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BONDS ARE BACK: INVESTING IN A HIGHER INTEREST RATE ENVIRONMENT

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The Federal Reserve began a series of interest rate hikes in early 2022 to combat the rising tide of inflation. The federal funds current target range of 5.00% to 5.25% represents a whopping 500-basis-point increase since the beginning of 2022 — not since the early 80s have we seen such a rapid rise in rates. Though interest rates have reached much higher at times historically, many people have become accustomed to the very low rates we've experienced since 2008. This higher interest rate environment has shifted the landscape for lenders, savers, and borrowers, and people are scrambling to adjust. For investors, higher interest rates mean that bonds are back.

Many investors probably haven't thought much about bonds for a while, and some younger investors have never even experienced a strong bond market. After all, bond yields have been low since the Global Financial Crisis of 2008-2009. But higher interest rates bring higher bond yields; just in the past two years, the average U.S. bond yield (based on the Bloomberg US Aggregate Bond Index) has climbed nearly three percent — from a paltry 1.5% on May 31, 2021 to an enticing 4.7% today (June 20, 2023). As the gap between projected equity earnings and bond income yields narrows, bonds are starting to look increasingly attractive.

As investors navigate this new high interest rate environment, this may be a good time to revisit your bond portfolio. Bonds are an often overlooked asset class which offer a number of worthwhile benefits. Bonds can offer capital preservation, generate income, serve as a low-correlation diversifier against equities, and protect against potential deflation. Carrying bonds in your portfolio also means you have ready cash for spending or for future stock purchases when it's time to rebalance.

If you are looking to add bonds to your portfolio, we suggest diversifying across the credit spectrum so that your portfolio isn't overly concentrated in any one area. In terms of duration, in the current environment, bonds of lower duration carry less interest rate risk and deliver a yield premium relative to longer-duration bonds. However, you do take some reinvestment risk with low duration bonds, not knowing the rate at which you will be able to reinvest your bond's proceeds at maturity.

Keep in mind that the situation is dynamic, with interest rates still rising but also with signs of inflation declining. Indications of a slowing economy suggest that equity growth could be dampened. In this type of environment, investors might want to rein in their exposure to equity risk. This could mean being more particular about stock selection, or possibly rotating into other asset classes. With bond yields higher than they've been in years, it looks like bonds are back and a strong option. Working with an investment advisor who has specialized expertise in these areas — such as Arnerich Massena — can help you make the most of your portfolio strategy in this high interest rate environment.