Bonds Are Back

Last year was a tough year in the bond market with the Bloomberg Aggregate Index losing 13%. The good news for fixed income is that 2023 looks to be shaping up to be a better year. This perspective takes a brief look back at bonds in 2022 and what's in store for this asset class in 2023.

In 2022, bond prices declined, and the income from bonds didn't help offset the price declines. As such, total returns were negative. Bond price performance is simply a function of supply and demand — when more sells than is being bought, bond prices decline. This net demand for bonds ebbs and flows, and while many investors are long-term investors, others trade around within the asset class based on their outlook of inflation, the economy, and other opportunities in the market. So why were investors selling bonds?

As shown in **Chart 1**, interest rates hit record low levels in August 2020 after fears of economic decline and deflation due to COVID-19 uncertainties. The demand for bonds at that time was high as the outlook for relative returns in fixed income in a deflationary environment was attractive. However, with vaccines on the horizon, and the corresponding outlook for economic recovery, bond demand slowed in 2021 and then quickly plummeted in 2022 as investors looked for higher returns in an inflationary environment. While bond math suggests that the 2022 bond market declines were certainly a possibility, investors were caught off guard by its significant decline.

Three traditional key benefits of bonds within a portfolio are liquidity, income, and portfolio ballast. In 2022, the portfolio ballast benefit was seemingly missing. Even though bond prices declined much less than stock prices, this decline was not consistent with historical bond behavior. With yields now higher and our outlook for inflation and economic growth lower, we believe that bonds will be better able to deliver on the ballast role.

With one of the worst bear markets for fixed income hopefully behind us, what's in store for this asset class in 2023?

Inflation Outlook

Two key mandates for the Federal Reserve (Fed) are to control inflation and maintain employment. The Fed has made it clear it will continue to hike rates until inflation is under control. Seventeen members of the Fed have even projected that the federal funds rate will need to get to at least 5% to effectively accomplish their goal of controlling inflation. While the bond market seems to think that inflation can be controlled at lower rate levels, the likelihood that the Fed projections come to fruition is high. If investors believe that inflation will be successfully contained, demand for bonds should grow and prices should correspondingly recover.

The Fed's employment problem is actually overemployment because as the workforce has decreased, job openings remain vacant. With too much demand for labor and not enough supply, wage inflation ensues, which can add to inflation pressures holistically.

Chart 1: Daily 10-Year Treasury Rate - Jan. 1983 to Jan. 2023

Source: Bloomberg

Economic Outlook

With consumer spending comprising over 70% of U.S. economic activity, its financial health is a key ingredient in our assessment of the direction of the economy. Consumer spending remains strong, giving the appearance that all is well. But we do not see this high level of spending as sustainable. While wages have grown amidst an imbalance of labor supply and demand, wage growth has not kept up with inflation.

So while employment and spending data may look attractive on the surface, we are seeing signs that this real wage deflation is causing consumer stress. One notable indication is the savings rate.

The personal savings rate recently plummeted to around 2% from around 9% during the COVID-19 crisis (Chart 2). Pre-pandemic, consumers saved around 5%. The strong consumer balance sheets that were built up during the pandemic are draining (Chart 3).

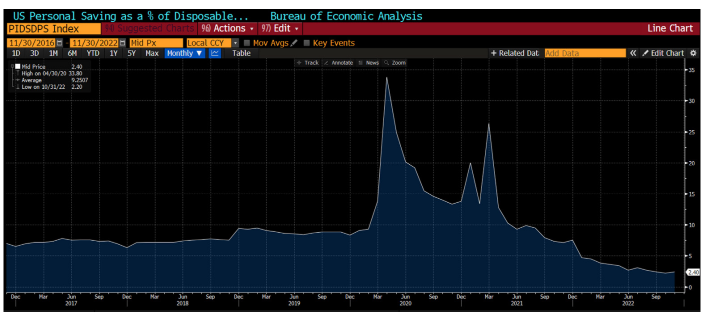
This depletion should result in a decline in consumer spending and economic growth and should help supplement the Fed's work in decreasing inflation.

What's Ahead in 2023

We believe this year looks a lot better than 2022 for bonds. Inflation should continue to decline as the Fed furthers its combative efforts and consumer spending slows from the effects of real wage declines. As a result, this should help improve the outlook and demand for bonds and increase bond prices.

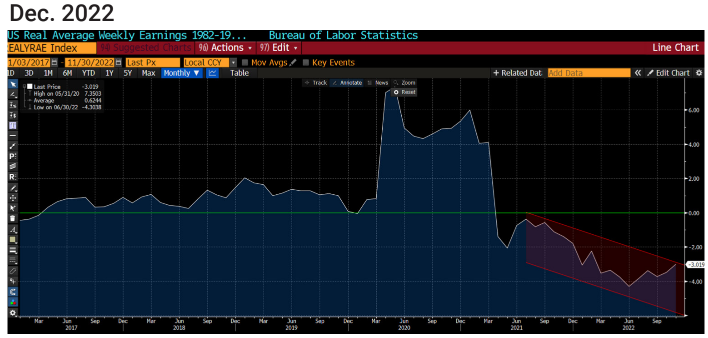
With the outlook for both higher income and stable-to-higher prices, we are optimistic for better total returns in the bond market. Even if inflation moves higher than expectations, we are entering 2023 with significantly higher bond yields than where we entered 2022 (or since 2010 for that matter), which can provide a significantly higher income component to offset potential negative effects a sell-off in the bond market might cause to total return.

Chart 2: Personal Savings Rate "as a percentage of disposable income" - Dec. 2016 to Dec. 2022



Source: Bloomberg

Chart 3: U.S. Real Average Weekly Earnings - Jan. 2017 to Dec. 2022



Source: Bloomberg