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Core Bond: No Time to Die

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Following the bond market's recent beating, term yields have already priced in aggressive Fed rate hikes, positioning core bonds to effectively diversify credit risk.

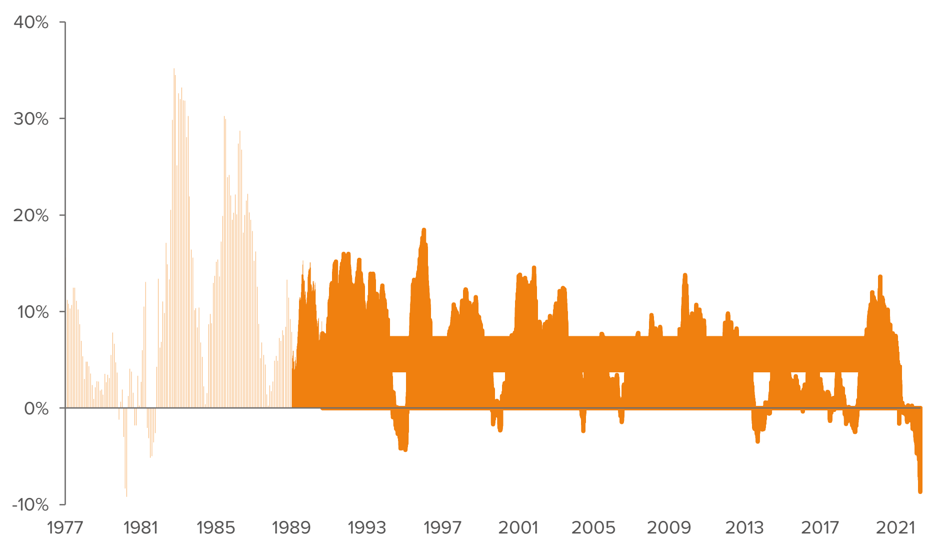
- Core bonds have historically performed surprisingly well following the first rate hike of a tightening cycle.
- The reason: rate hikes typically have minimal impact on longer-term yields, where core bonds tend to have more exposure.
- Rates now appear properly calibrated for a Federal Reserve squarely focused on fighting inflation.

Rate hikes are no doomsday for core bonds

Considering fixed income's dismal performance so far in 2022, Federal Reserve Chair Jerome Powell might be an eyepatch away from earning the title of archnemesis to bond investors. The Fed's plans for aggressive rate hikes in the face of surging inflation have driven the U.S. Aggregate Bond Index down 9% year to date, rivaling 1980 for the worst drawdown in the index's 46-year history.

Figure 1: Is the damage to bond markets already done?

Trailing 12-month total return, U.S. Aggregate Bond Index



As of April 26, 2022. Source: Bloomberg, Voya Investment Management calculations. **Data represents past performance, which is no guarantee of future results**.

Rather than endure the coming rate hikes, some asset allocators—knowing that bond prices move in the opposite direction of interest rates—have been looking to shift away from core fixed income into assets with less interest rate sensitivity, as measured by duration. But historically, most of the damage to bond markets occurs *in the run-up* to rate hikes. Once the Fed *begins* hiking, returns for core bonds have been surprisingly decent.

The current cycle that began in March is still early, and bond prices have continued to slide amid fears of more drastic tightening measures. However, over recent rate hike cycles, the U.S. Agg and its major components have produced curiously positive results (except for 1994 when the Fed was forced to defend the dollar) (Fig. 2). How is this possible? The answer lies in the shape of the yield curve.

Figure 2: Core bond sectors have performed well in most recent rate hike cycles

Rising-rate periods	Feb. '94 to Feb. '95	June '99 to May '00	June '04 to June '06	Dec. '15 to Dec. '18	Since 3/17/22
Rate change (bps)					
Federal funds target rate	+300	+175	+425	+225	+25
10Y Treasury yield	+172	+62	+60	+47	+57
Cumulative return (%)					
Short-term bonds	n/a	3.24%	4.09%	3.43%	-0.73%
U.S. Agg	-1.57%	1.40%	5.59%	5.73%	-3.36%
Treasury bonds	-2.93%	2.59%	4.90%	3.50%	-2.92%
IG corporate	-2.80%	-0.49%	5.26%	9.78%	-3.97%
Mortgage-backed securities	-0.17%	1.60%	6.26%	4.69%	-3.65%
GNMA bonds	-0.40%	2.28%	6.13%	3.98%	-3.44%

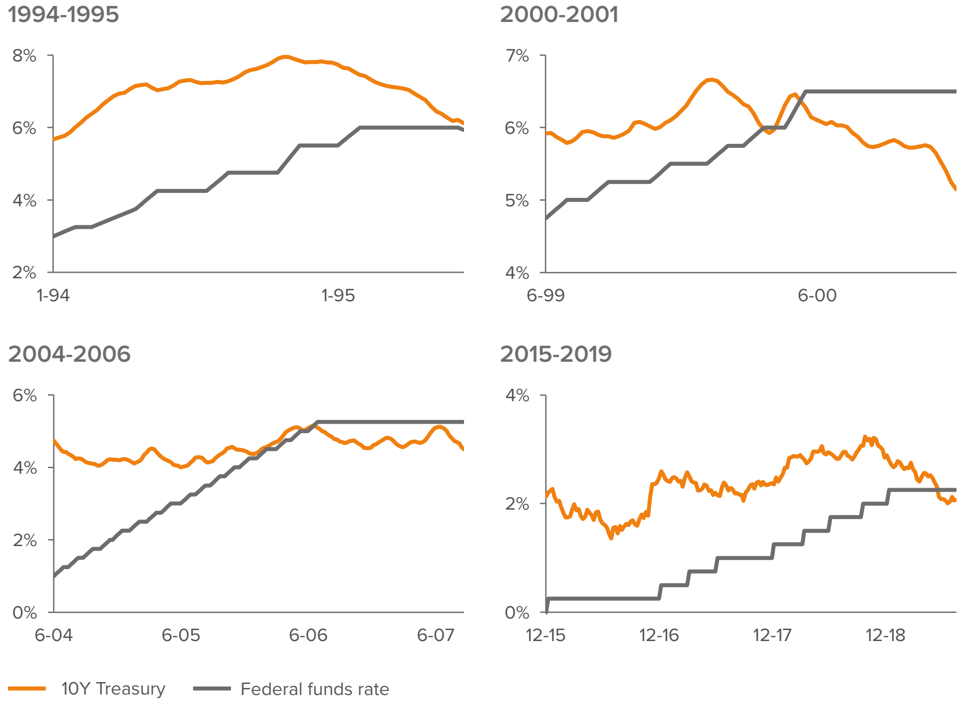
As of April 26, 2022. Source: Bloomberg, U.S. Department of the Treasury, St. Louis Fed, Voya Investment Management. Short-term bonds: Bloomberg Gov/Credit 1–3 Year Index; U.S. Agg: Bloomberg U.S. Aggregate Bond Index; Treasury bonds: Bloomberg U.S. Treasury Index; IG corporate: Bloomberg U.S. Corporate Investment Grade Index; mortgage-backed securities: Bloomberg U.S. Agency Fixed Rate MBS Index; GNMA bonds: Bloomberg GNMA Index. **Data represents past performance, which is no guarantee of future results.**

Fed tightening cycles have had little impact on long-term yields

A “rate hike” refers to a Fed increase in the target federal funds rate, which affects only overnight borrowing costs. However, rate hikes tend to have only a minimal impact on the 10-year Treasury yield, with short-term rates rising faster than long-term rates as the yield curve flattens (Fig. 3). The direction of term rates such as the 10-year—where core bond investors have more exposure—is largely out of the Fed’s direct control, determined instead by market expectations of growth, inflation and the subsequent path of monetary policy.

This forward-looking mechanism is well known when it comes to stocks: if a company enters a business line that the market views positively, the share price rises even before the company earns a dollar of revenue from the new venture. Bonds react the same way. In January, as inflation persisted and the Fed signaled the need for higher interest rates, bonds sold off in anticipation, well before rate hikes began. The first four months of 2022 have been undoubtedly painful, but the Fed following through on those plans shouldn’t compound the damage.

Figure 3: A rising fed funds rate hasn't translated into comparable increases in long-term yields



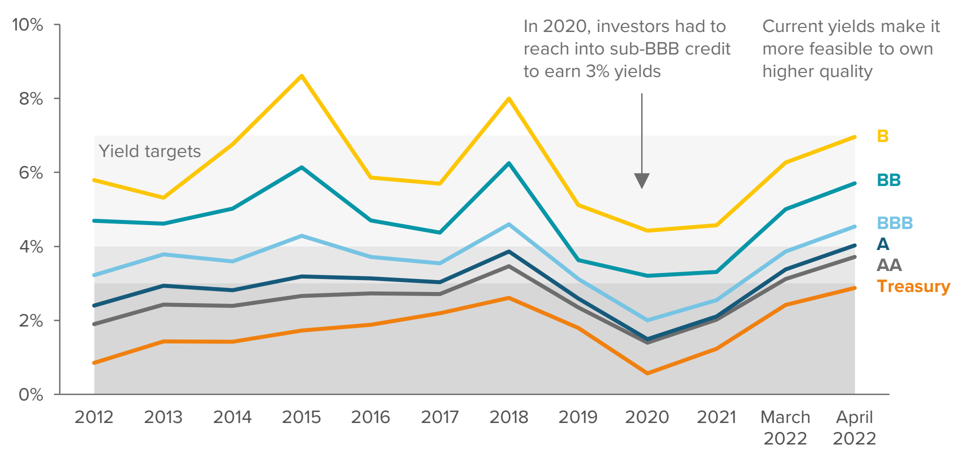
As of April 26, 2022. Source: Bloomberg, U.S. Federal Reserve, Voya Investment Management. **Data represents past performance, which is no guarantee of future results.**

Core bonds positioned to resume role as diversifiers

A key reason to own core fixed income is to diversify equity and credit risk. While that assumption didn't hold up well in the first quarter, episodes of positive correlation between rates and equities are typically brief. If recession risk were to increase, core bonds would likely rally due to their safe-haven status. As a bonus, now that yields have reset higher, investors may protect their portfolios while receiving higher income (Fig. 4).

Figure 4: Higher yields lower the bar

Yields by credit quality, 2012–2022



As of April 26, 2022. Source: Bloomberg Index Services Limited and Voya Investment Management.

Treasury as represented by the Bloomberg US Treasury Index. Yields by credit quality as represented by the Bloomberg US Corporate Aa, A and Baa subindices and the Bloomberg US High Yield Corporate 2% Issuer Cap Ba and B subindices. **Data represents past performance, which is no guarantee of future results.**

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