Allspring

MARKETING COMMUNICATION

Income Generator

Back in Bonds

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In early 2023, many financial pundits declared "bonds are back." In reality, though, bonds never left—and after suffering violent revaluation in 2022 as well as significant yield increases across the entire curve and up and down the ratings spectrum, we believe they're back to doing what bonds are designed to do:

01 Generate a steady stream of predictable income.

02 Provide a buffer against future price volatility.

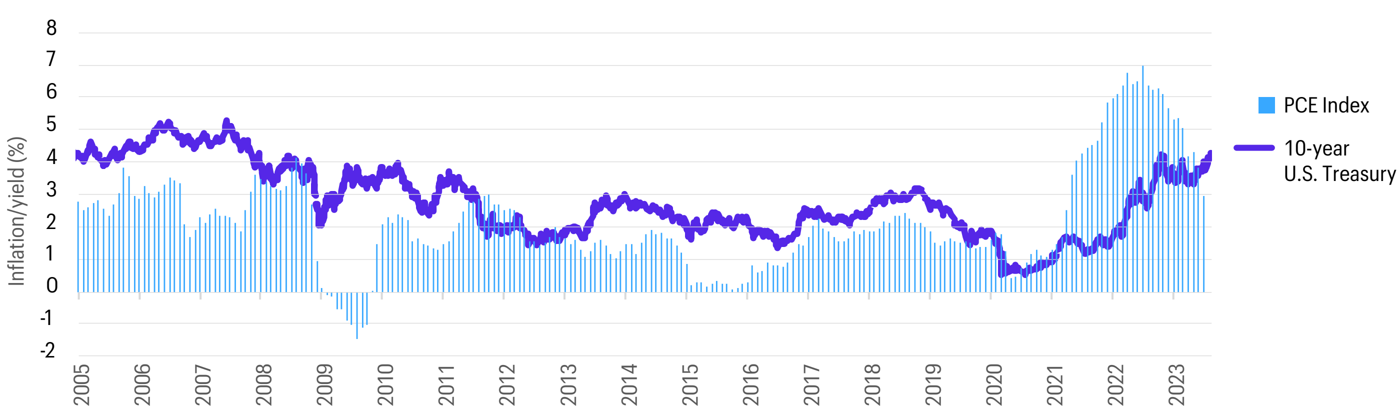
03 Diversify a broad investment portfolio against cyclical economic risks.

As a result, bonds are once again becoming a cornerstone portfolio allocation expected to generate steady, predictable returns over the coming months and years.

DELIVERING GENEROUS INCOME

In today's market, bond investors don't need to be heroes. A broadly diversified bond portfolio can potentially generate sufficient income that compounds above the expected rate of inflation and compensates for the possibility of an uptick in credit risk. For example, the average yield of U.S. Treasury notes and bonds currently stands around 4.35%. The spot level of inflation (as measured by the Personal Consumption Expenditures [PCE] Index) currently stands just above 4%, and longer-term implied rates of inflation are hovering near 2.5%. As a result, U.S. Treasuries offer a positive real yield that many investors are likely to find attractive over time.

U.S. POSITIVE REAL YIELDS



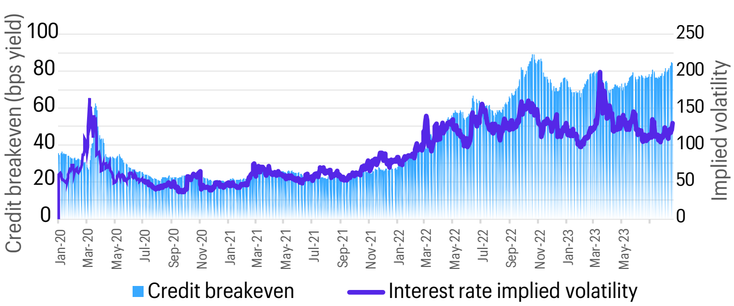
Sources: Allspring and Bloomberg

Investors willing to go down the rating spectrum and/or into global bond markets will find real yields even higher. Currently, for example, a broadly diversified portfolio of investment-grade, nongovernment bonds yields 5.00% to 6.00%, and a portfolio of high yield bonds yields 7.00% to 12.00%. At these levels, bonds can compensate for inflation risk as well as an uptick in credit risk. These positive real yields are a powerful tool for setting the cornerstone of a portfolio that has the potential to deliver a predictable, steady stream of income that could compound nicely moving forward.

BUFFERING AGAINST VOLATILITY

In 2022, the marked increase in price volatility unnerved many bond investors as inflation surged and prices plunged. At its core, a dramatic pivot in central bank policy to stem inflationary pressures uprooted many of the market stabilizers used in the aftermath of the Great Financial Crisis. Tightening of uber-loose monetary policy in the U.S. and around the world and lack of clear forward guidance from policymakers drove materially higher interest rate volatility and yields.

BUFFER AGAINST VOLATILITY



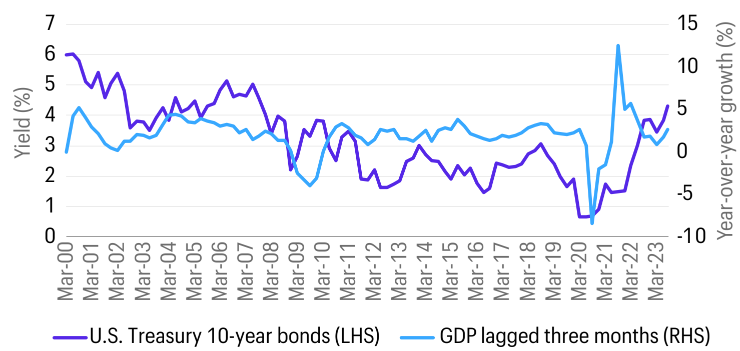
Sources: Allspring and Bloomberg
100 basis points (bps) equal 1.00%

While an "uncertainty premium" is certainly warranted given the long list of risks facing investors—for example, supply-chain constraints, inflation that's lower but not dead, and rising default rates, among others—bond investors can take comfort in policymakers' determination to quell inflation. Base rates in many countries are above the level of spot inflation, banks' lending standards are tightening, and financial liquidity continues to drain from the system. We believe these three powerful forces combined have pushed up breakeven yields and should work to bond investors' benefit over time. As a result, current yields should compensate for future interest rate volatility.

DIVERSIFYING

Bonds are a good hedge against slower economic growth and/or a recession as bond yields tend to follow growth expectations, but they are not a good hedge against inflation. Over the past several years, bond prices moved in tandem with other financial assets as inflation surged and policymakers tightened financial conditions in an attempt to cool inflation. However, as inflation pressures have started subsiding, bond prices have begun diverging from the prices of more cyclically exposed financial assets—namely, equities.

YIELDS TEND TO FOLLOW GROWTH EXPECTATIONS



Sources: Allspring and Bloomberg
GDP = gross domestic product
GDP lagged three months uses actual GDP to align with U.S. Treasury 10-year yields three months forward.

To be fair, inflation remains a dominant factor in today's market, with shifts in inflation expectations still affecting the prices of most financial assets. However, to the extent inflation continues to trend lower toward central bank targets and more typical historical patterns, cyclical growth expectations will likely reemerge as the dominant factor driving asset prices. Looking ahead, we expect bond prices to continue diverging from more growth-sensitive assets as inflation pressures subside and growth pressures emerge.

Riding the curve

To capitalize on these trends, bond investors should consider building broadly diversified portfolios that extend duration along the yield curve, maximizing yield, paying close attention to the bond quality within portfolios, using municipal debt for portfolio stability, and capturing global yield opportunities where possible.

Extending duration

Fixed income investors should consider extending along the yield curve and adding duration as yields rise. Short-/intermediate-maturity duration should benefit from a steeper yield curve. At this point in the cycle, a ~50% duration allocation is appropriate with plans to increase duration as/if yields rise further.

Maximizing yield

Consider maximizing yield at the front end of the curve. Short-duration, lower-quality securities could help boost a fixed income portfolio's overall yield without adding significant interest rate risk. With many companies extending debt maturities at higher coupon rates and some repaying maturing bonds, we expect balance sheet discipline to emerge as a central theme in 2024 as companies tackle the upcoming wall of maturities.

Moving up in quality

Quality is king in this cycle. In our view, issuers with strong cash flow, diversified sources of funding, and a low percentage of variable-rate debt are well poised to thrive in today's economic environment. Fixed income investors should lean heavily on fundamental analysis to determine which issuers meet these criteria. Good companies exist up and down the rating spectrum and across a multitude of sectors, but securitized products are a particularly good way to preserve quality without giving up (much) yield.

Adding munis for stability

U.S. municipal debt continues to benefit from solid fundamentals and favorable technical attributes. In an environment of slowing economic growth and potential recession, general obligation bonds have generally outperformed revenue sectors. Certain defensive municipal sectors should be favorable in this environment. New muni bond issuance remains low, and asset flows in the market have turned positive. These factors should provide a backstop for muni prices compared with taxable debt.

Going global

Global bond markets have started diverging from one another after the initial inflation shock of 2021/22. As such, interest rate differentials offer a good opportunity to diversify interest rate exposure and position in countries/regions with tight monetary policy and falling inflation.

Glad to be back

At the start of 2023, we laid out our "road map for bonds" for the year. At the time, we emphasized that publicly traded bonds provided a good alternative to other investments. Two-thirds of the way through 2023, the story remains the same. Bonds are doing exactly what they are supposed to: generating income, buffering volatility, and hedging cyclical risks. Looking forward, bonds in our view should generate a steady, consistent stream of cash flow and performance. It's time for them to again become a portfolio's cornerstone investment.

For further information

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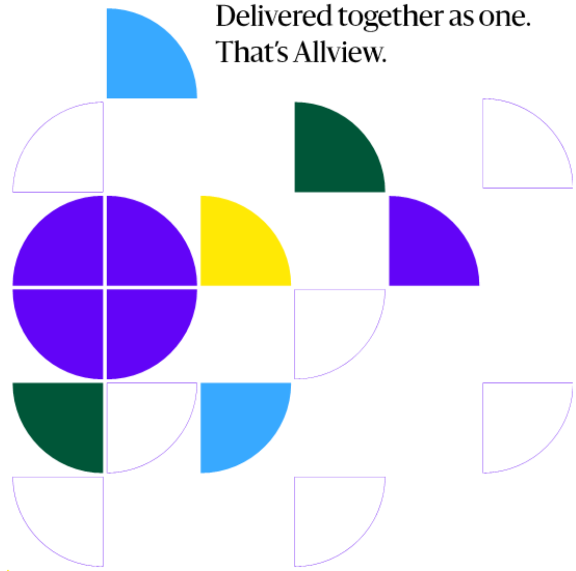

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