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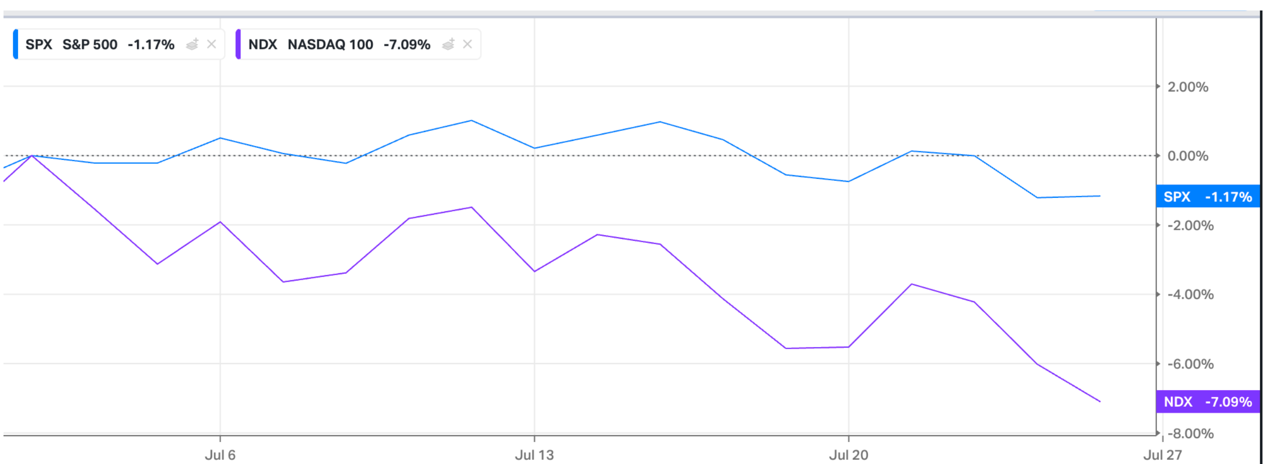
FCM Weekly Market Notes

Bonds Are Not a Haven from Wobbly Markets

Now is not the time to consider a traditional bond allocation as the antidote to shaky equity markets. So far in July, a global 60/40 portfolio benchmark has under-performed the S&P. More bonds in your portfolio trades one set of risks for another.

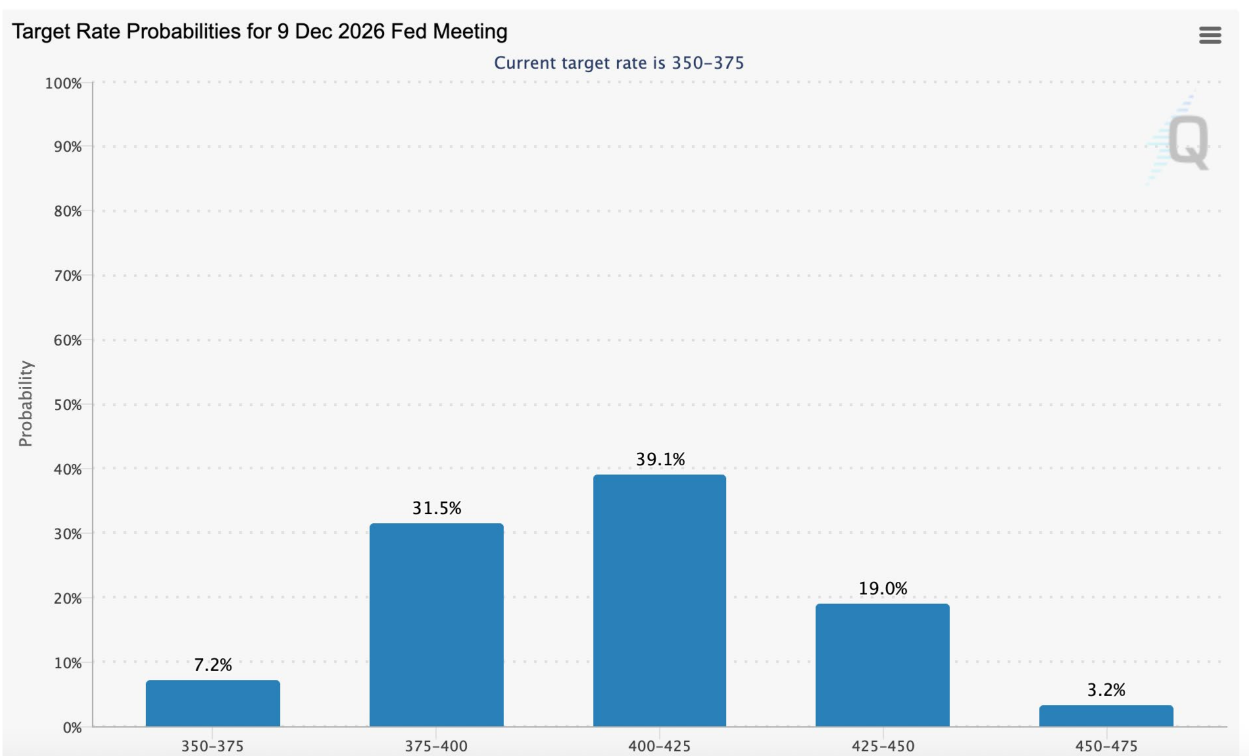
Tech is driving equity angst. As we have noted before, it's tough to avoid it in your equity portfolio. And we have frequently noted the risks of AI as a market driver are rising -- here, and here most recently. And the tech weakness appears to be accelerating:



The traditional balanced portfolio mindset would lead you to believe that a more generous helping of bonds is the answer to your problems. But the bond market cycle risks are rising at the same time.

Let's start with the best reason to avoid a traditional fixed income allocation as a portfolio anchor: a coming rate hike cycle. Stock valuations are tough to figure out, bonds are simpler: when US overnight rates are set to rise according to market consensus so too are total return risks over an indeterminate investment horizon.

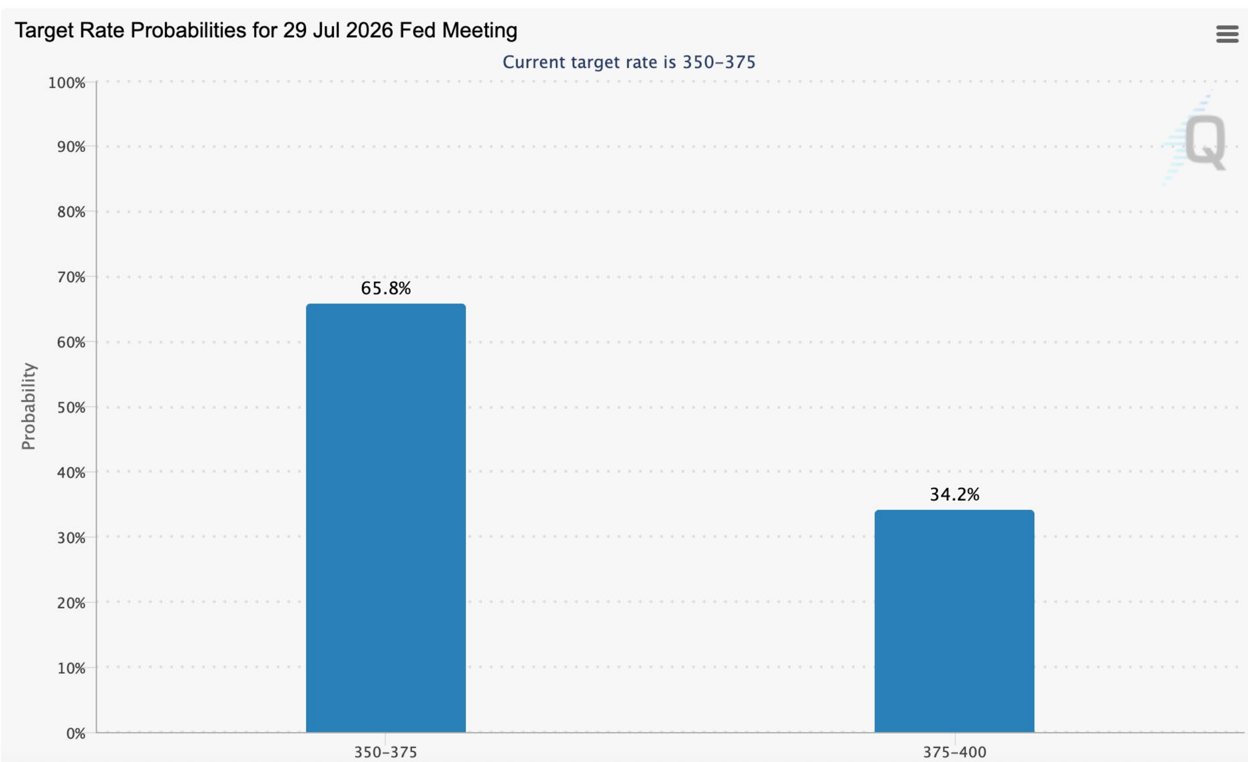
By December the market is pricing a scant 7% or so probability that rates stay where they are, and over a 60% chance that rates are hiked twice:



Of course, the solution for a fixed income investor is to lower their portfolio's duration, or sensitivity to interest rate hikes. But most investors rely on either ETFs or individual bonds or advisors who might not be attuned to bond market risks when focused on equity exposures. How likely is that investors, even sophisticated ones, can easily reduce their duration in existing holdings?

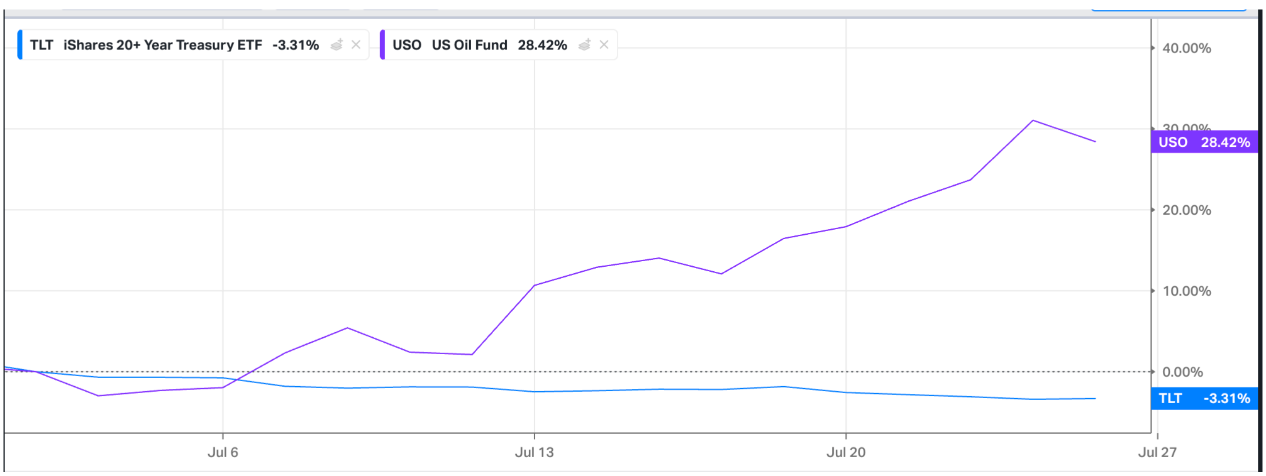
A second fixed income issue is the new Fed chair. The market does not yet have a firm handle on his inflation-fighting credentials. And unfortunately, he has repeatedly stated that Fed communication should be more sparing going forward. That leaves the market with less information at a more sensitive stage in the market cycle.

We have a Fed meeting this week, and this close to the meeting under almost any recent previous central bank chair, the market would feel like it has a very solid grasp on its outcome and price that with a probability likely above 90%. Not this time:



If this becomes the norm, that means more market volatility around the bond market, so your return is likely to be less compensation for a higher level of Fed risk going forward.

Of course, investors are aware that renewed hostilities in Iran will translate into a higher probability of future rate hikes the longer they are extended. Oil reserves are low and the ongoing inability of the US to extricate itself from the region suggests oil price spikes have become a higher probability. And rising oil means falling bond returns, particularly at the long end of the yield curve:



Lastly, a renewed effort to slap tariffs on virtually all US trading partners has become another risk to bonds as higher inflation for longer becomes a greater possibility. Clearly, consumers ultimately bear the burden in the form of higher prices for imported goods.

Unfortunately, the remaining risk to fixed income is a “not-so-black-swan” problem in the form of globally rising government debt loads. There is plenty of evidence in places like the UK and Japan that bond markets are growing increasingly sensitive to the issue. No one knows when it might definitively begin to impact US debt markets, but we do know for sure the political will to address the issue is completely lacking across the spectrum of US politics.

We see plenty of possibility of mitigating equity downside and producing income in the plethora of options-based income strategies now available for investors in liquid ETF form. The standard advisor route seems to be to tout alternatives or private debt and equity. We believe the high fee structures and illiquidity serve investors poorly—in many of these products, not all. And there is plenty of reason to believe liquidity will become an ever-more valuable portfolio attribute going forward.

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