With rate cuts looming, advisors find new reasons to bet on bonds

Recent years have taken the shine off of fixed income, both as a portfolio diversifier and a way to boost total returns. The prospect of falling rates next month promises to reverse that.

With the stock market on a wild ride and interest rate cuts looking likely next month, advisors are reawakening to the appeal of fixed income.

Many financial planners think the sweet spot for bonds now is in medium-duration, high-quality government and corporate debt. Andrew Grant, the director of manager research and investment solutions at Kayne Anderson Rudnick in Los Angeles, said he thinks that longer-term bonds have most likely already priced in the likelihood that the Federal Reserve will start reducing interest rates next month.

The Fed's key target rate now ranges from 5.25% to 5.5%. Yields on 10-year Treasuries are already well below that, approaching 4% on Monday.

Investors hoping for a fixed-income boost from rate cuts should probably look elsewhere, including high-quality corporate bonds, Grant said.

"So we're probably kind of trafficking in that four years of duration," he said. "We're going to probably have higher credit quality. We're going to be in that sort of A-plus range. We're going to be giving people a yield to maturity of somewhere around 6% to 7%, depending on what it is that we're invested in. And we're going to lower your volatility."

Advisors and analysts have long been predicting that bonds would rally once the Fed backed off its recent cycle of economic tightening aimed at combating inflation. Hopes were running particularly high early this year, when many economists were forecasting five or even six rate cuts across 2024.

When inflation proved sticky and rates didn't come down as fast as some had hoped, some investors no doubt came to regret their investment in fixed income. But Grant said those who were able to lock in high rates of return probably have no reason to second guess their decisions.

Yields on the 10-year Treasury, for instance, were well above 4% for much of 2023.

"When we were pricing in potentially six rate cuts, and people moved into bonds, they got kind of a head fake," Grant said. "But if you hung in there, you're back down at 4% on the 10-year. So now you can see your call was probably right for the most part."

Bonds for diversification and returns

Investors who turn to bonds to diversify their portfolios have had other reasons to regret their decisions in recent years. Fixed income has long been seen as inversely correlated to equities, meaning when stocks decline in value, bonds increase.

That premise proved faulty when the Fed's series of interest rate hikes to combat inflation sent both stocks and bonds plummeting in 2022. But the recent short-lived market sell-off gave fixed income a chance to reestablish itself as a solid risk hedge.

The yield on the 10-year Treasury fell 3.782% on Monday, its lowest level since July 2023. Since bond prices usually move in the opposite direction of yields, portfolios with healthy fixed-income allocations were able to weather the sell-off better than those more concentrated in stocks.

Diversification isn't the only reason to consider putting more money into bonds. The wealth management giant Vanguard predicted in a midyear report last month that bonds will return 4.6% to 5.6% in the next decade. Stocks, which Vanguard sees as generally overvalued, were forecast to return only 3.4% to 5.4%.

Jeffrey Kalapos, the chief investment officer at Coastal Bridge Advisors in Westport, Connecticut, said bonds were a tough sell for more than a decade after the housing collapse in 2008. The Fed's target interest rate never rose above 2.5% during those years.

"These low rates proved to be a challenging period for investors searching for yield in the fixed income markets," Kalapos said in an email. "At today's Fed target rate of 5.5%, finding yield in fixed income is not only possible, but it's plentiful. As of this writing, Treasury Bills maturing in less than six months are still yielding nearly 5%."

So many choices

Advisors say they can play a key role in helping clients evaluate the many investing options presented in the fixed-income world. Is it better to build a portfolio of individually selected bonds or to buy into a prefabricated investment vehicle like an exchange traded fund tracking a broad bond index? Is active management better than passive management? And what sort of durations and credit quality ratings should investors prefer?

Denis Poljak, the managing director and wealth manager at the Steward Partners-affiliated Poljak Group Wealth Management, said that during the Fed's rate-hiking campaign, he was recommending clients move their money into short-term Treasury bills. Now that a cut is in the offing, he too is looking more toward intermediate-duration corporate debt. The sweet spot for him, he said, are bonds with maturity dates ranging from five to seven years out.

Poljak said the recent market volatility provided a good reminder to check portfolio balances. Clients pursuing a typical 60-40 hedging strategy — placing 60% of their investments in stocks and 40% in bonds — may find the bull market of the past nearly two years has put their strategy out of whack. Investors may want to consider cashing out on some of their stock gains and reinvesting the proceeds ino bonds, he said.

"If my allocation is supposed to be 60-40, equities versus fixed income, and because of market upticks, it's now 70-30, this is a great time to rebalance the portfolio," Poljak said.

Poljak said one type of investment he's steering clients away from is high-yield corporate debt. Sometimes referred to as "junk bonds," these instruments become particularly risky at times when an economic downturn is at least a possibility, Poljak said.

"We are cautioning clients to really have their eyes wide open and to be investing prudently because there is a strong likelihood of recession," he said.

Case for active management

Poljak and Grant agreed that there is probably a place for both bond ETFs and other index funds, as well as individually owned bonds, in most investors' portfolios. Grant said he tends to favor active management of fixed-income portfolios, although he doesn't totally avoid passive managers.

The advantage of passive funds is that they allow investors to track a wide-ranging index like the Bloomberg U.S. Aggregate Bond Index, encompassing a huge array of government, corporate, mortgage and other types of debt, at a low cost. The trouble, Grant said, is that index-tracking funds can be so attuned to keeping aligned with their particular benchmark that they leave good investing opportunities on the table.

Active managers of bond funds are far less likely to be so narrowly focused, he said.

"They have the ability to make changes and pivot and adjust duration as they see fit," Grant said. "These managers get paid to make those calls, and they have a pretty good history of making the right call. No one's ever going to bat 1,000. But, you know, a lot of these managers typically get it right a majority of the time."

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