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Making sense of the bond market

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With expectations of continued volatility and additional rate cuts, bond investors should remain cautious — and flexible.

Gene Tannuzzo, CFA
Deputy Global Head of Fixed Income

Kris Moreton, CFA
Senior Vice President, Fixed Income Client Portfolio Manager

At the beginning of the year, markets were expecting one Federal Reserve Board interest rate cut in 2020. But then came the coronavirus, heightened uncertainty, and most recently, a sharp drop in oil prices. Now the Federal Open Market Committee has made one intermeeting rate cut, and more are expected.

Rationale for the rate cuts

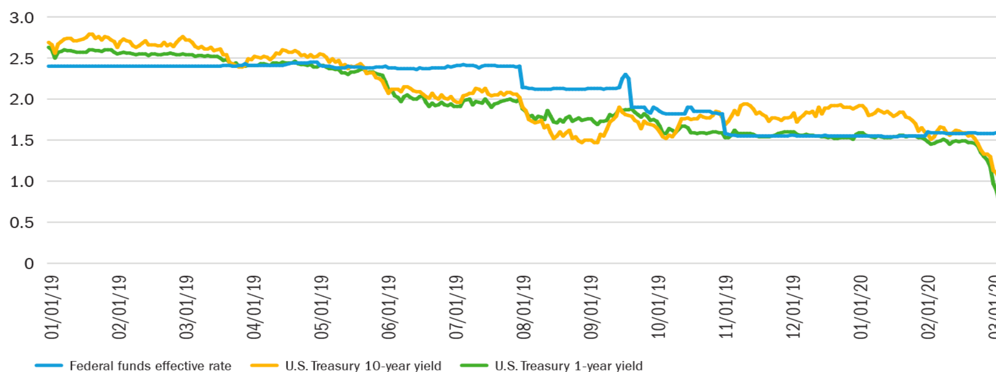
Lowering interest rates is a powerful weapon to combat deteriorating economic conditions:

- **For businesses**, a reduction in the cost of borrowing can support wages and employment, as well as companies' spending plans.
- **For consumers**, lower borrowing rates are an incentive to refinance mortgages and lower total debt expenses, which can mean more money in their pockets.

Heading toward zero

Yields on government bonds at all maturities have moved significantly lower. The U.S. Treasury 10-year yield reached an all-time low on March 9, 2020. Certain yield curve pairs are now inverted, indicating that the market expects further easing. We appear to be heading back to a zero percent fed funds rate.

U.S. fed funds rate and yields (%)



Source: Columbia Threadneedle Investments. The effective federal funds rate is the interest rate banks charge each other for overnight loans. One- and ten-year Treasury yields generally move with this rate.

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What's next?

If the U.S. federal funds rate hits zero — and if markets still don't show improvement — we expect the Fed to look at unconventional measures such as asset purchases, but negative interest rates are unlikely. A sustainable move higher in U.S. yields will require two things:

- A combination of data that indicates limited economic damage from the virus
- A policy response from governments — in the form of aggressive fiscal stimulus — to complement rate cuts. There are limits to what central banks alone can do, and investors will watch for a response from elected officials as well.

What bond investors can do

This presents real challenges for yield-based investors. The fall in Treasury yields exacerbates an already challenging low yield environment, and simply buying the highest yielding bonds can expose an investor to even more risk if the economy continues to deteriorate. More than ever, investors need to make sure they're getting paid to take risk, which requires:

- Intensive fundamental research on individual companies and industries to assess their ability to withstand a longer economic downturn
- Flexibility in allocating to both safe haven government and riskier high-yield bonds
- A keen eye on valuations to help generate yield while mitigating losses

But the impact of trade wars on confidence is a bigger source of investor uncertainty. The sell-off in equities and rush to safe havens such as Treasury bonds, gold and yen are signs of damage to confidence. Trade conflict also lowers capital spending (capex) as firms may decide to wait for trade policy uncertainty to end before undertaking major capital investments. In addition, supply chains are likely getting disrupted and reconfigured as U.S. producers try to find alternative sources of imported goods that are targeted by tariffs.

Bottom line

The current outbreak is novel, but the playbook for spikes in volatility like this remains pretty much the same. We expect further rate cuts, but their effectiveness would be enhanced by complementary fiscal stimulus. In the meantime, bond investors should remain cautious and be flexible in pursuing yield where the risk-adjusted returns have the most potential.

There are risks associated with fixed-income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

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