Pallas Perspective

September 15, 2023

After a Tough Couple of Years, Bonds Positioned to Play a Role in Diversified Portfolios

The release of this week's Consumer Price Index data for August revealed a rise in inflation compared to July. Though still lower than the previous year, the data suggests that the trajectory of interest rates looks likely to be higher for longer. However, following a historic third year of negative returns for the aggregate bond index, the role of bonds in a diversified portfolio is more attractive.

The catalyst for the bond market will be the prospective direction of the yield on the U.S. 10-year Treasury. Factors exerting upward pressure on the yield include additional Fed Fund rate increases to counter inflation, increased debt issuance by the U.S. Treasury, and reduced demand from major buyers like China and Japan. Conversely, factors contributing to lower yields would encompass Federal Reserve rate cuts as inflation nears its long-term, slower economic growth or a recession, and a flight to low-risk assets.

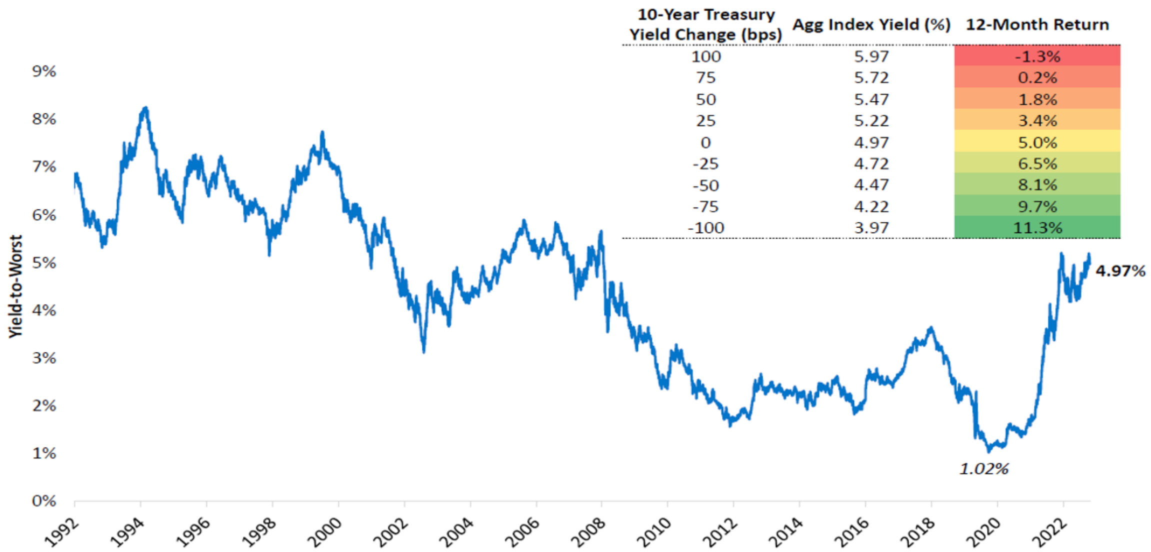
U.S. 10-Year Treasury Yield (5-Year)

Source: CNBC

Given the numerous factors influencing the short-term trajectory of the U.S. 10-Year Treasury Yield, one should anticipate heightened volatility in the near term. In fact, the bond market has already experienced historically elevated levels of volatility in 2023. However, longer-term trends suggest that the yield is likely close to a peak with further increases being relatively incremental versus the dramatic increase seen over 2021 and 2022. The current situation suggests an asymmetric risk and return profile for a diversified bond exposure may well play out looking forward.

Bloomberg U.S. Aggregate Bond Index Yield, Sensitivity to Rate Changes, and Implied 12-Month Return

(As of 8/31/2023)



10-Year Treasury Yield Change (bps)	Agg Index Yield (%)	12-Month Return
100	5.97	-1.3%
75	5.72	0.2%
50	5.47	1.8%
25	5.22	3.4%
0	4.97	5.0%
-25	4.72	6.5%
-50	4.47	8.1%
-75	4.22	9.7%
-100	3.97	11.3%

Source: DoubleLine, Bloomberg
The scenario analysis showing yield changes applied to the Bloomberg US Aggregate Bond Index (embedded in the chart), attempts to simulate possible performance outcomes using data. The methodology can include among other things, use of historical data, various factor or market change assumptions, and subjective judgments. For illustrative purposes only. Investment analyses applied by DoubleLine may not produce the desired results.

Source: DoubleLine, Bloomberg

While prospective returns cannot be guaranteed, bonds do seem to benefit from a decline in 10-year Treasury yields, offering a relatively low risk of capital loss even in the face of a potential rise of up to another 100 basis points in yield. The analysis suggests that bonds should provide a particularly strong role for a diversified portfolio in the event of slower economic growth or recession. For the first time in several years, the traditional role of bonds as a defensive asset allocation appears to be in place.

Pallas Capital Advisors will continue to monitor the investment landscape and look to position portfolios to navigate through the current environment while keeping on course with the long-term goals of our clients.