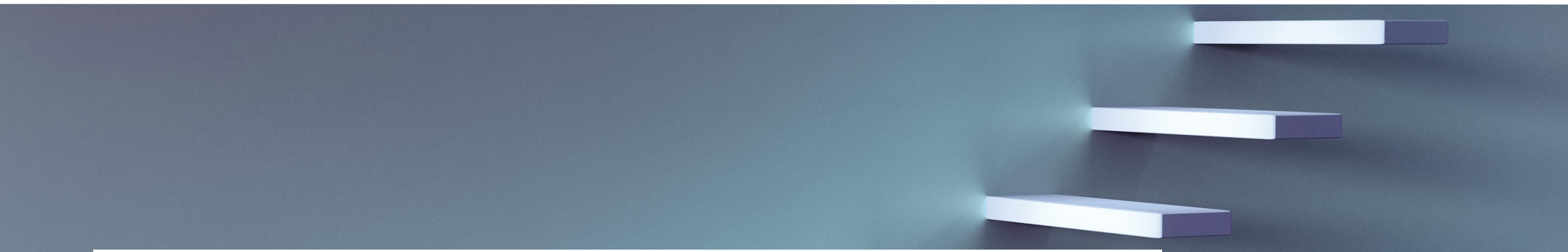


Looking ahead by learning from past bond market recoveries

June 2, 2020

High-quality bonds stumbled early in the current crisis. But there are many reasons to expect them to rise in a down market – making them our fixed income investment of choice.

History and textbooks tell us that a flight-to-safety from equities is mostly directed to cash and high-quality bonds. But in the first phase of the current crisis, high-quality bonds (investment-grade-rated) performed surprisingly poorly — some of the most defensive sectors performed as badly as low-quality, high-yield bonds (below investment-grade-rated). The fact that high-quality bonds performed so poorly relative to low-quality bonds in the early days of the market downturn suggests it was liquidity driven — investors were selling what they could sell most readily, en masse — and less about long-term credit concerns.

In the past two bear markets, 2002 and 2008, high-quality bond performance and asset flows behaved as expected and were more resilient than riskier assets. This time was different early on, but will it last?

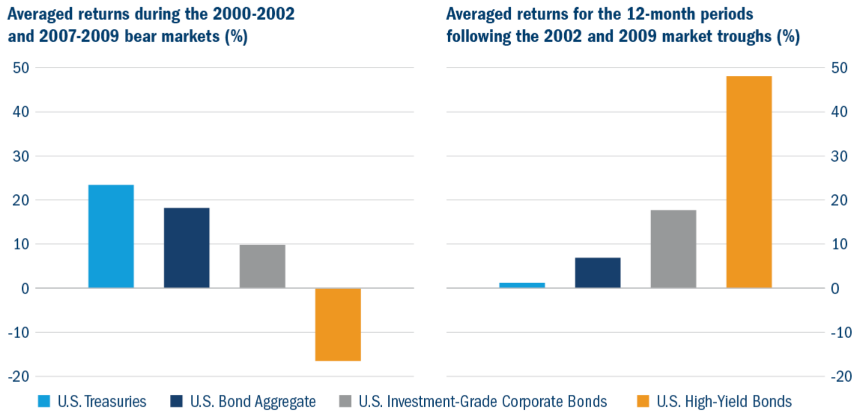
Based on experience and rational investing, the recent sharp decline in investment-grade bond prices appears to be an aberration and likely short-lived. In our view, high-quality bonds, especially in defensive market sectors like utilities and consumer staples, should revert to a more normal performance relationship relative to low-quality bonds and then follow a path similar to previous contractions and recoveries. This is not to say all investment-grade companies and industries are immune to downgrades or worse, but we have high conviction that exposure to high-quality bonds can help investors mitigate downside risk in a challenging, recessionary environment.

Download the full paper: Looking Ahead What bear markets and bull rebounds can teach us about how the stock market works, and how we may navigate current and future market contractions.

Columbia Threadneedle Investments

The average historical performance of high-yield bonds in the chart below shows a similar pattern to equities during both downturns and recoveries. For investors willing to accept increased default risk, maintaining a strategic allocation to lower quality, higher yielding bonds through bear markets can also be advantageous when markets rebound. Given our forecast for a slower economic recovery that may take a few years, the timing of a sustained market rebound has a high degree of uncertainty.

Bond returns during and after two major market corrections



Source: Columbia Threadneedle Investments based on Bloomberg Barclays index data. Bear market periods are defined as 03/04/00–10/09/02 and 10/09/07–03/09/09. US Treasuries are represented by the Bloomberg Barclays U.S. Treasury Index, which measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. The US Bond Aggregate is represented by the Bloomberg Barclays U.S. Aggregate Corporate Bond Index, which consists of publicly issued, fixed-rate, nonconvertible, investment-grade debt securities. US investment grade corporate is represented by the Bloomberg Barclays U.S. Corporate Investment Grade Index, which measures the investment grade, taxable corporate bond market. US high yield is represented by the Bloomberg Barclays U.S. High Yield Corporate Bond Index, which represents the universe of fixed rate, non-investment grade debt. It is not possible to invest directly in an index.

At the other end of the risk spectrum, some investors may be tempted to reallocate to cash until there's less uncertainty. But it's important to remember: if you aren't invested, you don't get to participate when markets rebound — which can happen quickly, even when there's still a lot of uncertainty. In the eight years following the global financial crisis, cash returned less than 0.25%* annualized. Safe and liquid, but also the worst performing asset class, and one that didn't keep up with inflation.

Bottom line: Focus on quality in fixed income

The poor short-term performance of high-quality bonds in the early days of the current crisis was due to investors rushing to raise cash by selling what they could. It was not about long-term credit concerns. We expect high-quality bonds to continue to recover and broadly follow their historical pattern and relationship relative to other asset classes. Most importantly, exposure to high-quality bonds can act as a shock absorber and can help investors mitigate downside risk to their overall portfolio in difficult and uncertain times, like we're experiencing now.

Disclosures

*Cash is based on the FTSE 3-Month U.S. Treasury Bill Index, an unmanaged index, which represents the performance of three-month Treasury bills. It is not possible to invest directly in an index.

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