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Amundi ASSET MANAGEMENT

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Why Investors Should Consider a Bond Allocation

INVESTMENT TALKS

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Executive summary

- *We believe intermediate-term bonds continue to offer a valuable and compelling option for an investor's asset allocation, and we see a return to the more typical negative return correlation relationship between bonds and equities.*
- *Initial yield can often be the best predictor of total return for bonds over the intermediate or longer term.*
- *In the recent past, longer-term yields have generally fallen after prior pauses by the US Federal Reserve, as investors discounted lower forward rate expectations.*

In the face of a potential recession later in 2023, US government money market funds have enjoyed record inflows, with investors attracted to their 5%+ yields—the highest levels in decades—as well as their low-risk status. However, we believe intermediate high-quality bonds continue to offer an important and compelling option for an investor's asset allocation due to historically elevated yields, longer duration profile and potentially negative return correlation to equities and other high risk assets.

Yields are near their highest level in 15 years

The Bloomberg U.S. Aggregate Index ("the Aggregate Index"), which represents a broad universe of intermediate-term investment grade bonds, currently offers a 4.85%[1] yield, only modestly lower than the 5.05% yield offered by government money market funds, and near its highest level since 2008.

Importantly, yield is often the best predictor of a bond's total return over the intermediate or longer term, and the yield of the Aggregate Index could currently represent an attractive valuation entry point for investors.

In contrast, yield is *not* a good predictor of longer-term returns for money market funds. This is because money market interest rates can change daily, presenting reinvestment risk over a short time horizon. Indeed, futures on the Federal Funds market currently forecast a 4.14% federal funds rate (almost 1% lower than current levels[1]), by the end of 2024. It is also important to note that the market has recently pushed out major rate cuts into 2024. Should the economic outlook deteriorate more quickly than current expectations, the US Federal Reserve could be driven to cut short-term interest rates sooner, further compromising money market yields and total returns.

Duration has historically benefitted from a falling interest rate environment

While the Fed has stated it is not poised to immediately lower rates, we should note that in environments where interest rates decline, bond funds' total returns have historically benefited. This has been due, in part, to the funds' longer interest rate duration profiles. Currently, the Aggregate Index carries a duration of 6.35 years[1]. Money Market funds, on the other hand, do not have significant duration exposure and will not benefit from falling interest rates.

Bonds with longer duration can benefit as the Fed cuts rates, just as they can suffer from rate increases. By the end of 2022, after the Fed's historic rate increase, the Aggregate Index yield had risen from 1.75% to 4.85%. Currently, with a 5.08%[1] federal funds rate, we believe the Fed is nearing the end of this rate hiking cycle; indeed, the market has priced in a terminal, or peak, federal funds rate of 5.4% by November 2023, followed by over 1% in expected rate cuts through December 2024.

Looking ahead, we believe investors may wish to focus on the benefit that longer-duration bonds may offer in a future environment marked by federal funds rate cuts beyond what is currently priced into the market. While cash offers limited upside, as historical results indicate, the Aggregate Index could generate an intermediate-term total return that is above today's yield.

As shown in Exhibit 1, when the Fed has eased monetary policy over the past 25 years, it has reduced interest rates quickly and sharply; in periods like today where rates exceed 5%, rate cuts have totaled 4.5% to 5% over an approximate 1½ year period. Fixed income markets currently forecast over 1% of federal funds rate cuts over the next 1½ years. The graphic below highlights that during the past Fed

[1] Source: Bloomberg, July 3, 2023

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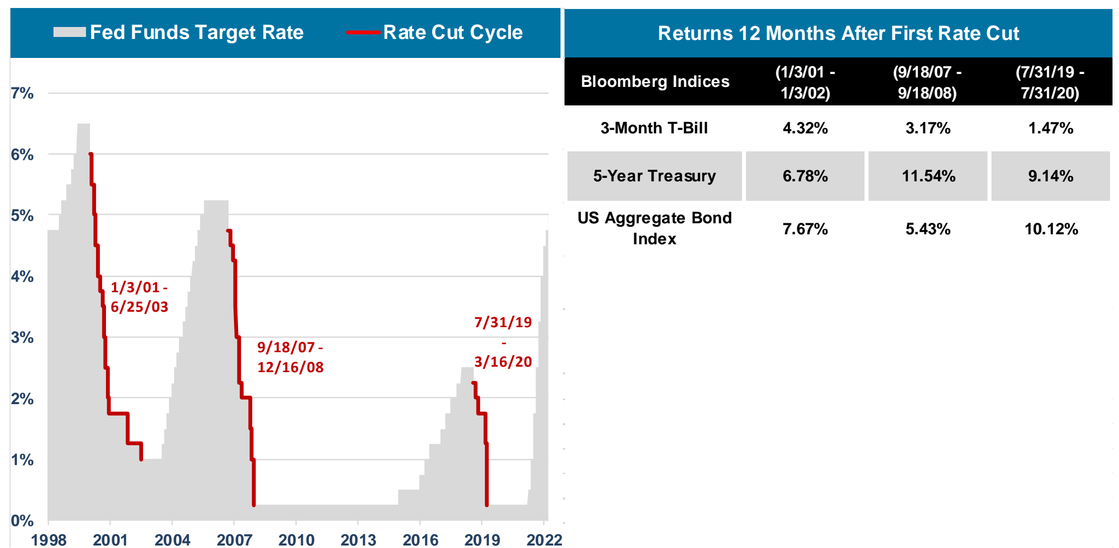
easing cycles, the Aggregate Index significantly outperformed cash. **This was even the case during the Great Financial Crisis, when credit spreads widened significantly.**

In other words, intermediate bond duration has tended to dominate credit spread movement during recent rate cutting cycles. It is also important to note that once the Fed has reached its terminal rate, longer-term yields have historically declined as investors start to discount lower forward interest rate expectations.

Exhibit 1: When the Fed cuts rates, intermediate bonds have benefitted



Returns 12 Months After First Rate Cut			
Bloomberg Indices	(1/3/01 - 1/3/02)	(9/18/07 - 9/18/08)	(7/31/19 - 7/31/20)
3-Month T-Bill	4.32%	3.17%	1.47%
5-Year Treasury	6.78%	11.54%	9.14%
US Aggregate Bond Index	7.67%	5.43%	10.12%

Source: Bloomberg as of May 5, 2023. **Data represents past performance, which is no guarantee of future results**. Rate cut cycles begin with the date on which Fed cut rates and end with the lowest rate in each cycle. Bloomberg indices represented include 3-month Treasury bills, 5- year Treasury bills, and the US Aggregate Bond Index, a measure of the US bond market. Indices are unmanaged and their returns assume reinvestment of dividends and do not reflect any fees or expenses. It is not possible to invest directly in an index.

We believe the Fed has neared its terminal rate and, as a result, bond returns should reassume their traditional role of portfolio "diversifier."

The negative return correlation of bonds and equities has returned

Historically. bonds often act as the portfolio "anchor" offering investors the potential for stable income and relatively low, or negatively correlated, returns. That role was upended in 2022, during the fastest, largest interest rate increase since 1974, as both bond and equity prices generally moved in tandem and sustained historic losses. As the Fed nears its terminal rate, we anticipate that bonds should reassume their traditional role of portfolio "diversifier.[2]"

[2] Diversification does not assure a profit or protect against a loss.

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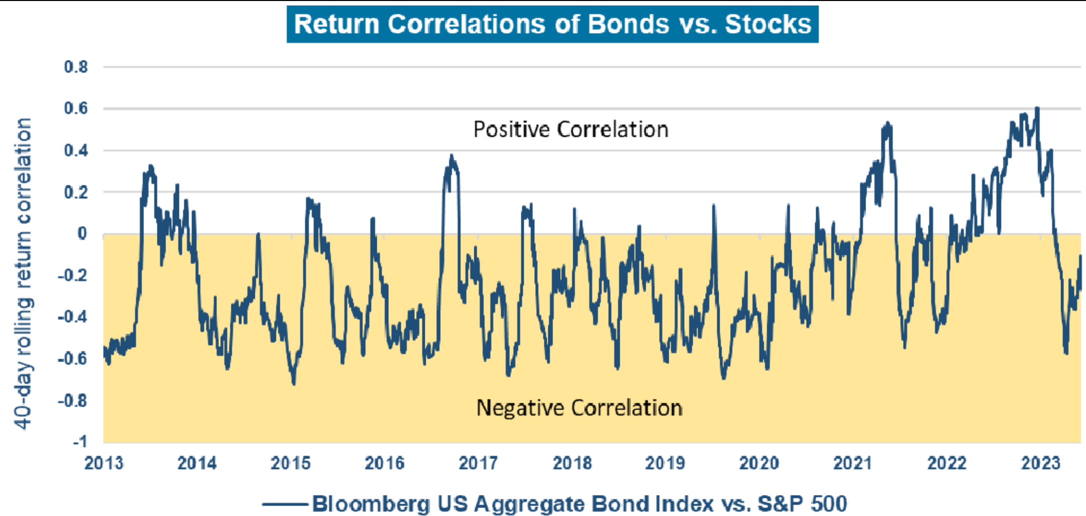
Exhibit 2: Historically, bonds have shown negative return correlation to risky assets



Source: Bloomberg and Amundi US as of 6/30/23

The return correlation relationship presented above highlights the beneficial role that bonds, compared to money market funds, can play to reduce return volatility. With higher yields and income, the 60/40 classic equity/bond allocation could once again become the dominant allocation target for investors.

Conclusion

In response to historic interest rate increases by the US Federal Reserve in 2022 and early 2023, investors are being offered historically elevated yield options across the yield curve. Understandably, many investors have flocked to money-market funds in search of safety and yield. We believe intermediate bonds offer benefits not available to a money-market investor—namely, the dual benefits of elevated income/total return potential and portfolio diversification. While the Fed's ultimate short-term interest rate path is somewhat uncertain, we believe the Fed is nearing the peak in the current tightening cycle and, in response, investors may be well served by extending the duration of their fixed income exposures.

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Index and Term Definitions

- **Initial yield:** The ratio of the current income generated by an investment to its current capital value and expressed as a percentage.
- **Bloomberg U.S. Aggregate Index:** An index that represents a broad base of intermediate-term investment grade bonds.
- **US Federal Reserve:** The central banking system of the United States, created on December 23, 1913, with the enactment of the Federal Reserve Act.
- **Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.
- **Equity risk:** The risks of investing in equity include share price falls, receiving no dividends or receiving dividends lower in value than expected.
- **Money market funds:** Funds that invest in high quality, short-term debt securities and pay dividends that generally reflect short-term interest rates.
- **Intermediate-term bonds:** Bonds issued with maturity dates that are between two and 10 years, with yields that tend to fall between short- and long-term debts.
- **Reinvestment risk:** The chance that cash flows received from an investment will earn less when put to use in a new investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).

Important information

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