OK Boomers – Bonds are Back!

Baird Advisors

In May 2021, Baird Advisors published a thought piece entitled "Wrong Rates at the Wrong Time – Sorry Boomers - Rates Have (So Far) Not Been Your Friend" (link to paper). In that paper we made the following comment:

Maybe we are at an inflection point in interest rates as some suspect. We are clearly experiencing the strongest pace of U.S. economic growth since the 1980s as the economy reopens and pandemic relief stimulus has left many consumers with cash to spend. Inflation is also rising due to both base effects and supply chain disruptions, and some fear that inflation may be stickier this time around, rather than transitory as the Fed expects. If true, and if growth and inflation concerns continue to push rates higher over the next several quarters/years, it will be an uncharacteristic and perhaps long overdue rate gift to the baby boom generation. Every basis point that yields rise helps in their transition from collecting a paycheck to living off their invested assets.

Fast forward one year and the bond market has been turned upside down. The Federal Reserve's view on inflation has quickly moved from "transitory" to do "whatever it takes to make sure it is not permanent." Ten-year Treasury yields have doubled just since year end 2021, increasing from about 1.5% to 3% in a little over four months. Two-year yields have moved up at an even faster pace increasing from .75% to about 2.80%. Yields have climbed at even a quicker pace for many other fixed income sectors including corporate, mortgage, and municipal bonds. While the negative fixed income returns produced by the rise in rates have been painful, the higher yields now available may be just the retirement gift that boomers (aged 58 – 76 years) have been looking for.

Municipal Yield Curve – Tax-exempt and Taxable Equivalent Yields (as of 4/30/22)

Maturity	Federally Tax-exempt AAA Yield	Taxable Equivalent Yield @ 32% Tax Rate	Taxable Equivalent Yield @ 40.8% Tax Rate
5Yr	2.53%	3.72%	4.27%
10Yr	2.75%	4.04%	4.65%
30Yr	3.10%	4.56%	5.24%

Source: Bloomberg

Value in Municipals

The case for bonds becomes even more compelling for tax-paying investors when looking at tax-adjusted yields in the municipal market. As shown in the chart above, AAA-rated five-year bonds now yield approximately 2.5% tax-free, which is equivalent to 4.25% pre-tax at the highest federal rate. Thirty-year AAA bonds offer a tax-free yield over 3.0%, equivalent to nearly 5.25% pre-tax, and it is becoming increasingly common to find AA-rated bonds at a tax-free rate of 4.0%, or higher, in the 20yr maturity range. For an investor in the top federal tax rate, this is equivalent to 6.75% pre-tax. Those in states with high income tax rates (e.g., NY or CA) are now able to find taxable equivalent yields of 8% or higher!

Peak in Rates?

As is always the case, a quick movement higher in rates and the associated negative returns they produce have investors understandably concerned about how high rates may go and when might they peak. The truth is no one knows. Predicting future rates is usually a losing game, but we can look to the markets to see what has already been "priced in" and the simple answer is, a lot. Fed funds futures, for example, currently expect the federal funds rate to

end this year in the 2.75% - 3.0% target range, up 275 bps in one year. If this occurs, it would be the largest and fastest rate adjustment in the federal funds rate since the 1994/95 cycle, after which market rates fell sharply. The Fed's own "dot plot" currently shows the federal funds rate peaking at 3.0% in early-2023, but admittedly there is much uncertainty around this forecast. The war in Ukraine combined with the lockdowns in China have clouded the outlook for inflation as commodity prices have moved higher and supply chain disruptions persist. This in turn has caused global economic growth to slow down materially. Many are now forecasting a 2022 recession in Europe and higher odds of a US recession in 2023 and beyond.

Our 2021 piece closed with the following:

Investors should not underestimate the likely strong and ongoing demand for fixed income from the baby boom generation. There is a generational wealth gap between baby boomers and other demographic groups that will not be closed any time soon. According to Fed data, baby boomers controlled 52.7% of all U.S. wealth at the end of 2020, compared to 26.9% for Generation X and just 4.8% for the millennials. As rates rise, demand will likely increase for bonds rather than decrease. Because rates have been near historical lows for an extended period, assets that would normally have been allocated to core fixed income have gone searching for more yield in other sectors and asset classes, often at greater risk levels. If yields on higher-quality fixed income assets rise, baby boomers will likely be even bigger buyers—enjoying the fact that they finally were able to capture the right rates at the right time.

As rates have risen around the globe, we would expect some of those traditionally core fixed income assets to return home to boomer portfolios. It remains to be seen whether the Fed will be successful at fighting inflation while engineering a soft economic landing and avoiding a recession. However, for investors looking to "***capture the right rates at the right time***" and "lock-in" tax-adjusted returns that compare favorably to the long-term return expectations for equities, with historically lower risk, municipal bonds may be worth another look. Hey boomers, you are in luck – bonds are back!

Disclosures

Fixed income is generally considered to be a more conservative investment than stocks, but bonds and other fixed income investments still carry a variety of risks such as interest rate risk, credit risk, inflation risk and liquidity risk. In a rising interest rate environment, the value of fixed income securities generally declines and conversely, in a falling interest rate environment, the value of fixed income securities generally increases. High-yield securities may be subject to heightened market, interest rate or credit risk and should not be purchased solely because of the stated yield. Municipal securities may or may not be appropriate for all investors, especially for those in lower tax brackets.. All investments carry risk, including loss of principal. Past performance does not guarantee future results.

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