THE WORST YEAR FOR BONDS IN HISTORY?

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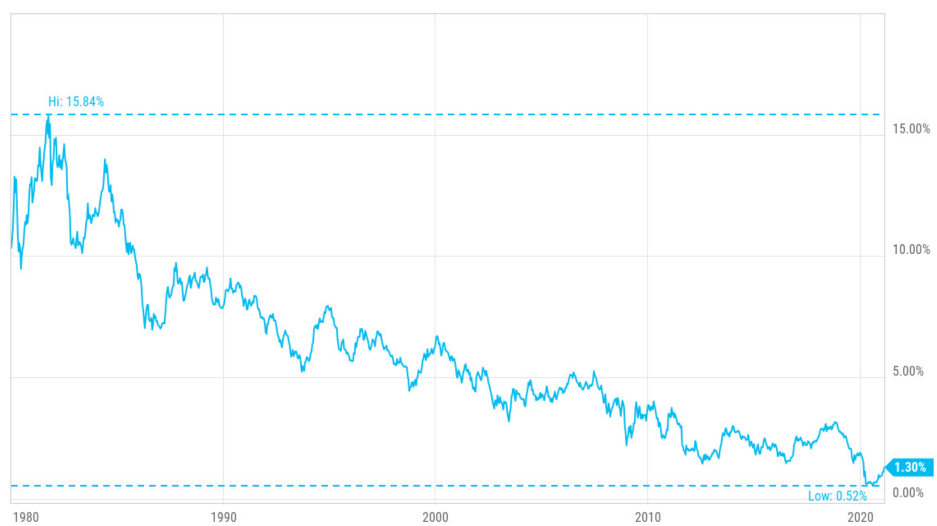
Over the past 40 years, bond yields have largely moved in one direction: down.

The 10-Year Treasury went from a yield of 15.84% in 1981 to an all-time closing low of 0.52% in 2020.

10-YEAR TREASURY RATE



Past performance is not indicative of future results. As of 2/18/21. Source: YCharts.

This has been a blessing for bond investors because prices move inversely to yields. And, over the last two years, as yields plummeted to historic lows, bond investors have experienced extraordinary gains.

Barclays Aggregate, Total Return (1977 - 2020)

Year	Return	Year	Return	Year	Return
1977	3.0%	1992	7.4%	2007	7.0%
1978	1.4%	1993	9.7%	2008	5.2%
1979	1.9%	1994	-2.9%	2009	5.9%
1980	2.7%	1995	18.5%	2010	6.5%
1981	6.2%	1996	3.6%	2011	7.8%
1982	32.6%	1997	9.7%	2012	4.2%
1983	8.4%	1998	8.7%	2013	-2.0%
1984	15.1%	1999	-0.8%	2014	6.0%
1985	22.1%	2000	11.6%	2015	0.6%
1986	15.3%	2001	8.4%	2016	2.7%
1987	2.8%	2002	10.3%	2017	3.5%
1988	7.9%	2003	4.1%	2018	0.0%
1989	14.5%	2004	4.3%	2019	8.7%
1990	9.0%	2005	2.4%	2020	7.5%
1991	16.0%	2006	4.3%		

Decade	Cumulative Return	Ann. Return
1980-89	222.7%	12.4%
1990-99	109.9%	7.7%
2000-09	84.7%	6.3%
2010-19	44.5%	3.7%

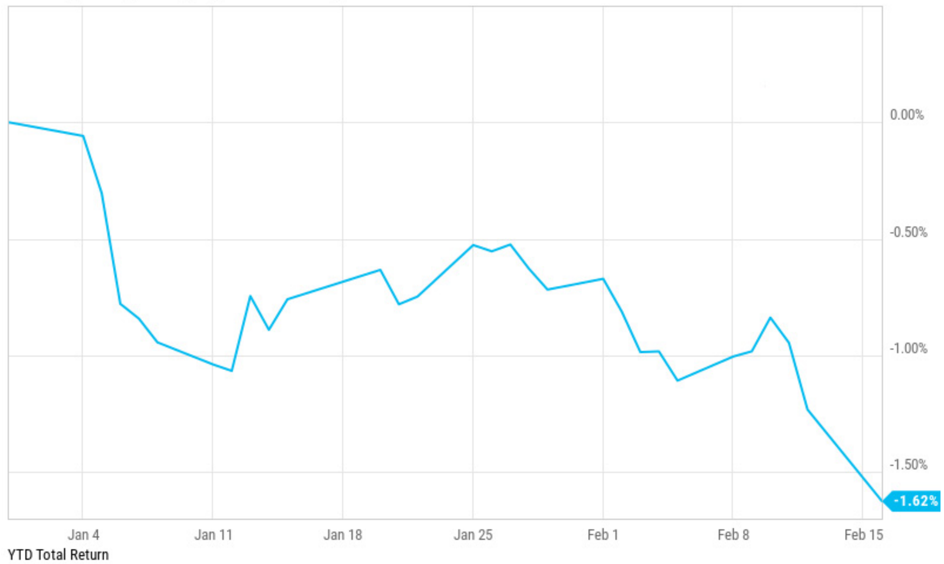
Past performance is not indicative of future results.
Source: Compound.

But, that was the past. What has served as a tailwind for decades (falling rates) is now a major headwind. There is simply no escaping bond math, which has shown that lower yields portend lower future returns.

With a 10-Year Treasury yield of 0.92% to start the year, it wouldn't take much of an increase to make this the worst year for bonds in history (-2.9% in 1994).

We're on pace for that right now, as the 10-Year yield has moved up to 1.30% and U.S. bonds are down 1.6% year-to-date.

BLOOMBERG BARCLAYS U.S. AGGREGATE LEVEL % CHANGE (YTD TOTAL RETURN)



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With a duration of roughly six years, a 100 bps (1%) increase in yields would lead to a decline of 6% in aggregate bond prices.

The longer the duration, the larger the decline in yields. We have seen this play out in the long-term zero coupon bond ETF (ZROZ), which is down over 23% from its high last March (its duration: 27 years).

What could cause bond yields to continue to rise from here?

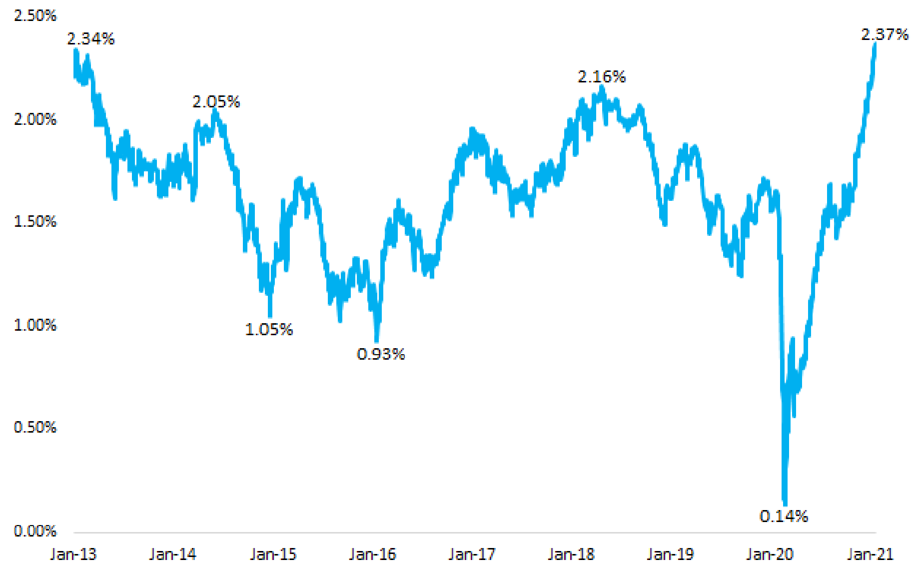
PIMCO 25+ YEAR ZERO COUPON BOND ETF (ZROZ) PRICE % OFF HIGH

Past performance is not indicative of future results. As of 2/16/21. Source: YCharts.

1) Rising Inflation

Inflation expectations in the U.S. are now at their highest levels since 2012. Interest rates tend to be highly correlated with rates of inflation.

INFLATION EXPECTATIONS 5-YEAR U.S. BREAKDOWN INFLATION RATE (%)



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2) Rising Supply

U.S. National Debt has increased over $4.6 trillion (20%) in the last year to nearly $28 trillion. It is expected to spike higher once again with the passage of a $900 billion stimulus bill in late December and another $1.9 trillion bill likely coming in the next month. More stimulus means more debt and more bond issuance. This increase in supply could put upward pressure on rates.

3) Rising Growth Rates

As the end of COVID-19 is now in sight, economic growth rates are expected to continue to recover. Historically, there has been a high correlation between nominal GDP and interest rates.

Collectively, these factors point to the potential for a continued increase in interest rates and what could very well become the worst year in history for bonds.

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Duration represents the interest rate sensitivity of a fixed income fund. For example, if a fund's duration is five years, a 1% increase in interest rates would result in a 5% decline in the fund's price. Similarly, a 1% decline in interest rates would result in a 5% gain in the fund's price.

The **Bloomberg Barclays U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and it is not available for direct investment.

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