Time to Consider High-Quality Bonds

After a year and a half of rapid tightening by the Federal Reserve (Fed), U.S. inflation has cooled to a pace that is roughly in line with their target. This cooldown allowed the Fed to announce at their January meeting that they no longer anticipate needing to raise interest rates further and could begin to cut rates in 2024. Now might be the time to consider high-quality bonds.

As a reminder, the Fed has two mandates – maximum employment and stable prices. With prices finally showing signs of stabilization, the Fed now appears to feel comfortable in shifting its focus toward ensuring that maximum employment continues.

Historically, the Fed tries to support maximum employment by reducing interest rates to stimulate growth and stave off recessions. Today, economic growth and hiring has slowed and it is unclear whether that slowdown may ultimately result in recession. As long as inflation remains tame, the Fed may feel that it can be more proactive than it typically has been in cutting rates to reduce the risk of recession and layoffs.

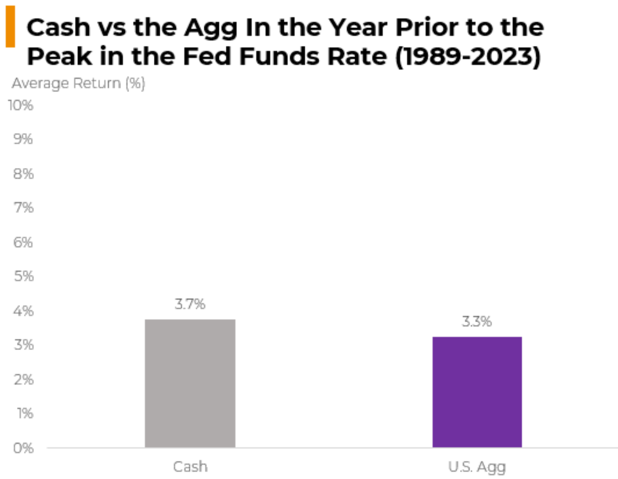
From an investment portfolio perspective, this growth uncertainty may lead to a rise in volatility of equity investments nearer-term. One traditional way to help mitigate that risk for diversified investors has been owning high-quality bonds.

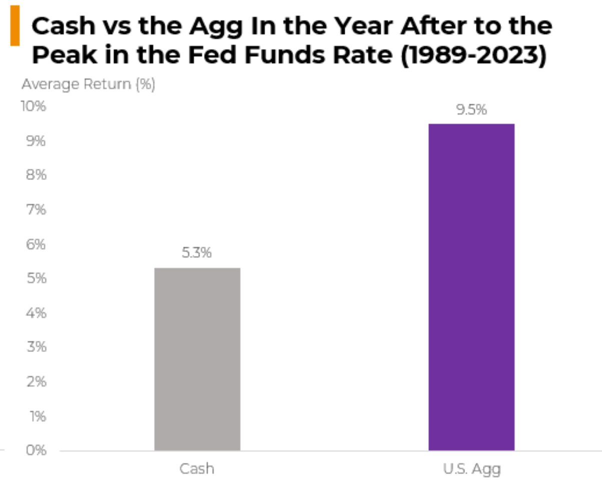
To be sure, the performance of these types of bonds suffered heavily during the recent inflation uncertainty and rapid tightening cycle response. But this pain has silver linings – valuations are much more attractive and income at a reasonable price exists again. Historically, current valuations have been an attractive entry point into high-quality bonds for long-term investors.

In addition, this higher starting point also means rates have more room to decline than has been the case in recent years (for example during a rate cut cycle and/or a recession). Remember, when interest rates fall, bond prices rise and vice versa.

This dynamic, coupled with the Fed looking to reduce the interest rate paid on cash and cash equivalent vehicles[1], also changes the value of owning bonds vs owning cash as an investment. As you can see in the charts below, historically while the Fed is still raising rates (left chart), cash tends to perform similarly to bonds. But once the Fed stops raising rates (right chart), bonds typically outperform cash. Bonds also tend to outperform cash over the long-term.

[1] Cash equivalent vehicles include short-term treasuries, certificates of deposit (CDs), and money market funds.





Past performance does not guarantee future returns. You cannot invest in an index. U.S. Agg: U.S. Aggregate Bond Index. Fed: Federal Reserve. Fed Fund Rate Peaks: March 1989, April 1995, June 2000, July 2006, January 2019, August 2023. Source: Bloomberg Finance, LP, Hartford Funds, O'Brien Wealth Partners, as of 12/31/23.

While cash and cash equivalents have many uses in a financial plan – such as for emergency funds and known upcoming expenses and liabilities – the value of cash as an investment vehicle is more limited. This is especially true in an environment where the Fed is more likely to cut rates rather than raise them. As such, we are closely monitoring opportunities to put additional investment cash to work in bonds in 2024. If you have questions or would like to talk, please reach out to your advisor or any member of our investment team.

8. Historical performance is not indicative of any specific investment or future results. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss of income and/or principal to the investor.
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