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Don't let them scare you out of bonds: The fixed income value proposition must look beyond supply | Fixed income market commentary 2Q 2024

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Key takeaways:

- Claims that higher supply can influence fixed income returns in the short run are just one issue investors should consider when evaluating bonds.
- History shows very clearly that when real yields increase, demand increases for high quality fixed income instruments.
- As the Fed begins cutting rates, it's likely the money in short-term Treasuries and money markets will come back into bonds.
- Bonds have historically done an excellent job protecting portfolios during economic slowdowns.

"Don't Let Them Sell You a Bond Fund" was the headline-capturing conclusion of a recent paper that compared owning fixed income today to the Greek myth of Sisyphus, implying that achieving a total return was ultimately unattainable due to excessive future bond supply always demanding higher yields. Like Sisyphus endlessly pushing the rock up the hill, the investor grinds for income intermittently, only to ultimately succumb to higher rates, starting over with no total return as the rock rolls back down.

The argument of too much future bond supply as a reason to avoid fixed income is quite common, but I challenge the paper's core thesis: That our government, to sustain current interest rates on its deficit and keep the economy humming, will have to issue an incremental amount of Treasuries that the market cannot absorb through organic demand and that too much supply will cause higher yields and low-to-no returns. I believe this is a *gross* oversimplification of the current fixed income value proposition.

We believe that fundamentals drive bond returns

The thesis that higher supply can influence bond returns in the short run has certain merits, but it's just one technical consideration that ignores a much larger, more fundamental picture relevant for investors in the medium to long run. To determine a bond's value proposition over the next three to five years, we believe you must look at much more than just supply. We believe that fundamental drivers will push bond demand to meet and even overcome the future supply overhang.

The assumption that more supply equates to higher yields (lower returns) implies that demand is not elastic for high quality fixed income. However, history shows very clearly that when yields – specifically real yields – increase, demand increases for high quality fixed income instruments. This is fairly intuitive. As the after-inflation, returns-to-maturity increase, more investors seek these returns and shift out of money markets, equities and other instruments. The easiest way to demonstrate this with data is through the counterfactual: there is a very low historical correlation between supply issuance, deficits and forward returns. If the thesis of supply was correct, you would expect to consistently see negative or low returns in years with high supply growth.

The following chart shows the returns of 10-year U.S. Treasury issuance versus returns since 2006, and it's obvious that something other than relative supply is driving returns. We believe that "something" is fundamentals: when real and nominal yields are high, break-evens are low (the Fed is seen as credible), and forward returns are above average.

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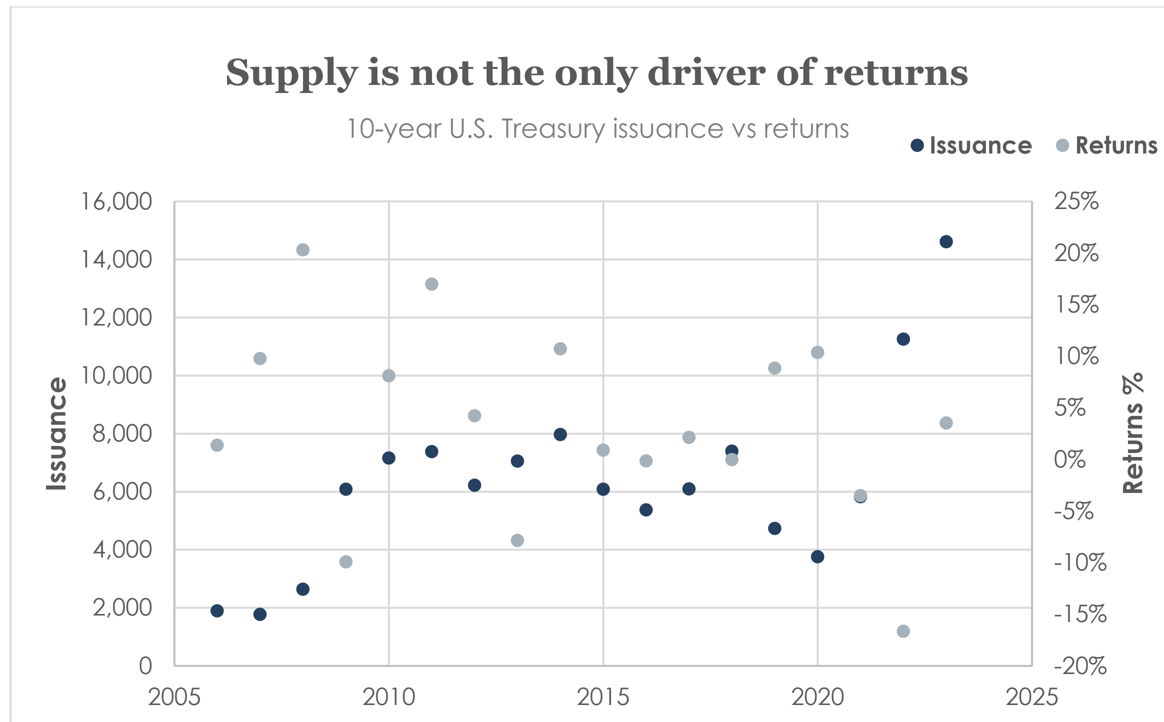

Data source: Bloomberg, 2006-2023.

The supply thesis overlooks the uniqueness of the current environment.
Second, the supply thesis incorrectly ignores how unique our current circumstances are. The COVID-19 pandemic and its related effects caused an inflationary shock, prompting the Fed's rapid rate hikes as a response, all while massive fiscal and monetary stimuli drove economic growth. This unprecedented combination of countering forces has resulted in the longest inverted yield curve in history. So what's the point? The long-sustained inverted yield curve has incentivized roughly $6 trillion in money market assets as investors enjoy the safety and relatively guaranteed returns of over 5% from short-term Treasuries, with the comfort that the Fed is unlikely to cut rates rapidly. Additionally, we estimate there's likely over $1 trillion in high quality fixed income parked in short-duration positions. As the Fed begins cutting and prospective returns in those areas go down versus longer-duration fixed income assets, it's very likely a critical mass of that money parked for safety will come back into bonds over time. These numbers, depending on the percentage that reenters the asset class, will dwarf the estimates in supply growth.

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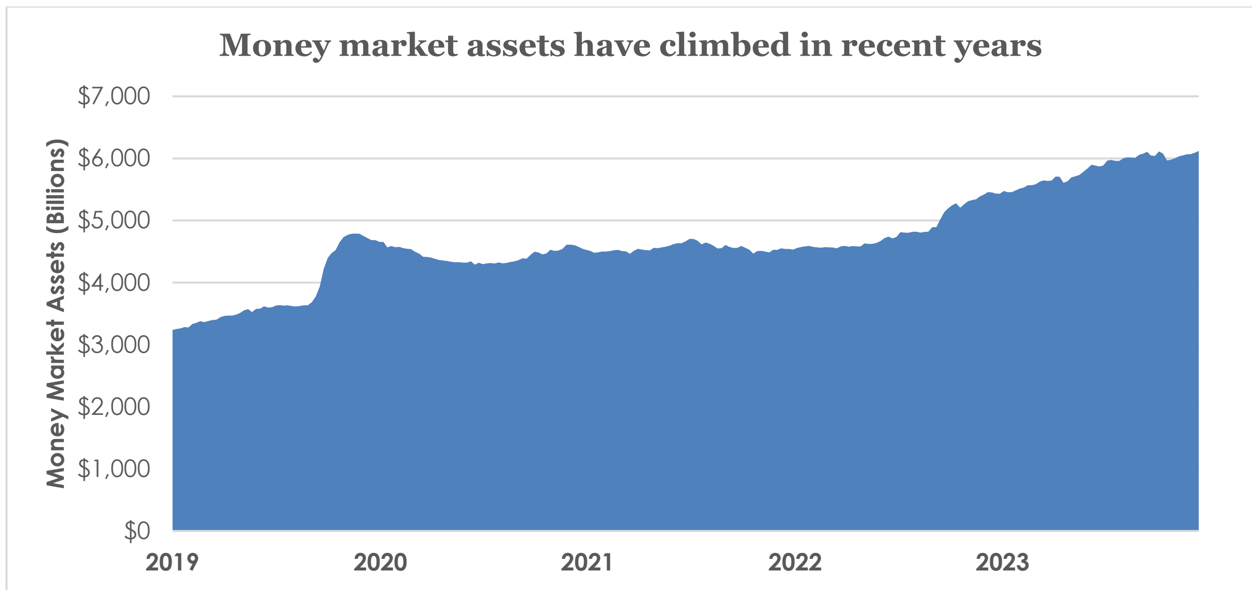

Data source: Bloomberg, July 1, 2019-June 30, 2024.

Bonds can help improve returns during downturns

Finally, we must remember the diversification that bonds provide. A recent Citywire event, where I talked to many allocators over a two-day period, solidified what we already heard repeatedly from current and prospective clients: There is still a ton of pain from the losses incurred during the great rate reset over the past three years, most notably in 2022. This has caused many investors to assume that bonds won't protect the rest of their portfolios in future drawdowns in the equity market. However, we must not forget that bonds have historically done an excellent job protecting wealth during economic slowdowns. Because recessions are inherently deflationary, there is no reason to expect that bonds won't be a great diversifier and protector when we go through the next economic contraction. At elevated real yields above 2%, I would argue they are poised to protect assets even better (i.e., show even better total returns) versus prior downturns. Let's just look at the history for context.

Chart 3: Bonds provide important diversification in economic slowdowns

Event	Year	10-Year Treasuries	5-Year Treasuries	30-Year Treasuries	S&P 500 Index	Value of $100 invested in the S&P 500	Value of $100 invested in 60/40 Portfolio
Covid	**2020**	18.27%	10.86%	39.60%	-6.98%	$93.02	$104.98
Economic Pause	**2018**	0.08%	1.45%	-2.33%	-4.38%	$95.62	$97.26
Oil/Economic Turmoil	**2015**	6.70%	4.86%	9.74%	-0.61%	$99.39	$102.47
PIIGS Sovereign Crisis /Economic Slowdown	**2011**	9.47%	5.04%	21.09%	1.14%	$101.14	$105.43
Global Financial Crisis	**2009**	11.11%	8.44%	17.66%	-38.09%	$61.91	$82.11
Dot Com Bust 2	**2003**	18.26%	14.56%	20.97%	-24.76%	$75.24	$92.32
Dot Com Bust 1	**2001**	13.77%	13.92%	11.54%	-26.62%	$73.38	$89.26
Economic Slowdown '89/'90	**1990**	6.84%	8.52%	4.64%	-3.10%	$96.90	$100.80

Data source: Bloomberg. All returns are shown as trailing 12-month total returns as of 3/31/2020 for COVID, 12/31/2018 for Economic Pause, 9/30/2015 for Oil/Economic Turmoil, 9/30/2011 for PIIGS Sovereign Crisis/Economic Slowdown, 3/31/2009 for Global Financial Crisis, 3/31/2003 for Dot Com Bust 2, 9/30/2001 for Dot Com Bust 2, and 12/31/1990 for Economic Slowdown '89/'90. The 60/40 portfolio shows the value of $100 invested in 60% S&P 500 and a 40% equal weighting of 5-, 10-, and 30-Year U.S. Treasuries.

Don't let them scare you out of bond funds

The supply narrative certainly plays a role in short-term market prices, but it's essential to keep an eye on the long-term value. Despite some technical challenges from supply, the bond market still offers attractive risk-adjusted prospective returns even with the strong run this quarter. And we shouldn't overlook the stability that bonds provide to diversified portfolios when economies go through slowdowns, which they tend to do every eight years. My message to those who own fixed income today is this: ***don't let them scare you out of bond funds***. And for those who don't own bonds today or those who sold bonds during the past three years, I would say today is a perfectly okay time to let them sell you a bond fund that matches your risk tolerance and investment horizon.

Instead of viewing the bond market as Sisyphus endlessly pushing the boulder uphill, think of it more like the myth of the phoenix. Just as the phoenix rises from its ashes stronger and renewed, the bond market is rising from the ashes of the 2022 rate reset, and it has the potential to regenerate and provide robust opportunities despite the setback. By keeping a long-term perspective, investors can capitalize on these cyclical rebirths, ensuring their portfolios maintain income and diversified return streams while remaining resilient through economic cycles.

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Yield is the annual rate of return of an investment paid in dividends or interest, expressed as a percentage. A snapshot of a fund's interest and dividend income, yield is expressed as a percentage of a fund's net asset value, is based on income earned over a certain time period and is annualized, or projected, for the coming year.

Maturity is the weighted average of the stated time to maturity for the securities held in the portfolio.

The Oakmark Bond Fund invests primarily in a diversified portfolio of bonds and other fixed-income securities. These include, but are not limited to, investment grade corporate bonds; U.S. or non-U.S.-government and government-related obligations (such as, U.S. Treasury securities); below investment-grade corporate bonds; agency mortgage backed-securities; commercial mortgage- and asset-backed securities; senior loans (such as, leveraged loans, bank loans, covenant lite loans, and/or floating rate loans); assignments; restricted securities (e.g., Rule 144A securities); and other fixed and floating rate instruments. The Fund may invest up to 20% of its assets in equity securities, such as common stocks and preferred stocks. The Fund may also hold cash or short-term debt securities from time to time and for temporary defensive purposes.

Under normal market conditions, the Fund invests at least 25% of its assets in investment-grade fixed-income securities and may invest up to 35% of its assets in below investment-grade fixed-income securities (commonly known as "high-yield" or "junk bonds").

Fixed income risks include interest-rate and credit risk. Typically, when interest rates rise, there is a corresponding decline in bond values. Credit risk refers to the possibility that the bond issuer will not be able to make principal and interest payments.

Bond values fluctuate in price so the value of your investment can go down depending on market conditions.

All information provided is as of 06/30/2024 unless otherwise specified.

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