Bonds Behaving Badly ...or are they?

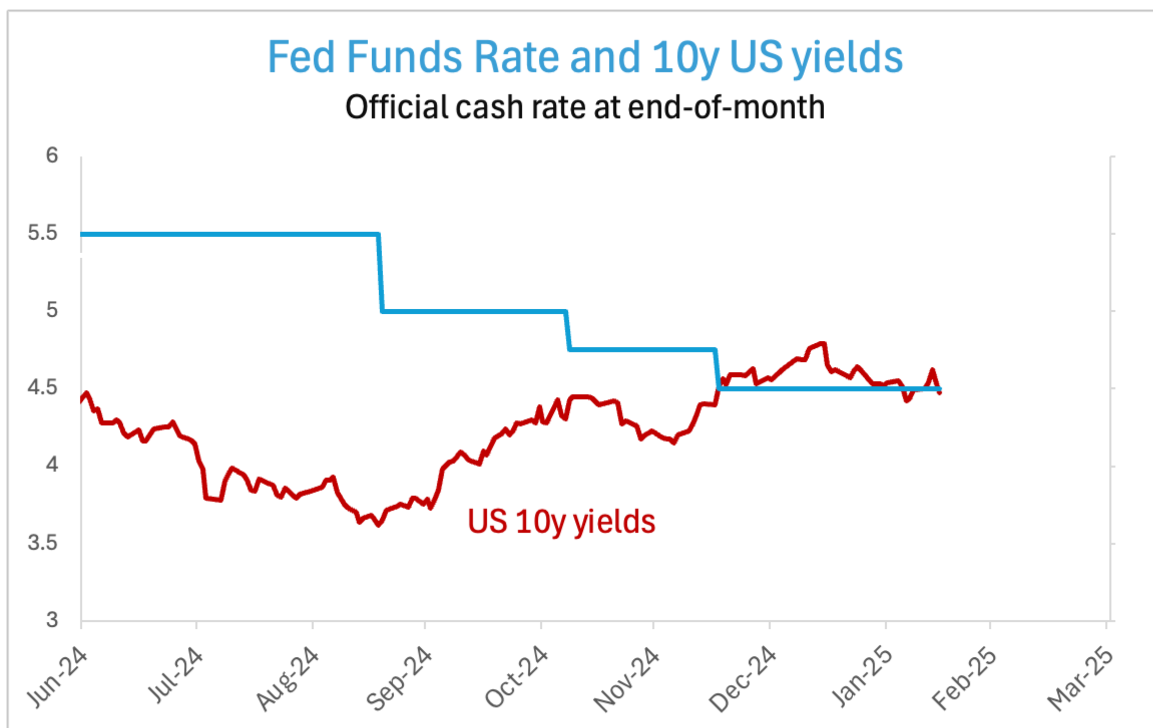
You would think bonds should be a good place to be when the Federal Reserve has been cutting interest rates since September last year, yet the Bloomberg Global Aggregate Bond Index finds itself in negative territory since the Fed made the first of its three cuts in September 2024. The US Government's 10-year bond yield has been going up while the overnight rate has been going down. Bonds are behaving badly – or are they?

Over the past 40 years, in virtually every instance when the US Federal Reserve (Fed) was cutting its key policy interest rate, long-term interest rates moved in lockstep lower with the reduction in short-term interest rates. But it appears that the US Government's 10-year (US10Y) bond yield is behaving badly, as it has been going up (and hence the return of the Global Agg has been negative[1]).

It has now been nearly three months since the Fed first cut interest rates and while short-term borrowing costs are falling, long-term borrowing costs are rising, creating a headwind for anyone wanting to borrow long-term, and causing some angst for anyone holding bonds with longer duration – like the Global Agg index.

The chart below shows the upper band of the Federal Funds rate since June last year plotted against the US10Y. Oddly, when rates were steady at 5.5% yields did start to come down and bonds had strong positive returns – most likely on expectations of inflation and economic growth. But since rates have started to come down the US10Y has been going up. So what's going on?

[1] Between September 18th 2024 and February 14th 2025 the Bloomberg Global Aggregate Bond Index (hedged AUD) has returned -0.61%



Source: Federal Reserve, investing.com

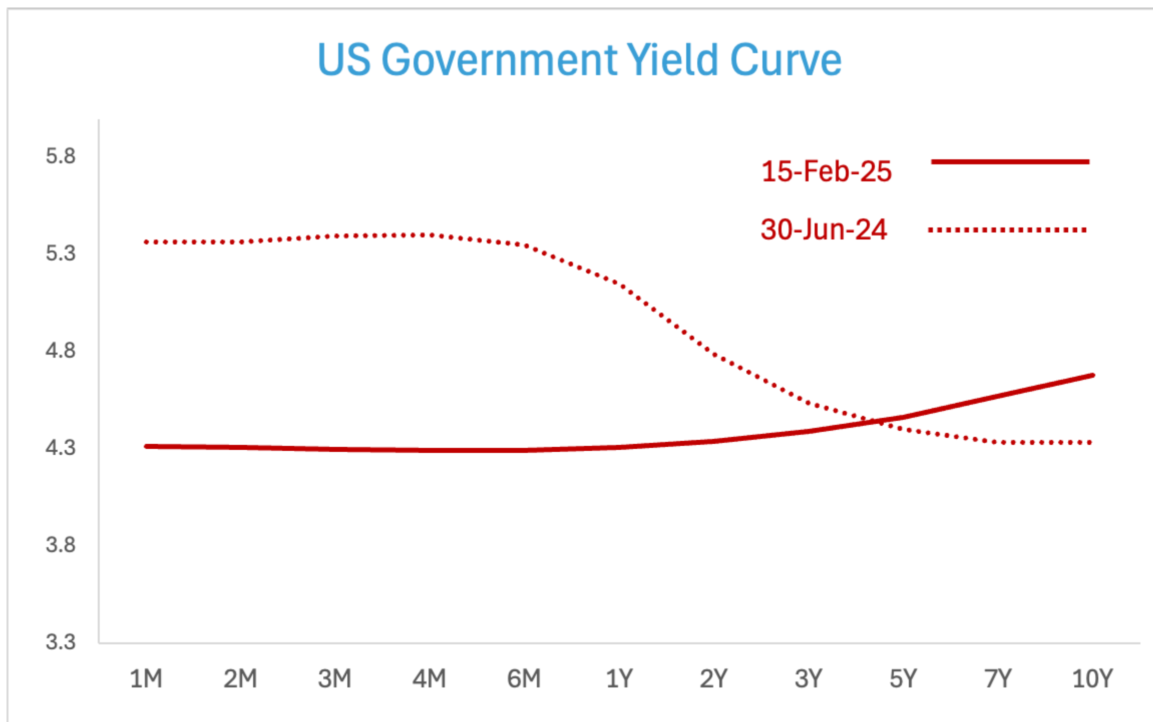
Some of the explanation is simply conventional economic theory, which says long-term interest rates should be higher than short-term rates during periods of economic growth. This is because a strong economy usually leads to inflation, which means the central bank (in this case, the Fed) would be raising interest rates at some point in the future. That implies that today's high long-term interest rate reflects the market's anticipation of higher interest rates in the future.

Another explanation for the “un-inversion” of the yield curve – also charmingly referred to as a Bear Steepener - is that US bond investors are becoming worried that President Trump's policy platform will push already high levels of deficit spending even higher. The US Congressional Budget Office continues to show that the debts of the US Government are on pace to exceed levels only ever achieved during World War II[2]. Bond investors are thus demanding higher interest payments, given the expected supply of new bonds to fund all this spending.

The chart below shows this un-inversion. Back at the end of June last year – just before the Feds started cutting rates – the yield curve was inverted. This meant that 2 year yields were higher than 10 year yields, which implies that the bond market was becoming more pessimistic about the economic prospects for the near future. But today the yield curve is back to a “normal” curve, where long term yields are higher than short term yields.

As a point of interest, many times in the past when the yield curve has been inverted a recession has followed, thus the inverted curve has been seen as a sign of impending economic doom. However, this time it appears that the Federal Reserve have navigated a “soft landing” (some might say that there has been no landing at all) as the US economy is growing strongly and the “R” word is no longer mentioned.

[2] https://www.cbo.gov/data/budget-economic-data#3



Source: Federal Reserve, investing.com

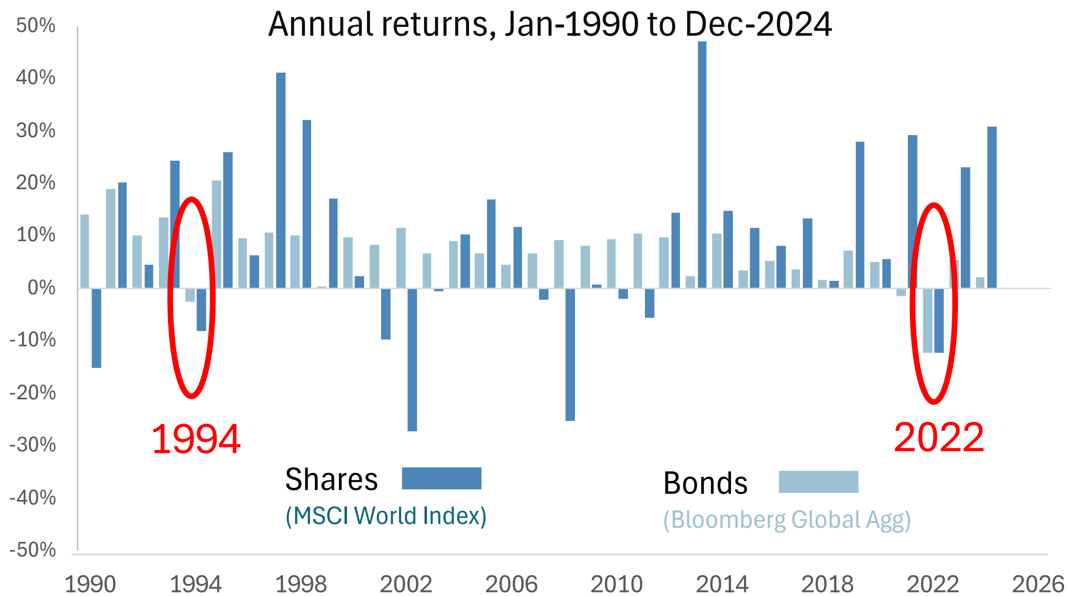
What all this actually tells us is that central bank policy on short term interest rates has no bearing on what longer term yields do. It is a mis-conception – promoted by the media and bond fund managers – that cutting interest rates will be good for bonds because longer term yields will also fall. Since the great bond sell-off of 2022 bond fund managers have proclaimed that "this year will be the year of the bond" at the start of 2023, 2024 and 2025... Eventually they will get it right, but the lesson is not to listen to forecasts around stocks or bonds!

Longer term yields are just market prices that change with every trade on expectations of future inflation, employment, productivity, etc. Interest rates are set by central banks – longer term yields are set by the market.

The bright side of the recent bond selloff is that the two major asset classes have moved in different directions. That's called "negative correlation" and is seen as a positive from a portfolio perspective. Recent losses might be cold comfort for bond investors, but at least diversification isn't dead.

However, it is important to realize that bonds are not negatively correlated to equities. Over the last 30 years the correlation between the Bloomberg Global Aggregate Index (hedged AUD) and the MSCI World ex-Australia index (in AUD) is a small positive 0.1. That's because most times bonds and equities give positive returns. In fact, there are only two annual periods where stocks and bonds have been negative (and for similar reasons) – back in 1994 and 2022, as shown in the chart below.

Shares and Bonds



No one complains when stocks and bonds rise together, but the fact that the two major asset classes suffered simultaneous losses in 1994 and 2022 prompted a lot of angst for investors. The financial media in both those years decried the “death of diversification” and the “end of the 60/40 portfolio.” High inflation and rising interest rates are typically bad for both stocks and bonds. Correlations tend to rise during such periods.

Bonds are not behaving badly. They are reacting to market expectations as they have always done and remain an important part of any balanced portfolio. When equities have had major falls then most times bonds have had strong positive returns to cushion the downturn. A balanced, diversified portfolio of stocks and bonds remains as important as ever.

The message for investors is the same as always: Maintain perspective, tune out the day-to-day noise that can lead to impulsive decisions, be true to your goals, and put your faith in a history that has rewarded those who embrace the long term.

Dr Steve Garth
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