which pushed up both bonds and stocks. From these cycles, we can see that Fed policy affected the direction of stocks and bonds in the same manner and was a big driver in these rising correlations.



Stocks and bonds are represented by the S&P 500 and Bloomberg Aggregate indexes, respectively. (Sources: Bloomberg, Confluence)

We expect inflation to decline cyclically in 2024, but over the longer term, inflation is likely to be not just higher than the pre-pandemic era, but also more volatile. Higher inflation will tend to lower equity valuations, raise bond yields, and cause Fed policy to be more erratic. Collectively, these trends will tend to make investing riskier. At some point, stock and bond correlations will probably decline. But such a change may be hard to predict, and it may involve significant changes in the market environment, perhaps including acute economic conditions, geopolitical events, or intense domestic political policy shifts.

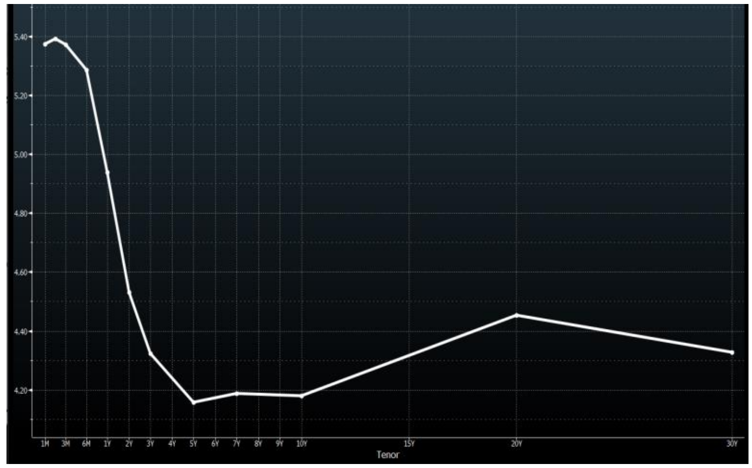
One way to address a higher-risk environment would be to increase the overall allocation to bonds, given their low volatility relative to stocks. However, actively managing the exposure within the bond allocation may be equally (or perhaps more) important than the overall proportion. Longer maturities have interest rate volatility on par with equities, so we believe it's prudent to limit, and sometimes completely avoid, exposure to longer maturities as our economy shifts into an environment of higher inflation. The good news is that short and intermediate maturities can properly fulfill a bond allocation without high levels of interest rate risk.

Increasing the exposure to bonds to help address the consequences of higher inflation may seem counterintuitive, but we believe the strategy is prudent so long as interest rate risk within the bond allocation is properly managed. If the positive correlation between stocks and bonds were to decline, the utility of bonds to address risk would rise, potentially paving the way to a lower bond allocation at some point down the road.

Treasury Sector

In our view, the yield curve remains the elephant in the Treasury room. Its inverted shape, where short-term yields are much higher than longer-term ones, defines both return and risk, with the outcome determined by the future shape of the curve. The good news is that for conservative investors, yield levels remain attractive and there are many ways to address risks.

U.S. Treasury Yield Curve, as of 3/1/2024



(Source: Bloomberg)

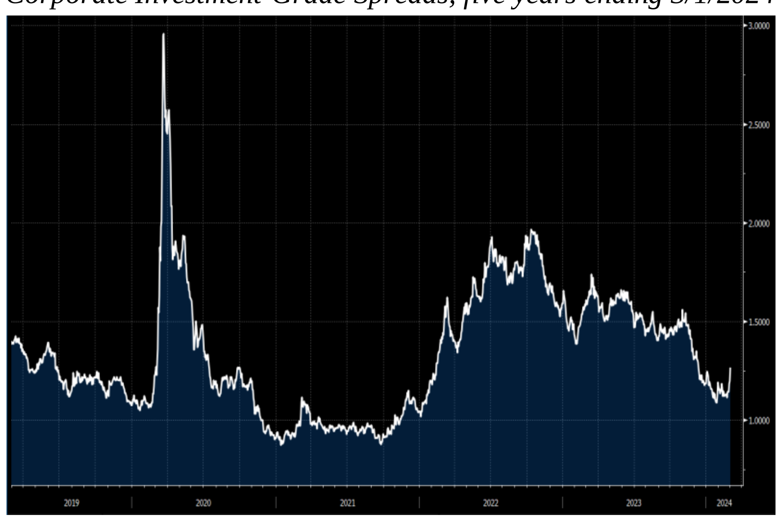
In modern history, inverted yield curves have presaged recessions with great accuracy. However, we don't believe a recession is imminent on the near horizon. Instead, we expect a mild slowdown in growth this year followed by higher growth, indicating that inflation should decline cyclically then move above pre-pandemic levels in the longer term. In this scenario, we believe the shape of the yield curve will normalize, with longer-term rates being above shorter ones.

A yield curve change from inversion to normalization presents two risks: longer maturity bond prices may fall, driving longer rates higher; and/or short-term bonds mature into a lower-yield environment. Fortunately, the solution is straightforward — focus bond allocations on intermediate maturities, where both price and reinvestment risks are more muted. This strategy allows income-oriented investors to participate in Treasury yields, while limiting risk.

Corporate Sector

Investment-grade corporate bonds have performed well in the post-pandemic era, delivering surprisingly steady results as the Fed raised interest rates. The next chart illustrates investment-grade spreads over the past five years. The trend shows that after recovering from the pandemic-era spike, corporate bond spreads widened as the Fed began raising rates in 2022, reflecting concerns that higher rates would drive interest burdens higher right in front of a potentially recessionary environment.

Corporate Investment-Grade Spreads, five years ending 3/1/2024



(Source: Bloomberg)

Many corporate borrowers took advantage of the very low interest rate environment during and after the pandemic by issuing longer-maturity bonds to lock in the low rates for many years. This strategy provided a measure of insulation to rising rates and played a role in limiting credit problems. So, despite tighter Fed policy, default rates remained relatively low, paving the way for spreads to narrow almost back to levels that existed prior to when the Fed began raising rates.

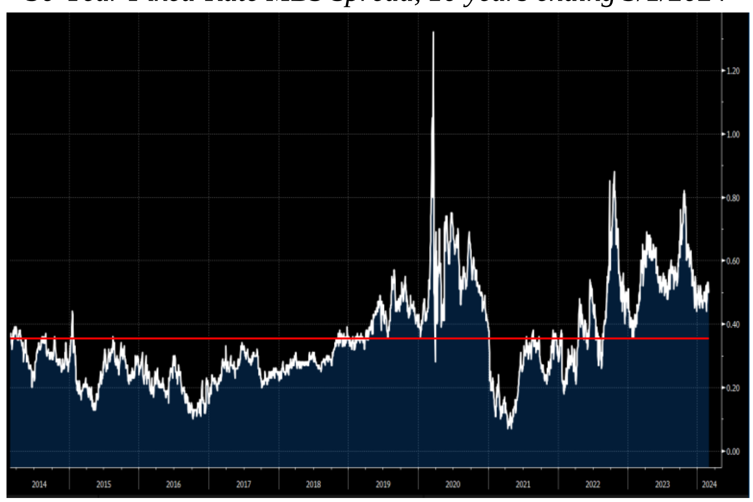
Looking forward, we believe corporate credit trends are unlikely to become problematic. However, with spread levels on the narrow side of history, we believe a moderately underweight exposure is appropriate.

Mortgage-Backed Securities (MBS) Sector

Navigating risks in the MBS market is notoriously challenging. Much of the difficulty is a function of the changing nature of interest rate risk inherent to these securities. A typical MBS has a structural condition wherein it is effectively short a call option, which is held by the borrower. When interest rates are relatively stable, MBS may outperform as the bondholder collects the option premium in the form of additional yield relative to other securities. However, when interest rates change, interest rate risk increases. Bondholders experience lengthening duration as rates rise, creating larger swings just when prices fall; however, duration shortens as rates fall, exposing bond holders to reinvestment risk as yields decline. Thus, MBS duration often changes in patterns contrary to most other sectors of the bond market, creating a condition known as "negative convexity."

Mortgage rates followed the broader bond market trend and rose in 2022 and 2023, creating a situation where mortgage refinancing slowed dramatically, while at the same time MBS prices declined. These conditions have created an environment where most MBS are now trading below par, while duration has lengthened and stabilized. From our perspective, the adverse effects of negative convexity are largely built into the MBS sector, indicating it may actually now have a measure of positive convexity. Incremental duration-lengthening for many MBS pools may be quite limited if rates rise, while prices below par offer upside should interest rates decline. Accordingly, we have become more constructive toward the MBS sector, particularly with recent spreads wider than historical averages. This chart illustrates the spread of 30-year fixed-rate MBS over the last 10 years, with the average spread depicted by the red line.

30-Year Fixed-Rate MBS Spread, 10 years ending 3/1/2024



(Source: Bloomberg)

Municipal Bond Sector

Finances of state and local governments remained strong until late 2023, owing to increasing property values, healthy sales tax receipts, robust hospitality taxes, and steady income taxes. Although recent data from the Census Bureau exhibit pressures on revenues on a year-over-year basis, the year prior witnessed record collections. Moreover, the data are merely 1% below the record level and represent an increase of nearly 25% relative to pre-COVID collections. These figures have led to budget surpluses and, combined with budget reductions of 3.1%, on average, have resulted in state and local government rainy day funds being at all-time records. Looking forward, continued federal stimulus from the Bipartisan Infrastructure Law and the American Rescue Plan Act will place additional resources in the coffers of state and local governments for the next several years.

Against this halcyon backdrop, municipal bond investors appear to be reacting to movement in the rates market as opposed to the fundamentals of the sector. According to Morningstar, investors reduced their municipal bond mutual fund holdings by a net -$21 billion last year, which was preceded by a reduction of -$150 billion in 2022. Although this pace of redemption could have weighed heavily on prices, the low relative supply of municipal bonds in the form of new issuance over the past two years helped to restrain price erosion stemming from a supply/demand imbalance.

Given our assessment of the health of municipal finances, we suggest a slight overweight to general obligation bonds (GOs) relative to municipal revenue bonds. The prospect of continued volatility in the rate of inflation encourages our recommendation of a shorter duration versus the benchmark and our preference for a laddered structure with an emphasis in the intermediate maturities.

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Confluence Investment Management LLC

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