The Bear Market in Bonds

All readers are well aware of turbulence in the stock market, which would normally mean stability and perhaps even rallying in the bond market. When stocks zig, bonds are supposed to zag.

Not in 2022.

Investors have been shedding government and corporate bonds at a rapid clip this year, with the Bloomberg Global Aggregate Total Return Index for bonds sinking into bear market territory last week. This drawdown marks the first bear market for this index since its inception over 30 years ago.[1]

Corporate bonds have not fared much better. Spreads – which in this case is the difference in yield between corporate bonds and government bonds (Treasurys) – have risen alongside Treasury bond yields. Investors are demanding higher yields from corporations perhaps in response to more challenging economic conditions ahead, and those rising yields are denting returns on existing bonds. Spreads have risen in roughly half of all the weeks in 2022, which is already more than we've seen in any year this century.

A key reason it is so rare for spreads and Treasury bond yields to rise at the same time is that normally the Federal Reserve would be cutting rates when the economy was showing signs of weakening. The opposite is happening today, of course, as the Federal Reserve has made clear that getting inflation under control is a higher priority than economic growth and full employment. When interest rates rise, Treasury bonds decline in price.

Zacks Investment Management has maintained a relatively cautious stance on fixed income over the past couple of years, maintaining a short duration in the portfolio in order to reduce volatility and interest rate risk as much as possible. We also continue to diversify across different income-producing asset classes, pursuant to each client's objectives.

Preferred stocks, for instance, offer an income-generating alternative to the traditional fixed-income asset class. Preferred stocks are still stocks, so generally speaking, we would expect higher volatility and more frequent drawdowns than we would in bonds. But 2022 has been somewhat of an outlier year, with the Zacks Preferred Strategy down just -6.02% through the

first half of the year compared to its benchmark, the ICE E-L F&A Preferred, which is down -14.40%. Our strategy also yields about 3% more than the 10-year U.S. Treasury, which in short has meant higher income with less volatility.[2]

One of the key reasons the Zacks Preferred Strategy has fared so well is the defensive posture in the portfolio, specifically with an overweight to well-capitalized banks. Banks' strong financial position makes their ability to pay dividends more secure, providing support to their market values. In a rising interest rate environment – which we're currently in – the potential for a fixed rate coupon to turn into a floating rate coupon on more than half of the positions in the Zacks Preferred Strategy is also providing support to the portfolio.

Municipal bonds are another possible avenue for diversification, though they do not work for every type of investor (based on tax-equivalent yield). In cases where municipal bonds make sense, shorter duration municipal bonds have held up much better than similar duration U.S. Treasuries and corporate bonds throughout 2022, and we have not seen a rise in municipal bond yields like we've seen in the taxable arena. The intermediate portion of the curve appears more attractive than the shorter end of the curve, which is where we've kept focus. Unlike the Treasury yield curve, the municipal bond yield curve remains positively sloped, and balance sheets for local and state municipalities continue to improve.

The unpredictable nature of inflation, interest rates, Fed policy (to an extent), and reactions in the stock and bond markets has created an environment in 2022 where investors need to be flexible and active, in my view, which is what we've been doing this year in our fixed income management and also in alternatives to fixed income.

Bottom Line for Investors

The positive correlation we have seen between bonds and stocks in 2022 has created challenges for many investors, particularly since it is so rare for stocks and bonds to enter a bear market around the same time. I do not believe this is part of a longer-term trend, however, and/or that traditional methods of stock-bond diversification have broken down. Asset allocations are designed based on the risk-return profiles they generate over 5, 10, or 20+ years – not a single year.

For 2022, however, I think investors should approach the fixed income markets with an active and flexible approach. Certain municipals look good on a relative basis, and at current levels, investment-grade corporate bonds are now paying meaningful yields. Preferreds offer a strong alternative to fixed income as well, in my view, and they also have the added benefit of having more than 90% of dividends treated as qualified for tax purposes. For investors willing to take on duration and credit risk, a preferred stock allocation is a viable option.

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] Wall Street Journal. September 8, 2022. https://www.wsj.com/articles/broad-declines-drag-bonds-into-rare-bare-market-11662602793?mod=djemMoneyBeat_us

[2] Strategy Report 2022.

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

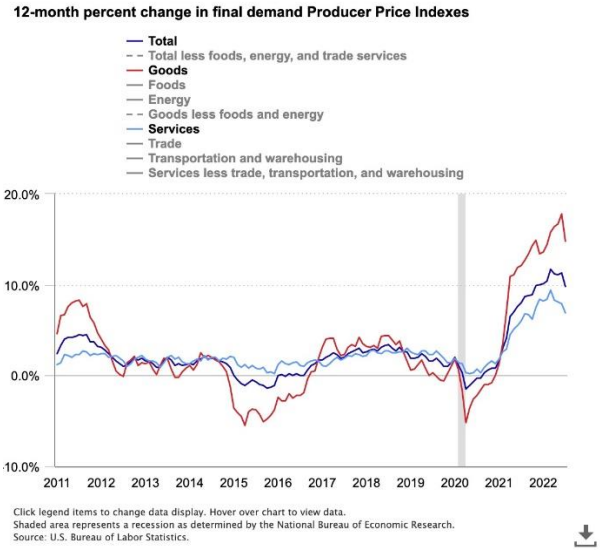
- **Federal Reserve's status of lifting interest rates**
- **Acceleration of inflation**
- **U.S. dollar's ongoing strength**

Higher-Than-Expected Inflation Reading Sends Markets Spiraling

For the month of August, consumer prices (CPI) rose 8.3% year-over-year, which was a slight decline from July's 8.5% pace. The problem was that month-over-month, prices rose 0.1% from July even as prices eased for gas, airfares, and items like rental cars – which had driven significant inflation earlier in the year. That meant that core prices – which exclude food and energy and give a broader picture of prices for consumer goods and services – rose far more than expected, signaling that inflationary pressures could be more broad-based than anticipated. Indeed, core prices rose 0.6% from August to July, which all but confirms that the Federal Reserve will continue pursuing its hawkish path with interest rates. According to Moody's Analytics, the average household is now spending about $460 more each month to buy the same basket of goods and services as compared to 2021 prices, marking a significant uptick. Incomes have risen over the same period, helping to offset some of the higher costs, but wages have not gone up as quickly as inflation. The market responded with a sharp selloff, with every sector in the S&P 500 falling and the index plunging by -4.3% in a single day of trading – the biggest selloff since the depths of the Covid-19 bear market in early 2020. It appears the market had been hoping that the inflation print would confirm a downtrend, which would have taken the pressure off the Fed to raise rates so aggressively. The readout did the opposite, however, all but assured at least a 75-basis point increase at the Fed's September 20-21 meeting.[1]

Some Slightly Better Inflation News

Consumer prices remained sticky in the month of August, but more hopeful news could be found in the producer-price index (PPI), which measures what suppliers charge businesses for the delivery of goods and services. Generally speaking, changes to the PPI will show up in the CPI numbers with a lag, as businesses can adjust pricing over time as input costs fall. PPI in August fell 0.1% from July, which followed a 0.4% decline from June to July (see chart below). The year-over-year decline in August was also notably significant compared to July, with the PPI rising 8.7% in August compared to the 9.8% increase posted in July. Both the CPI and PPI data are fickle from month-to-month, so focusing on one or even a few months' worth of data can be misleading. Even still, it wasn't all bad news on inflation for the month of August.[2]



U.S. Bureau of Labor Statistics[3]

The U.S. Dollar's Ongoing Strength

The greenback continues to have a historic run. In 2022 alone, the dollar has appreciated by 13% against a basket of other developed currencies, and has risen by 17% against the pound. The dollar has also risen to parity against the euro, a first in over 20 years. The reasons for the dollar's persistent strength are many, but the primary driver has been the U.S.'s economic strength relative to the world in the post-pandemic period. Europe continues to struggle with growth and China has been hampered by its zero-Covid policy, with rolling shutdowns and restrictions still the norm. The United States has also been engaged in monetary policy tightening, and higher rates arguably stand to attract more foreign capital. But an unsung reason for the dollar's resilience has been long periods of innovation, growth, and improved profitability of U.S. corporations. Innovation spurs investment, which means foreign capital flows into this country and pushes up the value of the dollar. For those who believe the U.S. economy will remain competitive and resilient relative to the rest of the world for a long time to come – which we believe here at Zacks Investment Management – a stable and high U.S. dollar is likely to follow.[4]

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[1] Wall Street Journal. September 13, 2022. https://www.wsj.com/articles/inflation-report-keeps-fed-on-aggressive-rate-rise-path-11663090209?mod=djemRTE_h

[2] Wall Street Journal. September 14, 2022. https://www.wsj.com/articles/u-s-supplier-inflation-remained-elevated-in-august-11663161329?mod=djemRTE_h

[3] U.S. Bureau of Labor Statistics. August 16, 2022. https://www.bls.gov/opub/ted/2022/producer-prices-up-9-8-percent-from-july-2021-to-july-2022.htm

[4] Wall Street Journal. September 11, 2022. https://www.wsj.com/articles/for-wall-street-a-strong-dollar-is-front-and-center-11662849218?mod=djemRTE_h

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