Is It Time To Invest In Bonds Now?

By: Joe the Investor

The return on bonds has been abysmal for the last 10 years or so. Even though a safe portfolio typically consists of close to 50% bonds, the risk and return profile of bonds has been horrible. The coupon yield has been close to 1% for a very long time, and the interest rate risk is high. The interest rate risk is the likelihood of the interest rates rising, causing losses on the price of the bonds. Since interest rates were close to zero for many years, the likelihood of interest rates rising was much higher than interest rates falling. This risk went higher the longer your investment term was. The only alternative was to bet on negative interest rates like what happened in Europe and Japan until recently, but this did not make any sense because it is in effect paying people to borrow money, which would have bankrupted the financial system if it was done for too long. The third risk which was not amplified until recently is inflation risk. Inflation tends to deteriorate the purchasing of any kind of debt – be it bonds, cash, GICs or mortgages.

What Has Changed Today?

The interest rates have been rising around the world in the amount of around 3% in the last 6 months. This has led to losses in bond prices in the range of 10% to 20% this year. In effect, the interest rate risk scenario has been realized. The coupon yield which was 1% or less would now be 3% or 4% depending on the maturity of the bond and the length of time the bond is held. This means that the reward is much higher and the risk is much lower than just 1 year ago. The third risk which is inflation however is still running hot. If inflation is your biggest concern, you should not be buying bonds or any fixed income unless it is for mitigating other risks such as stock market volatility. The hedge against inflation is physical goods or commodities. The risk and return profile in holding commodities is different than holding bonds, so the adage of diversification still applies.

The Key Is The Interest Rate

The reason why the risk / return profile of bonds has improved so dramatically is because of the sharp rise in interest rates. Should the rates stop rising, the risk / return profile will cease to improve, but can still be investible if the coupon yield holds and losses do not continue due to further interest rate hikes. Should the interest rates start falling, you will have positive returns on the price of the bond if you purchased bonds at “the top” of the interest rate cycle, but any future investments of cash flow will not be as lucrative. Should the interest rates keep rising, the bonds will continue to lose value and the coupon yield will continue to improve for future investments.

What Are Central Banks Going To Do?

There are sources of information that can be examined when it comes to central banks: What they say they will do and what they actually do. The issue is that what they actually do may not be known until months in hindsight. What they say they will do is telegraphed in advance, but there is a good chance that the central bank signals are wrong. Central banks like inflation because it allows them to issue more debt to the governments and charge a higher amount of interest to those governments. The downside is that this game can only be played for so long until interest is no longer being paid, and the central bank issued debt becomes worthless.

Reading The Tea Leaves

People try to anticipate intentions by using drivers to determine the action of the central banks. The drivers which are cited the most right now are the economic strength and the inflation numbers. What is interesting is that economic strength is supposedly very strong according to the numbers, but there are conflicting signals like weakening mortgage demand, lower real estate prices, higher degrees of homelessness, more layoffs among large corporations, small business closures and lackluster consumer confidence ratings. These indicators are showing a weakening economy, not a stronger one. This indicates that the central banks will start to “pivot” or change directions on interest rates.

In terms of inflation, the reverse is true. The narrative has been downplaying inflation saying that it is “transitory”, “peaking” and “positive for the economy”. All of these statements turned out to be lies and inflation is indeed persistent and problematic. This indicates that the central banks will keep raising interest rates to get inflation back to their target of 2%. There is one fly in the ointment using this approach. Inflation is likely understated because food and energy price increases are excluded from the core numbers, and these are the two most important components of inflation for most people. If the central banks really want to contain inflation, they will need to raise interest rates north of 8%. The issue with this is the large amount of government, corporate and consumer debt that exists today, which far exceeds any other time in modern history.

What To Do

The million dollar question is: Which path will the central banks take? Nobody knows the answer to this except possibly the people who operate the central banks. In order to protect yourself against opposite possibilities, you may need to have commodities exposure in the event of a further interest rate spike, some fixed income in case the central banks “pivot” on interest rates, and some equities in case the interest rates may take a neutral path. Diversification is still as important as ever, but it will now include hedging against central bank intentions as well as market risks.