Fixed income
October 2022

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Why should you consider owning bonds now?

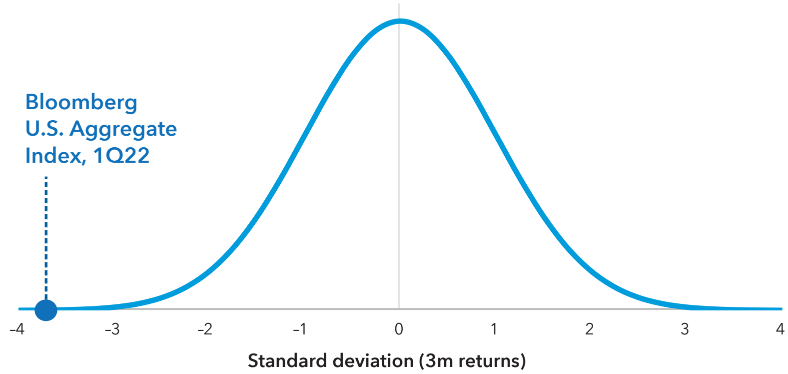
Key takeaways

- Early 2022 was bad for bonds but led to an attractive entry point for investors
- A significant number of Fed hikes are already priced in
- Income opportunity in bonds is the brightest in years
- Yields at current levels have historically delivered attractive returns

Early 2022 was bad for bonds but led to an attractive entry point for investors

The extent of the Q1 drawdown in fixed income markets was both large and rare relative to history. As inflation jumped to the highest levels in decades, the U.S. Federal Reserve scrambled to catch up and indicated an aggressive rate hiking campaign. This triggered the core bond benchmark, the Bloomberg U.S. Aggregate Index, to decline by roughly 6% in the first quarter. That was the bond market's worst quarter in 40 years – the nearly 4-standard deviation move would be the equivalent of stocks declining 24% in a quarter – but it also led to a cheapening in valuations which may prove compelling.

Magnitude of the bond market's first-quarter loss relative to history

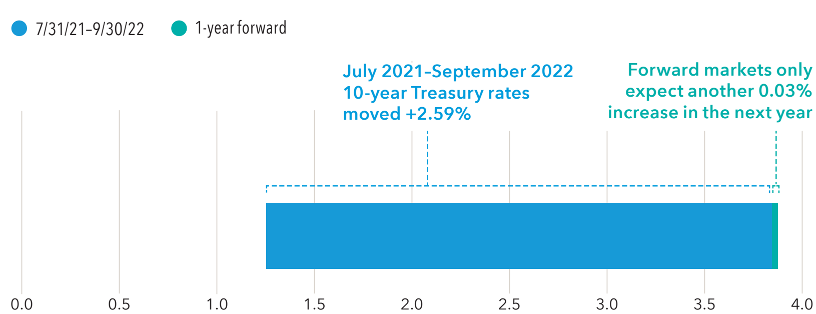


As of March 31, 2022. Source: Bloomberg.
The location on the normal distribution curve for the 1Q22 returns are based on 30 years of rolling 3-month data.

A significant number of Fed hikes are already priced in

While the Fed's current hiking cycle likely has more rate increases to come, current bond prices already anticipate that move. At this point, the market has priced in a significant number of short-term rate increases in the coming quarters and longer dated Treasury yields (e.g. 10-year) already reflect that. In fact, forward rates suggest relatively limited moves on longer dated yields in the next year, which should lessen the negative impact on bonds.

Change in 10-year Treasury yields (%)



Source: Bloomberg. Data as of 9/30/2022.

Income opportunity in bonds is the brightest in years

Yields across fixed income sectors are sharply higher than their lows over the past few years. Going forward, investors now have the potential to earn significantly more income from bonds. In fact, a greater portion of investors' income needs could potentially be met with traditional fixed income than would have been the case in recent years. Higher income can offer more cushion for total returns over time, even if price movements remain volatile.

Yields of key fixed income markets (%)

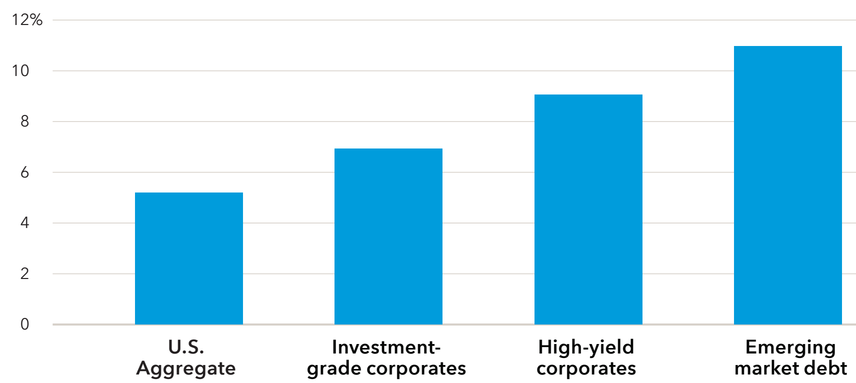
	Recent low	9/30/22	Change
U.S. Aggregate Index	1.02	4.75	**3.73**
Investment-grade corporates	1.74	5.69	**3.94**
High-yield corporates	3.53	9.68	**6.15**
Emerging markets debt	4.36	8.44	**4.08**

Sources: Bloomberg, Bloomberg Index Services Ltd., JP Morgan, Federal Reserve. As of 9/30/22. Sector yields above include Bloomberg U.S. Aggregate Index, Bloomberg U.S. Corporate Investment Grade Index, Bloomberg U.S. Corporate High Yield Index and 50% J.P. Morgan EMBI Global Diversified Index / 50% J.P. Morgan GBI-EM Global Diversified Index blend. Period of time considered from 2020 to present. Dates for lows from top to bottom in chart shown are: 8/4/20, 12/31/20, 7/6/21 and 1/4/21. "Change" figures may not reconcile due to rounding.

Yields at current levels have historically delivered attractive returns

Starting yields in fixed income have historically been a good proxy for forward returns. Today's higher yields suggest higher returns going forward. For example, in periods over the past few decades when yields were at levels similar to those in late May, bond returns were strong across the five-year periods that followed.

Five-year forward returns at recent yield levels



Starting yield to worst	U.S. Aggregate	Investment-grade corporates	High-yield corporates	Emerging market debt
	4.75%	5.69%	9.68%	8.44%

Yields and returns as of September 30, 2022. Sources: Capital Group, Bloomberg. Data goes back to 2000 for all sectors except for emerging markets, which goes back to 2003. Based on average monthly returns for each sector when in a +/- 0.30% range of yield to worst. Sector yields above include Bloomberg U.S. Aggregate Index, Bloomberg U.S. Corporate Investment Grade Index, Bloomberg U.S. Corporate High Yield Index and 50% J.P. Morgan EMBI Global Diversified Index / 50% J.P. Morgan GBI-EM Global Diversified Index blend.

Past results are not predictive of results in future periods.

Bloomberg U.S. Aggregate Index represents the U.S. investment-grade fixed-rate bond market.

Bloomberg U.S. Corporate Investment Grade Index represents the universe of investment grade, publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements.

Bloomberg U.S. Corporate High Yield Index covers the universe of fixed-rate, non-investment-grade debt. Bloomberg U.S. Corporate Investment Grade Index represents the universe of investment grade, publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements.

The indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index.

The J.P. Morgan Emerging Market Bond Index (EMBI) Global Diversified is a uniquely weighted emerging market debt benchmark that tracks total returns for U.S. dollar-denominated bonds issued by emerging market sovereign and quasi-sovereign entities. J.P. Morgan Government Bond Index – Emerging Markets (GBI-EM) Global Diversified covers the universe of regularly traded, liquid fixed-rate, domestic currency emerging market government bonds to which international investors can gain exposure.

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