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These Are the Best Bond Bets Right Now as Interest Rates Rise

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Federal Reserve Chairman Jerome Powell.
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The quarter mercifully about to end provided an object lesson of the eternal verity that rules the bond market: When yields rise, prices fall, which they did in historic fashion.

Yields are up sharply since the start of the year, extending the losses that actually stretch all the way back to the beginning of 2021. Since then, the Bloomberg Global Aggregate Bond Index shows a negative total return of about 11%, which comes to $2.6 trillion, eclipsing the $2 trillion loss suffered in 2008 in the 2007-09 financial crisis.

From the turn of the year through Thursday, the benchmark 10-year Treasury note yield rose by 86.1 basis points (1/100ths of a percentage point), to 2.375%, the highest level since May 2019. The lion's share of that surge—54.7 basis points—occurred in March, as the debt markets came to terms with the beginning of the Federal Reserve's long-awaited (and arguably belated) reversal of its super-easy

monetary policy. That stance was adopted during the dire days of the March 2020 collapse in the economy and financial markets from the effects of the Covid-19—and was maintained until recently, despite the economy recovering vigorously and inflation taking flight, with consumer prices up 7.9% in the latest 12 months to a four-decade high.

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Perhaps not coincidentally, the 10-year Treasury yield has broken above its downward sloping trend line that stretched all the way back to the historic peak over 15%, reached in September 1981, according to Evercore ISI. And were the benchmark to move back above 3%, its 2018 apex, it would further indicate a breakout, according to a report by the firm's keen chartist, Rich Ross.

What's happened to bond investors already is bad enough. The iShares Core U.S. Aggregate Bond exchange-traded fund (ticker: AGG) had a total return of negative 5.77% from the beginning of the year through Wednesday, Morningstar reports. That was only slightly less than the SPDR S&P 500's (SPY) negative 6.27%. That means the fixed-income portion of a balanced portfolio failed to compensate for equity declines. The Vanguard Balanced Index Fund (VBAIX), which tracks the classic 60% stock/40% bond mix, had a negative 6.50% return in the same period.

The silver lining, according to a research note from Bank of America analyst Ralph Axel, is that the surge in Treasury yields has effectively discounted the Fed's expected tightening campaign. In particular, the two-year note's yield nearly has tripled since the end of 2021, jumping 140.5 basis points, to 2.135%, through Thursday, with about half of the increase coming in March. The five-year Treasury yield is up 112.9 basis points, to 2.395%, which puts it above the benchmark 10-year note.

Based on futures trading, the Fed's key policy rate—the federal-funds rate—is expected to end the year in a range of 2.25%-2.50%, according to the CME Group's FedWatch site. That would include 50-basis-point hikes at both the May 3-4 and

June 14-15 Federal Open Market Committee meetings, rather than the 25-basis-point moves that have been the rule in recent years. It would also be well above the 1.90% median forecast in the FOMC's Summary of Economic Projections, released just on March 16.

But an array of Fed speakers, led by Chairman Jerome Powell, are calling for more-assertive action if needed to rein in inflation. The futures market now is projecting a mid-2023 peak of 2.75%-3% for the fed-funds target, up from 2.50%-2.75% at the end of the previous week.

James Kochan, the former fixed-income strategist for Merrill Lynch and Wells Fargo funds and a market veteran who was around for the historic highs in yields, thinks rates will rise a lot farther than that. In particular, given the economy's strong momentum, he doubts that 2%-3% rates will cause a slowdown, even if inflation falls to 5%.

Much of the expectation of a peak in rates, and by extension the economy, relates to the yield curve. A narrower spread between short- and long-term interest rates historically has been a precursor of a slowdown, and the tight gap of 20 basis points between the Treasury two- and 10-year note yields has aroused recession worries.

But the central bank's massive purchases of Treasury and agency mortgage-backed securities, which has doubled the size of its balance sheet to nearly $9 trillion, has artificially lowered long-term yields. Michael Contopoulos, Richard Bernstein Advisors' director of fixed income, says the 10-year yield would be closer to 3.70% were it not for this quantitative easing. So, he argues, the yield curve's recession signal is distorted.

Kochan says he is sticking with his recommendation of the past two years: Bond investors should be in short-duration sectors of the high-yield market, where current income might offset price declines. He'd avoid longer-duration Treasury and municipal bonds. "I would rather take on a degree of credit risk than interest-rate risk," he writes in an email.

Cliff Noreen, head of global investment strategy at MassMutual, agrees. While corporate spreads (the extra increment of yield for credit risk) have widened somewhat this year, he finds that high-yield issuers' fundamentals are generally strong, with robust profits, high margins, and reasonable leverage. The outlook for downgrades and defaults also is favorable.

Floating-rate corporate loans are among the most attractive sectors, Noreen said in an interview. Their returns should be enhanced with further rises in the short-term rates on which the loans are based, such as Libor (the London interbank offered rate) and its successor, SOFR (the secured overnight financing rate). MassMutual favors this asset class for its policyholders, he added in an email.

Individual investors can gain exposure to the sector through an ETF, such as Invesco Senior Loan (BKLN) or closed-end funds, which I've frequently highlighted, most recently in January. Those loan CEFs are cheaper now, mainly because of a widening in their discounts from net asset values, which were down only fractionally.

In the muni market, shorter-term yields also have risen substantially, making them a worthwhile alternative to cash holdings that still yield only a fraction of a percent. For instance, a triple-A two-year tax-free muni yields 1.62%, making it a worthwhile alternative to the comparable Treasury note for investors in federal tax brackets above 24%.

But some new issues offer better relative yields, observes Kyle Gerberding, director of trading at Asset Preservation Advisors, an Atlanta-based muni specialist. He points to a Texas Permanent School Fund bond for Lamar, Texas, with a 5% coupon maturing in 2027, priced at a premium to yield 1.98%, or 84% of the comparable Treasury. Texas PSF bonds carry a triple-A rating and were described by our colleague Andrew Bary three years ago as the ultimate safe investment.

As badly as the bond market has been hit this year, yields could rise further, generating more losses. These relatively defensive, shorter-duration alternatives provide some yield to help ride out turbulence ahead.

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