Caution or precaution? Fixed-income outlook for the second half of 2019

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An environment of slow growth and easy money is a tailwind for fixed income. But investors should not throw caution to the wind.

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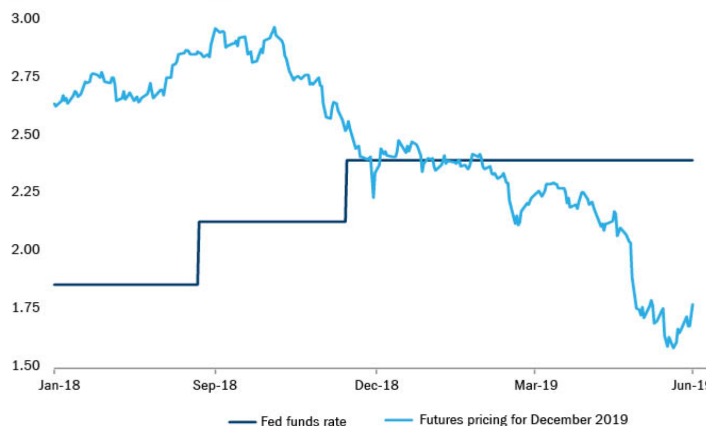
Central banks have been pivoting toward easier policy — a theme that's been dominating bond market performance in 2019. In particular, the Federal Reserve has signaled potential interest rate cuts, marking a meaningful shift compared with the hiking cycle of the past three years. This has been a driving force behind double-digit returns in many bond market sectors in the first half of the year.

Rate expectations change from hikes to cuts



Source: Columbia Threadneedle Investments, Bloomberg, as of 06/30/19.

While interest rate cutting cycles are often associated with recessions, there's more nuance to the Fed's approach this time around. Recent research suggests that when interest rates are low, central banks respond more quickly and forcefully to the early signs of economic weakness — they want to prevent a broader downturn where they'd have limited ability to respond.[1] This supports the idea that the Fed, European Central Bank and others should ease policy on a precautionary basis before an actual recession begins so they can prolong the expansion. As Fed Chair Jerome Powell recently commented, "An ounce of prevention is worth a pound of cure."

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1 Bernanke, Ben S., Michael T. Kiley, and John M. Roberts (2019). "Monetary Policy Strategies for a Low-Rate Environment," Finance and Economics Discussion Series 2019-009. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2019.009.

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Looking back, there are two somewhat recent examples of precautionary rate cutting cycles by the Fed that allowed for economic soft landings in 1995 and 1998. A closer look at bond market performance around those cycles can be helpful as we review the bond market opportunities for the remainder of 2019.

6 months **before** rate cut	Yield change (%)	Excess returns (%)			
	10-year Treasury	Investment-grade corporate bonds	High-yield corporate bonds	Mortgage-backed securities	Emerging markets debt
1995	-1.83	0.79	0.51	-0.85	-1.88
1998	-1.14	-3.20	-12.05	-1.12	-31.20
H1 2019	-0.68	5.99	9.63	4.11	9.09

6 months **after** rate cut	Yield change (%)	Excess returns (%)			
	10-year Treasury	Investment-grade corporate bonds	High-yield corporate bonds	Mortgage-backed securities	Emerging markets debt
1995	-0.36	0.35	0.06	0.41	9.80
1998	0.69	2.32	5.79	0.69	17.51
H2 2019	?	?	?	?	?

Source: Columbia Threadneedle Investments, Bloomberg. Past performance does not guarantee future results.
See disclosures for indices used to represent asset classes.

In these two periods, the bond market was quite volatile before the rate cut — particularly in 1998 — but generally performed well when the Fed began to lower rates. Surprisingly, Treasury yields actually rose after the Fed starting cutting rates in 1998 because the cutting cycle was more modest than market expectations. In the past six months, we've seen declines in Treasury yields alongside strong excess returns in credit sectors. It seems that some of the good news may already be in the price because returns were very frontloaded. If the Fed delivers the rate cuts markets expect, we could still see further gains, but that's not a sure thing.

Bottom line

In our view, the Fed is likely to cut interest rates a few times before year end. But that doesn't guarantee robust returns from the bond market. Following a lackluster period for the bond market last year, the first half of 2019 has been quite rewarding to bond investors. We believe it's unlikely for this performance to be repeated. An environment of slow growth and easy money is certainly a tailwind, but investors should not throw caution to the wind. We think the high-quality cash flows of the investment-grade corporate and MBS markets will provide the best risk-adjusted returns moving forward.

It is not possible to invest directly in an index.

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