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EPISODE 49

Everyone Hates Bonds. That's a Mistake.

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- Fixed income markets are poised to deliver a negative return this year for the first time since 2022. Yet, forward real returns have improved, particularly for high grade bonds.
- US Treasury yields have risen about 100 basis points across all maturities since the start of 2026. Foreign rates are about 90 basis points higher.
- The Fed's new resolve to fight inflation driven by an external energy shock is a major change in policy. Core inflation has been gradually slowing.
- Energy shocks don't take place every year. Yet US rates have risen across all maturities into the distant future.
- We don't see a peak in the US or global economy or profits soon. Yet the S&P 500 dividend yield hasn't budged from 1% even as long-term Treasury yields have risen from 4% to 5% this year.
- As the AI-related profit boom matures and finally subsides or busts, long-duration Treasuries are the only major asset class that deliver consistently high returns during severe equity bear markets. By comparison, high yield bonds have a 60% positive correlation to equities.
- We are focusing presently on short duration fixed income (including floating rate debt) plus high yield credit. The future, however, portends a shift toward higher grade, longer-duration bonds, likely in 2027.

Listen Closely to Fed Chair Warsh (July 29th)

> *"Some of the increases in market interest rates (since the last) FOMC meeting are among the most significant in the last two decades, ranking around the top decile or so....The markets have done quite a bit."*

Interpretation: Perhaps Warsh is saying that markets have done the tightening for him, excusing his lack of action until yesterday.

Fed Chair Warsh at September 16 FOMC

> *"Today's decision removes a dose of accommodation"*

Interpretation: Does Warsh think Wednesday's action was just a mere dose?

> *"What's changed since the last FOMC meeting? Geopolitics. I mean, there's no hiding from hot spots around the world."*

Interpretation: Now the Fed views supply shocks are reasons to raise rates. What's next? Tightening on the next pandemic?

Everyone Hates Bonds. That's a Mistake.

Everyone hates bonds. No one will add duration to bond portfolios.

We think that the Chair's view that the Fed was not vigilant and lacked inflation-fighting credibility is a strong driver of bond market performance.

While there have been vast flows into both equities and short-term cash-like securities this year, the net short position in long-duration Treasury futures is nearing a record high. Ironically, it is these very bonds that deliver strong returns when risk assets have retrenched sharply (see figure 1).

The US market has been completely repriced. Yields are about 100 basis points better even after compensating for inflation (see figure 2). We could only wish future equity returns could improve so much, so fast.

Where Investors Have it Wrong

We are not bearish "bond ghouls" who always see disaster for the economy just ahead. Our own equity allocation at CIO group is neutral (fully invested, but not overweight) after a modest reduction at end of August. And we did not place investor money in long-term bonds recently, having chosen floating rate assets that sustain and grow yield as the Fed hikes rates.

Yet as we watch investor behavior, we see US 10-year note net short positions nearing a record high even as yields rise (see figure 3). In short, investors have dismissed the growing value of higher rates for long duration bonds.

FIGURE 1

Returns During Equity Bear Markets and Past 30 Years

Prepare for Bust: Holding Some Negatively Correlated Assets Drives Stronger Risk-Adjusted Returns

Peak-to-trough total return	2000-2002	2007-2009	Last 30 years
S&P 500	-46.4%	-45.2%	1,800%
IT	-81.9	-45.2	4,810
Healthcare	-10.2	-25.7	1,696
30-Year Treasury	31.5	28.4	294
2-Year Treasury	21.9	9.5	130
Gold	11.6	22.7	1056

SOURCE: CIO GROUP, BLOOMBERG, HAVER ANALYTICS

FIGURE 2

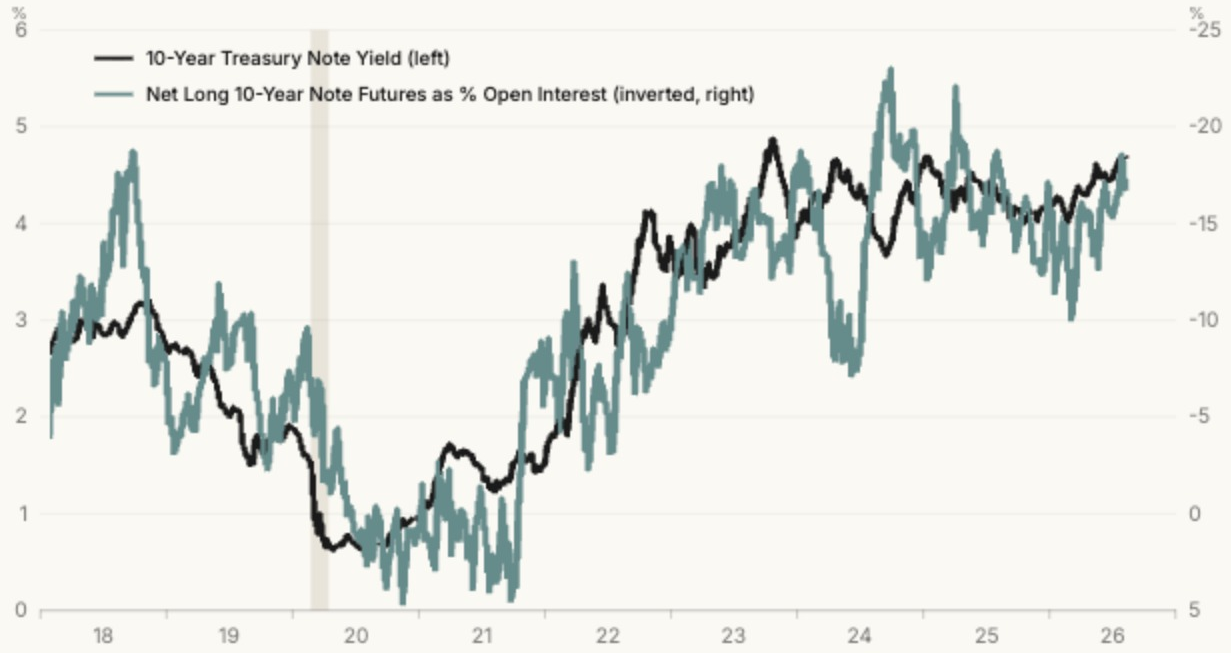
Real TIPS Yield at Average US Treasury Duration



SOURCE: CIO GROUP, HAVER ANALYTICS

FIGURE 3

Net Short Positions and Yields: US Treasury 10-Year Note Futures



SOURCE: CIO GROUP, HAVER ANALYTICS

Worried Higher Rates are Abnormal? Far From It

Yields near 5% for 10-Year US Treasuries are not unusually high, unless you compare them to the Covid period or the years after the Global Financial Crisis. The rise in yield is still closer to a "normalization," unwinding the unusually low yields of the past two decades. Yet bull and bear market psychology - chasing strong performance, shunning value, will likely trip up many investors over the coming few years.

Why Are Yields Rising?

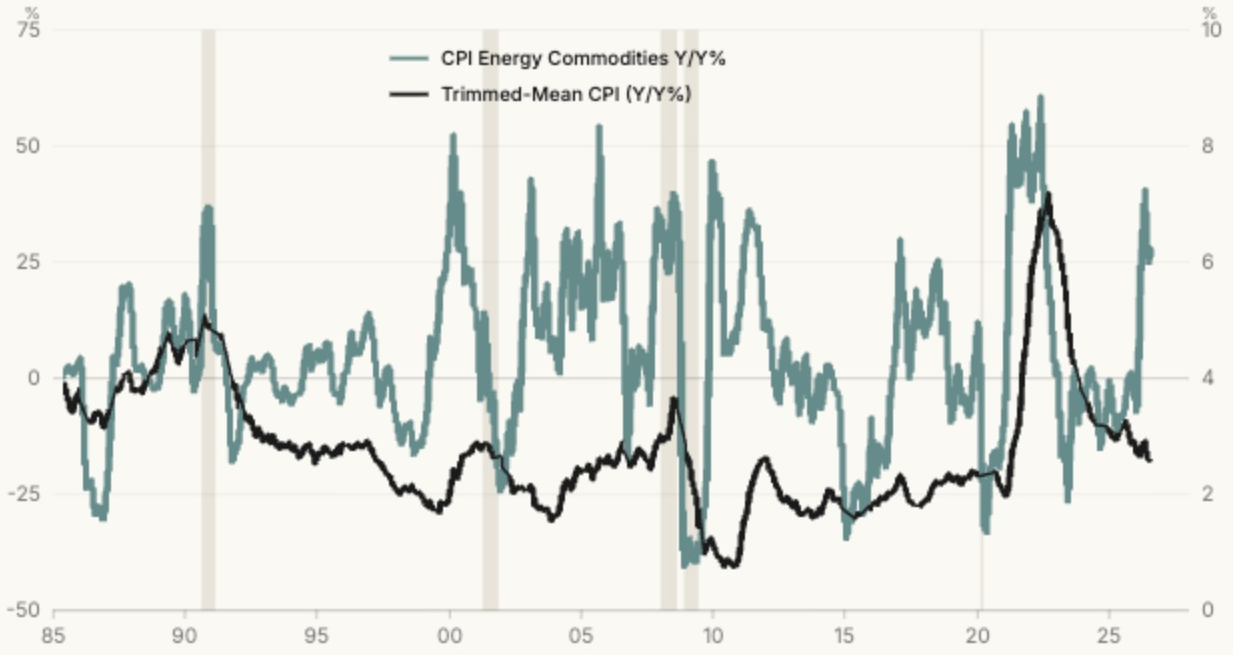
Fed Chair Warsh's decision to actively push down inflation with policy action is under-appreciated in this year's bond rout. As figure 4 shows, either core inflation, or the new Fed Chair's preferred "trimmed mean" indicator, shows that inflation is falling slowly and consistently. Yet in his view, current policy rates (and the Fed's balance sheet) are not positioned to hasten a swift enough return to "2%" inflation.

Shocks, driven by tariffs, trade wars and real wars – all actions taken by the US -- are inflationary. Spiking energy costs have worsened the overall picture. In short, it is policy action that has put the economy and price stability at risk, not the Fed or the current rate levels.

As Warsh noted in his previous (July) press conference, yields have risen across all maturities this year. This means higher bond returns (from current price levels) well after today's shocks pass. It means greater income for today's bond holders if and when new inflation shocks occur.

FIGURE 4

CPI for Energy Goods vs CPI "Trimmed Mean" Y/Y%



SOURCE: CIO GROUP, HAVER ANALYTICS

Aren't Deficits the Main Threat?

This year's roughly $2 trillion in US net borrowing - about 6.2% of GDP - is the unfortunate result of failing to align growing Federal entitlement expenditures (such as social security and Medicare payments) with tax receipts (See our Point of three weeks ago).

The future US budget deficit outlook remains bleak without bipartisan scope for action. Yet, the budget deficit this year differs little from Congressional Budget Office projections made a year ago. Only the repayment of tariffs - deemed illegal by the Supreme Court - has grown the deficit more than projected. And as for corporate borrowing, overall debt growth is moderate. Only AI spending seems atypical and extreme.

The Index is Worth Understanding

The Bloomberg US Bond Aggregate - let's call it the "S&P 500 of bonds" - has delivered a negative 1.5% return in 2026. To the extent that yields have risen without a commensurate rise in economic growth, means the Fed and markets are delivering a true tightening of financial conditions.

As yields have risen everywhere, the US dollar has also strengthened marginally.

Note that the value of "rate" assets will deliver more in the future. High yield debt and floating rate debt have generated positive returns this year and we've benefited from overweights, protecting value. However, it would be difficult to repeat this performance now that yields have risen significantly (see figure 5).

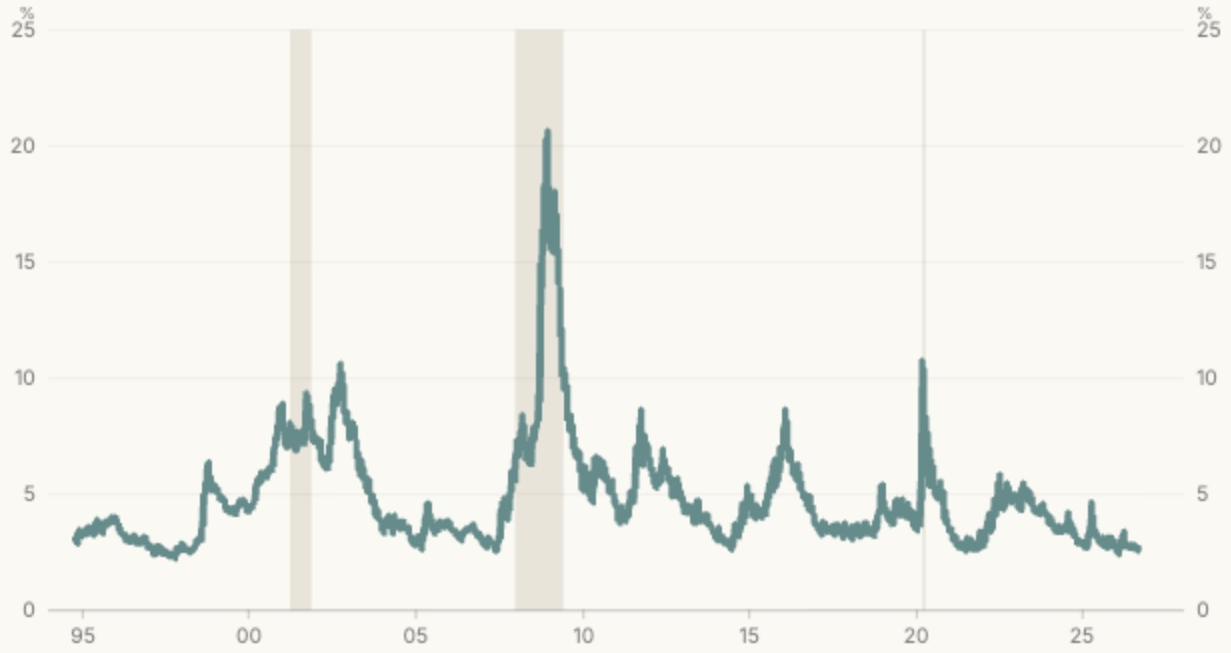
"Credible Fed, Credible Dollar"

The Fed's decision to actively fight inflation rather than wait patiently is a positive for the US dollar's credibility. Despite delegating communication of "dollar policy" to the US Treasury, it is the work of the central bank that preserves the internal and external value of a currency.

The Fed's decision to act - with markets now pricing in an additional 50 basis points of rate hikes in the coming year - sends a powerful message about the legitimacy of the Fed's inflation target and the FOMC's approach to managing it. Tightening with open Presidential opposition is a powerful signal the Fed will act on its Congressional mandate.

FIGURE 5

US High Yield Debt Spread Over US Treasuries (%)



SOURCE: CIO GROUP, HAVER ANALYTICS

For investors in bonds, portfolio pain is front loaded. But portfolio gains in the future beckon. The value of diversification into safer bonds presents itself in the worst of times (see figure 1). History shows such moments are indeed recurring, but investors for the past 15 years may have forgotten what preparedness means.

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