Bonds versus Stocks: Here We Go Again

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The past week marked another episode of the long-running debate between the viability of investing in bonds versus stocks. Interest rates continued to rise, and for a while there were a few bond vigilantes knocking on the door. Suddenly the increase in rates was taking the wind out of the sails of growth stocks. Let us put the recent run-up in interest rates in perspective. On March 19th of 2018, the 10-year treasury was 2.85% and as of last Friday, the rate was substantially lower at 1.74%. Current rates are not high enough to threaten the bull market in stocks. However, they are undermining the logic of owning bonds. Year-to-date, the 10-year Treasury note is down 5.9% versus a gain of 4.5% for the S&P 500. For the past 12 months, the 10-year Treasury note is down 4% versus a whopping gain of 65.2% for the S&P 500! Small-cap stocks as measured by the S&P 600 are up by more than 21%. Yet, investors are still pouring billions into the bond market every week!

The Barclay's Capital High Yield bond index yields a reasonable 5.1% but, year-to-date it is down 0.05% and for the past 12 months is up 29.94%. What a difference a year makes. The real problem for investors who are seeking "safety" in government bonds is that such bonds are not relatively safe given these statistics. For the billions of dollars that investors put into ten-year bonds around the beginning of the year, they have locked in a ten-year return of less than 1%. While the year-to-date loss in those bonds will be recouped in ten years when those bonds mature, investors who buy new bonds today will receive a yield of 1.74%. Over ten years, the difference in returns is 0.74% per year or 7.40% over the life of the bond. In this example, a little patience paid off with a huge increase in yield.

The combination of the fear that inflation is coming back along with an imminent proposal to raise income and capital gains tax rates puts additional pressure on investors who are trying to preserve wealth. The Fed says it is happy with a 2% rate of inflation (if reached, the real return on that 10-year bond drops to near or below zero) and, in a taxable portfolio such an investment becomes a guaranteed loser.

On the other hand, the stock market has provided above average returns over the duration of the pandemic as noted above. Even the so-called risky high yield market has given investors in those securities traditional stock like returns along with a 5% income return.

These divergent trends are likely to continue. First quarter corporate earnings should be surprisingly good, and analysts have continued to raise their expectations for the year. On the other hand, a rebounding economy and temporary pops in inflation data may drive up interest rates further and bond prices down accordingly. Investors who follow a strict protocol of rebalancing their portfolios to some fixed ratio of bonds to stocks may find themselves continually selling winners and buying losers at least as measured by the relative performance of bonds vs. stocks year to date. A prudent strategy would be to hold winners and sell losers.