Market Insights

Bonds are Back

U.S. | 1Q 2023
As of January 20, 2023

J.P. Morgan
ASSET MANAGEMENT
2022 was the worst year for core bonds in almost half a century, as the U.S. Aggregate declined by 13% on the back of the Fed’s most aggressive rate hiking campaign since 1980. Bonds tend to come under pressure when the Federal Reserve is active; 1994, 1999, 2013, and 2018 were all years in which the Federal Reserve was raising rates or communicating they would tighten policy.

Encouragingly, however, the years following bond market declines tend to see healthy returns. Though core bonds logged negative total returns in both 2021 and 2022, with the Fed likely to conclude its rate hiking cycle in 2023, interest rate volatility should decline allowing for some much-needed stability in the bond markets.
The inflation heatwave that prompted aggressive Fed action should cool considerably in 2023. In fact, disinflation is now evident in most CPI components; supply chain pressures have eased noticeably allowing for core goods prices to come down, energy inflation continues to deflate alongside falling gas prices, and shelter inflation—which accounts for more than 1/3 of CPI—should decline in 2023 on the back of lower home prices and lease rates.

Interestingly, year-over-year spikes and declines in inflation tend to look like the Eiffel tower: it goes up and comes down symmetrically, meaning prices decline as quickly as they increase. From our vantage point, the other side of the inflation tower should continue to crystallize in 2023.
Historically, policy rates tend to go up by the escalator and down by the elevator. The challenge last year was that the Fed took rates up in the elevator to kill inflation, spooking the bond market. We expect the Fed will pause this year as inflation cools and growth slows, and eventually ease policy in late 2023. This should translate to a boost in bond prices.

While slower growth and falling inflation suggest the Fed can be a bit more cautious in 2023, whether or not the Fed begins cutting rates in the second half of the year is still unclear. Still, the Fed is almost done tightening, suggesting monetary policy will be increasingly sensitive to economic fundamentals such as softer growth and cooler inflation.
Last year, elevated volatility led valuations to reset across the capital markets. As the dust settles, bonds are looking outright cheap relative to the past 20 years, with valuations in U.S. Treasuries and core fixed income a standard deviation below their long-run average. This has presented an attractive entry point for investors. Moreover, it could be some time before yields are as attractive as they are today. Bond yields should decline as growth slows, inflation cools, and the Fed prepares to ease policy, suggesting a small window for investors to lock in these juicy yields and benefit from any subsequent decline.
Diving in, bond yields across a variety of sectors are attractive relative to recent history. The grey bars show the range of yields over the past decade, the light purple bar shows the median, and the dark blue diamond—which reflects current bond yields—represents the current reading. In all cases, the blue diamond is above the purple line, indicating that bonds are attractive.

Importantly, current yield levels are a strong predictor of future fixed income returns. For context, if investors were to buy the Bloomberg U.S. Aggregate at a yield of 4.5-5%, historical relationships suggest a potential total return of ~5% annualized over the next cycle. With the trailing 5-year return on bonds now flat against a backdrop of elevated yields, core bonds represent an attractive opportunity on a forward looking basis.

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Consistently ranked as one of the world’s leading financial institutions, J.P. Morgan provides a range of innovative and effective investment management and products to meet the needs of individual and institutional investors.

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Difficult asset classes

The Bloomberg Barclays Emerging Markets Local Currency Debt Index tracks the performance of local currency debt issued by sovereign and quasi-sovereign entities in emerging market countries and represents highly liquid sovereign debt held in emerging market local currencies and expirations. The index is designed to reflect the performance of these types of obligations, with the exception of the United States, and also includes foreign currency denominated bonds issued by non-U.S. governments, international organizations and emerging market companies, and exchange-traded and FTSE-listed derivatives. The index is rebalanced when necessary to ensure its quality and, therefore, its ability to accurately reflect the performance of the underlying asset class.

Turnaround strategies

Employing a turnaround strategy requires a significant degree of skill, experience, and knowledge, as well as access to a wide range of resources. The potential for success is high, but the risks are also significant. The strategy involves identifying companies that are in distress or experiencing financial difficulties and then investing in them in the hope of achieving a turnaround and realizing a profit. This strategy is typically used in situations where other investment strategies have failed to produce favorable results.

Equity market neutral strategies

Employing an equity market neutral strategy requires specialized skills and knowledge, as well as access to a wide range of resources. The potential for success is high, but the risks are also significant. The strategy involves identifying companies that are in distress or experiencing financial difficulties and then investing in them in the hope of achieving a turnaround and realizing a profit. This strategy is typically used in situations where other investment strategies have failed to produce favorable results.

Distressed Restructuring Strategies

The use of derivatives may not be successful, resulting in investment losses, and the cost of such strategies may reduce market conditions than other types of investments because they may be more sensitive to changes in economic or political conditions. Equity securities investing involves a greater degree of risk and increased volatility. Changes in currency exchange rates and international trade policies can affect the value of foreign securities.

Alternative investments involve greater risks than traditional investments and should not be deemed a complete investment program, since they may be subject to a higher degree of market risk because of concentration in a specific industry, sector or geographic area. The price of real estate, risks related to general and economic conditions, changes in the value of the underlying property owned by the trust and differences in accounting and taxation policies outside the U.S. can raise or lower returns. Some overseas markets may not be fully developed, and changes in regulations in those markets could affect the ability of the portfolio to realize gains or to meet obligations. Investing in emerging markets can be more volatile. The potential for higher returns is greater, but the potential for loss is also greater. This strategy is typically used in situations where other investment strategies have failed to produce favorable results.

J.P. Morgan Asset Management – Definitions

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