Mitch on the Markets

Portfolio Manager Investing Insights

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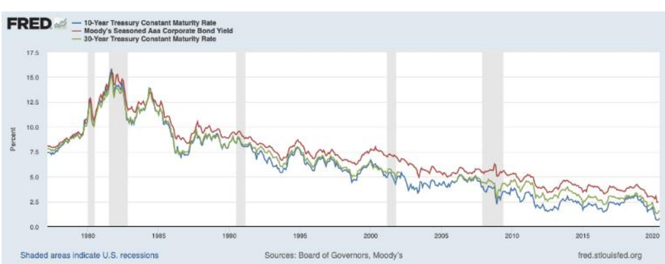
Should Bonds Be in Your Portfolio Anymore?

Bonds have a long history of being vital sources of capital preservation and income in investment portfolios, particularly for retirees. But that reputation is fading.

Yields on high-quality corporate bonds and risk-free U.S. Treasuries have been marching lower for the better part of 40 years, to the point where they no longer provide the level of income that most retirees need from an investment portfolio:

U.S. Treasury and Corporate Bond Yields Have Been Falling Since the Early 1980s



Source: Federal Reserve Bank of St. Louis[1]

The risk-free rate (U.S. Treasury yield) now hovers around 1%, which means that bond investors today are likely to *lose* purchasing power over time given the effects of inflation. The outlook also remains fairly bleak: interest rates are actively being pushed lower by the Federal Reserve and central banks across the world, with bond buying and stimulus programs running at near full steam. The end result is that interest rates are not likely to move substantially higher for several years, in my view.

This environment may have many investors wondering whether it's worth owning bonds anymore. I think the answer first depends on your tolerance for volatility, your income needs, and your long-term goals. I personally would argue that a majority of investors do not need significant fixed income in an investment portfolio with a long-term time horizon. But that does not mean bonds are dead, or that they can no longer play a vital role for some investment strategies.

For one, bonds can still be used to diversify a portfolio and reduce risk. Looking at the S&P 500 Index and the Bloomberg Barclays Aggregate U.S. Bond Index over the last ten years, there is basically zero correlation between the two.[2] When bonds zig, stocks zag, and vice versa. For investors, that means when stocks in a portfolio experience price declines, bonds usually see price increases. The end result is less portfolio volatility – an outcome that's important for many investors, even if it means slightly lower total returns over time. Second, even though most high-quality bonds are paying very little interest at the moment, they still offer very high probability of principal protection – which, again, is important to some investors. The so-called 'sleep at night' factor.

At the end of the day, the issue I see in the bond markets today is less about low interest rates and more about investors "reaching for yield." There is a trend among retail investors of moving further out on the bond risk curve in order to obtain income, in many cases buying lower quality high-yield bonds and even emerging market debt (where yields are much higher). If that sounds like you, then *maybe it is time* to sanity check the role of bonds in your portfolio, and decide whether they're worth owning at all. Chances are, you can produce similar levels of income with better risk profiles elsewhere, for example in dividend-paying value stocks.

Bottom Line for Investors

Bonds continue to serve many key functions in portfolio management. And for many older investors, bonds are – and will remain – a bedrock for your investment strategy.

But in the current market environment, no single bond investment is capable of producing the income *and* principal protection that many investors seek. Investors need to get creative, and I think one smart option is to build a customized portfolio of high-quality corporate bonds coupled with dividend-paying value stocks, to strike a balance between income, stability, and long-term growth.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Board of Governors of the Federal Reserve System (US), 10-Year Treasury Constant Maturity Rate [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGS10, June 8, 2020.

[2] BlackRock Blog, April 14, 2020. https://www.blackrockblog.com/2020/04/14/why-you-own-bonds/

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- We are officially in a recession, but how long will it last?
- What the unclear jobs data teaches us
- The Fed likely to keep pressure on interest rates
- Some major retailers see better-than-expected sales figures

What We All Knew is Now Official: The U.S. Entered a Recession in February

Official data usually takes several months – or even years – to confirm an economic recession. But the swiftness and steepness of this economic contraction made confirmation this time around much easier. The National Bureau of Economic Research (NBER) announced this week that the U.S. economy officially entered a recession in February, which marked the end of the longest economic expansion on record (128 months). There are reasons to also believe that this economic recession could wind up being the shortest on record – initial jobless claims peaked in March and employers actually added 2.5 million jobs last month, blowing nearly every estimate out of the water. Because the economic contraction was so severe to the downside, the estimated 2.5 million jobs ended up being the most jobs added in a single month on record, dating back to 1948. The stock market appears – at least for now – to be confirming that the economic recession is over, though it remains to be seen how quickly the economy can reclaim lost jobs and return to pre-pandemic growth levels. On a global scale, the world has never before seen so many countries enter a recession at the same time, even when considering the Great Depression and Great Recession.[1]

What the Unclear Jobs Data Teaches Us

Though the U.S. economy was said to have added 2.5 million jobs in May, the unemployment data is arguably fuzzy at best. The pandemic has created all sorts of challenges to accurately detailing the unemployment picture, with the U.S. Labor Department issuing "misclassification error" warnings for three months straight. At issue is how workers and non-workers are classifying themselves on Labor Department surveys. Many respondents are classifying themselves as "employed but absent from work," which the Labor Department believes should deem them "unemployed." The Census Bureau is also having difficulty gathering data, as in-person interviews have declined substantially and as fewer people respond to its Current Population Survey.[2] There are two takeaways we can garner from the unclear data in the labor markets. First, the errors in counting do not change the bigger picture: Americans without jobs remains at a historically high point, with tens of millions of Americans currently out of work. The second takeaway is the most important, in our view: when trying to ascertain a complete picture of the U.S. economy, one should not rely on a single data point, such as the unemployment figures. Myriad data points are needed to gain meaningful macroeconomic insights.

The Fed Likely to Keep Pressure on Interest Rates

Federal Reserve Chairman, Jerome Powell, made some comments on Wednesday that indicated the Fed's medium-term outlook on interest rates. The takeaway: interest rates are likely to remain low for years. Chairman Powell said the central bank has no plans to raise interest rates through 2022, and that they will continue to purchase Treasury and mortgage securities at a consistent pace for the foreseeable future, putting downward pressure on the long end of the interest rate curve. The Fed's accommodative approach is good news for businesses and mortgage borrowers, but bad news for savers and banks – assuming the yield curve remains flat.[3]

Some Major Retailers See Better-Than-Expected Sales Figures

Small signs of life are starting to emerge in the Consumer Discretionary sector, as U.S. consumers step back out into the economy to shop. Two anecdotal pieces of data this week came from Macy's and Kohl's, two popular big box stores. Macy's said sales at reopened stores are down 50% as compared to before the pandemic, which is actually far better than the estimated -85% decline. Kohl's said this week that sales were down 25%, which again is better than expectations. Macy's expects to have 400 locations reopened this week, and Kohl's has already reopened most stores across the country.[4] Consumer confidence is rising.

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[1] The Wall Street Journal, June 8, 2020. https://www.wsj.com/articles/recession-in-u-s-began-in-february-nber-panel-says-11591636626

[2] The Wall Street Journal, June 10, 2020. https://www.wsj.com/articles/coronavirus-pandemic-makes-unemployment-calculation-harder-11591781401

[3] The Wall Street Journal, June 10, 2020. https://www.wsj.com/articles/fed-debates-how-to-set-policy-for-the-post-pandemic-economy-11591781402?mod=hp_lead_pos1

[4] The Wall Street Journal, June 9, 2020. https://www.wsj.com/articles/shoppers-surprise-retailers-by-returning-to-stores-11591733058

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