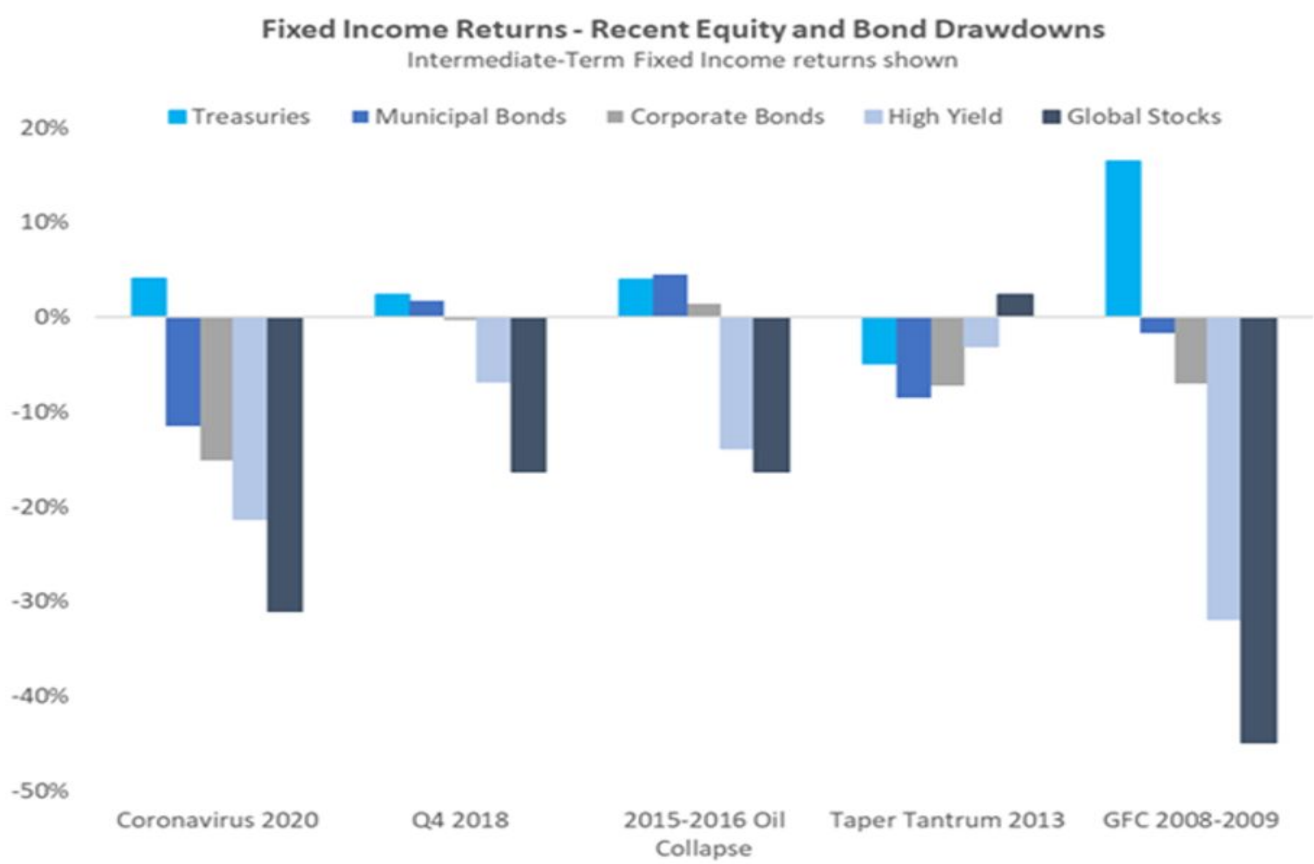
Bonds Behaving Badly

Masked by the headline grabbing Dow point moves, bond markets are experiencing erratic trading and large price swings not seen for some time. While typically these moves are less than that of more volatile stocks, bonds are supposed to be the risk-control ballast to a portfolio. I will try to shed some light on recent developments and why we believe there are still a lot of positive reasons to continue to build portfolios using fixed income.

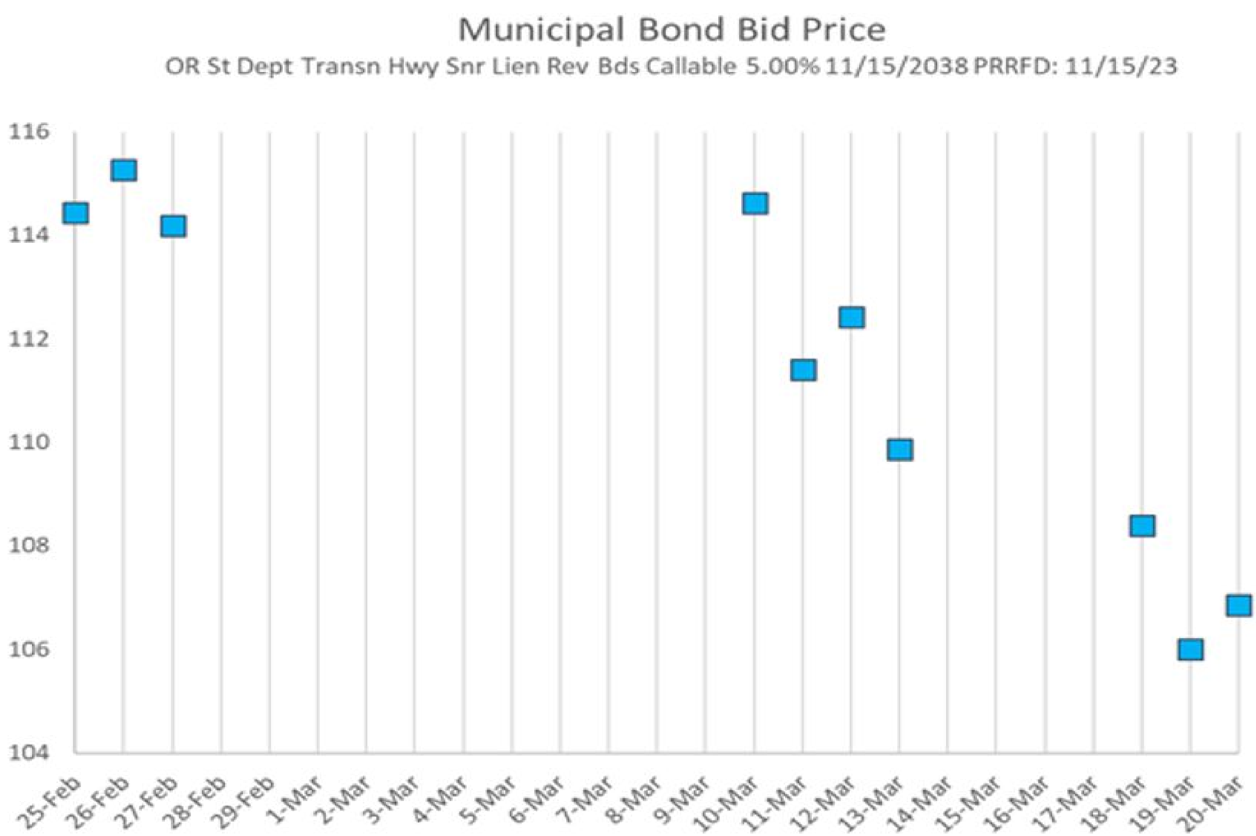
When equity market declines first began in February, bonds behaved well, moving up in price as yields fell. This continues to be the case for the highest quality fixed income with no credit risk – U.S. Treasuries. However, as the near-term outlook for economic activity started to dim, bonds with any bit of credit risk began to fall. This was exacerbated in the last two weeks by low liquidity and panic selling.



Source: MorningStar 3.20.20

Many areas of fixed income were expensive prior to this crisis, and certain companies are increasingly becoming stressed in the near term, so some of the decline is warranted. But there are many indications that this selling in bonds is particularly overblown, and dislocations abound. Let’s look at one example for municipal bonds.

The graphic below shows the various daily prices for a particular Oregon Highway department municipal bond over the last couple of weeks. Several observations. First you can see that this bond does not trade every day, far from it, in fact it did not trade the first week of March! This is more common than you think across fixed income – bonds are not stocks… You can also clearly see the price dropping off precipitously to as low as 106 last Thursday – roughly 9% from recent highs! That can be a major shock to anyone opening their brokerage account on any given day. In fact, this bond is held in several high net worth accounts. Should this bond fall in price that much? Or did someone need to sell and that’s the only price they could get? This bond and issuing agency is rated AAA (higher than the U.S. Government according to S&P). This particular bond will be called in 3 years, and is actually pre-refunded, meaning it’s been called and paid for by another debt issue and backed by treasuries. This is more or less as safe as it gets, yet the bond has been pummeled, at least based on recent spotty prices.



Source: MorningStar 3.20.20

There are issues regarding liquidity and bond fund structure that we can't get into here (read this if you want to dive deep), but here are several takeaways for bond investors at this junction:

- Quality has helped – Treasury prices have fluctuated a lot, but all-in have been a helpful equity market hedge through this downturn.
- Being Short has helped – short duration may help protect against future moves higher in interest rates.
- Bonds are self–healing. Bonds mature at par, barring default. Investors get their money back before stockholders, bank loans, and unsecured debt. Bond prices have gapped down in some instances, but it's been less than a month and many bonds have not paid their coupon payments yet. As this occurs, total returns begin to recover.

Opportunities are vast. Yield spreads on select corporate and municipal bonds are as attractive as we've seen in recent memory. This is helpful for investors seeking income and also reinvesting that income going forward. Take a look at forward returns after the aforementioned drawdowns

Forward 1-year Return	Coronavirus 2020	Q4 2018	2015-2016 Oil Collapse	Taper Tantrum 2013	GFC 2008-2009	Median
Treasuries		6.7%	-1.5%	4.3%	4.0%	4.1%
Municipal Bonds		7.2%	-1.1%	11.5%	12.6%	9.4%
Corporate Bonds		14.7%	5.3%	10.2%	24.0%	12.5%
High Yield		17.0%	23.5%	10.5%	48.6%	20.2%
Global Stocks		31.4%	24.5%	19.2%	55.7%	28.0%

Source: MorningStar 3.20.20

As many individual bonds "Trade by appointment" like the one highlighted above, we encourage clients and advisors to avoid assessing performance over short-term, daily periods. We also never promote going to cash, but understand clients have liquidity needs and emotions, and if clients want to sit in cash for a period of time we'd encourage them to keep their individual bonds invested (especially municipal bonds) to avoid selling at forced prices. Please reach out with any questions or concerns.

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