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The Case for Rebalancing into Bonds, in Pictures

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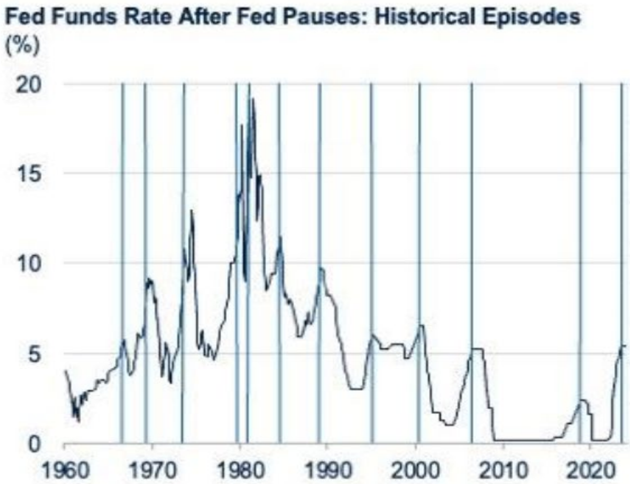
With yields up at levels not seen in more than a decade, bonds are definitely catching the eye of investors. But with equities delivering strong gains and Treasury curve inversions incentivizing investors to idle in cash, will bond returns be competitive? In the current market environment, we see a compelling case for rebalancing into bonds vs. both stock and cash. The figures below tell the story, highlighting the pros and cons of cash, bonds and stocks, as well as their roles in portfolio construction.

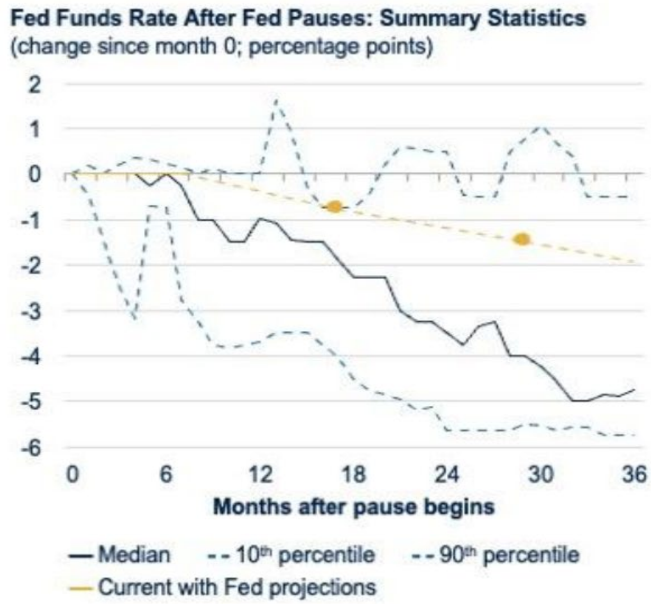
Before jumping into the figures, a few conclusions to set the scene:

1. True, cash rates remain high. But unlike bonds, **the returns from cash over the long term are highly uncertain**. And to that point, central banks are preparing to cut rates.
2. **Equity valuations look full relative to bonds.** This is not so much a knock against stocks, but this configuration has historically signaled that bonds are set to deliver better-than-average returns and Sharpe ratios.
3. **In environments where central banks are on hold or cutting rates, bonds have historically been good shock absorbers**, on average delivering solidly positive returns in quarters when equities experience steep declines.

FIGURE 1: DESPITE AN INVERTED YIELD CURVE, CASH MAY NOT OUTPERFORM OVER THE LONG TERM AS THE FED EASES POLICY.

Given the ongoing inversion of the U.S. Treasury yield curve, at first blush, cash may appear to be the best investment option. History, however, indicates otherwise: once a central bank puts its policy rate on hold, the cash rate falls more often than not. Indeed, many policy cycles end with precipitous reductions in policy rates.

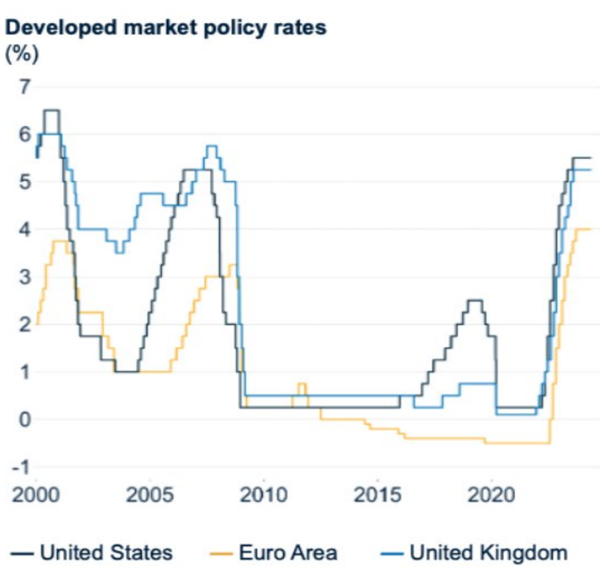


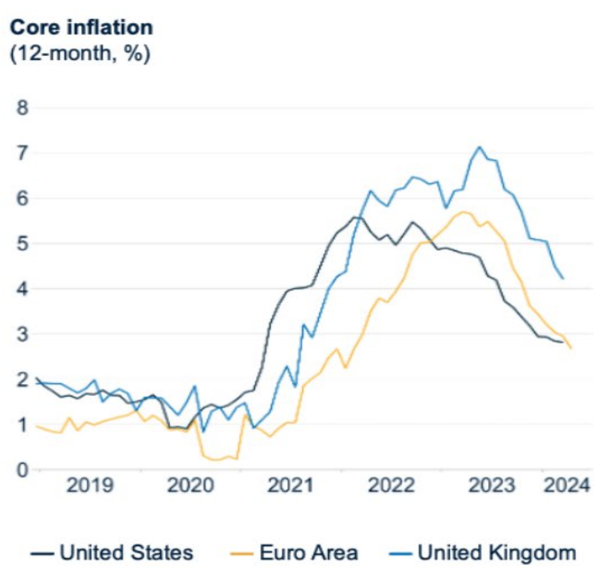


Source: Federal Reserve, Haver, PGIM Fixed Income as of April 2024.

FIGURE 2: THE ECB AND THE BANK OF ENGLAND HAVE ALSO BEEN ON HOLD AND ARE NOW LOOKING TO CUT RATES.

The same is likely in the euro and sterling fixed income markets. Yes, these cash rates are also high amidst inverted government yield curves; but inflation numbers have declined substantially, and the central banks are signaling that their next moves will likely be cuts. Therefore, despite the appeal of cash in an inverted-yield curve environment, the expected rate cuts may render cash as an ineffective vehicle for generating competitive returns over the long term.

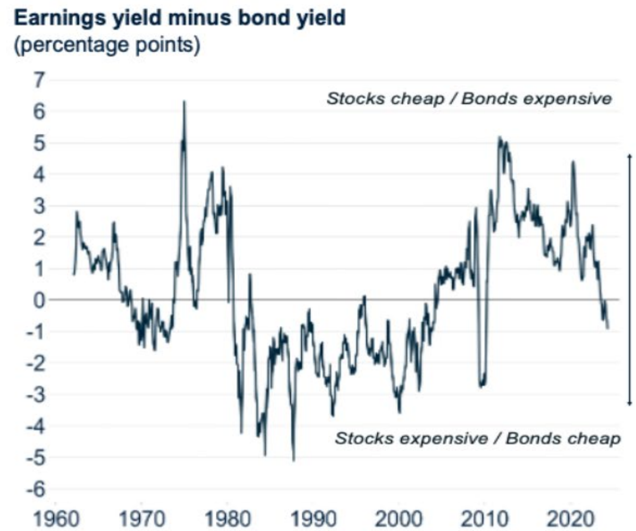




Source: Macrobond, PGIM Fixed Income as of May 15, 2024.

FIGURE 3: EQUITY VALUATIONS ARE NOT CHEAP VERSUS BONDS.

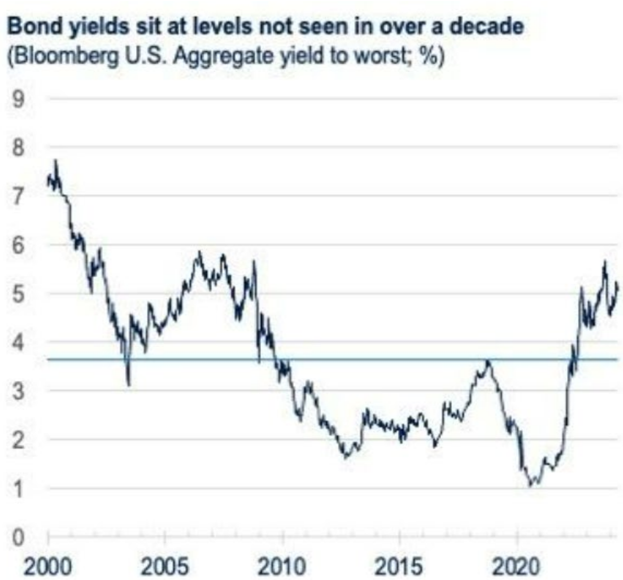
Whether you're looking at the last few years, or the last century, equities might seem like the place to be. Notwithstanding the excellent wealth building capacity of stocks over the ultra-long run, in the current context, it's worth considering that the recent repricing of bonds has taken yields to generational highs; the same cannot be said of equity valuations. For example, comparing the earnings yield of the S&P 500 with the 10-year Treasury yield shows that stocks have lost their relative valuation advantage vs. bonds. We look at the potential implications for risk and return in a subsequent figure.



Source: Bloomberg, Haver, S&P, Macrobond, PGIM Fixed Income, May 15, 2024.

FIGURE 4: WITH YIELDS BACK UP AT 2002 LEVELS, THE OVERALL FIXED INCOME BACKDROP LOOKS PROMISING.

In contrast to equities - where price-earnings ratios are high and earnings yields are low - the revaluation in bonds has taken yields back to levels not seen for more than a decade. For long-term investors, this is a critical point: if past is prologue over the long term, these yields are likely to translate into returns ([i.e., Yield is Destiny](#)).



Higher yields signal higher returns ahead, a la 2002*
(%)

Periods	Starting Yield		Aggregate Return
1992-2002	6.76	→	7.45
2002-2012	4.38	→	5.29
2012-2022	1.75	→	1.27
2022-...	4.68	→	?

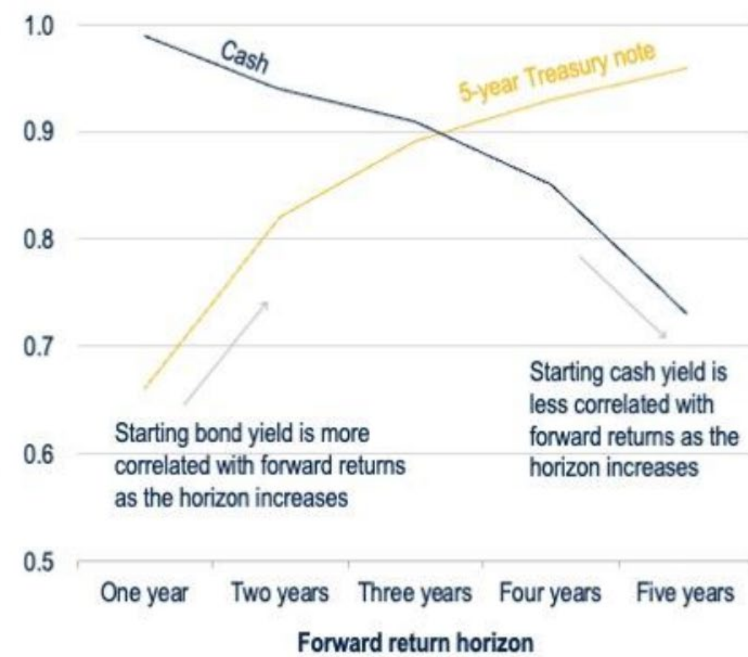
Source: Chart left: Bloomberg as of May 2024. Chart right: PGIM Fixed Income. "Yield is Destiny; Bonds are Back," The Bond Blog, PGIM Fixed Income, December 20, 2022.

FIGURE 5: HOLDING CASH BECOMES RISKIER THAN BONDS FOR LONG-TERM INVESTORS.

Now that we've looked at the asset classes individually, we'll look at them from a portfolio perspective. First, cash may seem like the preferred option amidst the inverted yield curves. But, over time, the certainty around expected cash returns logically declines. In contrast, given bonds' long durations and longer maturities, they provide a level of certainty or confidence for a targeted level of return. Therefore, cash may actually be the riskier option over the long term.

Correlation of starting yield with forward returns (1962-Present)

Forward return horizon	Cash	5-year Treasury note
One year	0.99	0.66
Two years	0.94	0.82
Three years	0.91	0.89
Four years	0.85	0.93
Five years	0.73	0.96

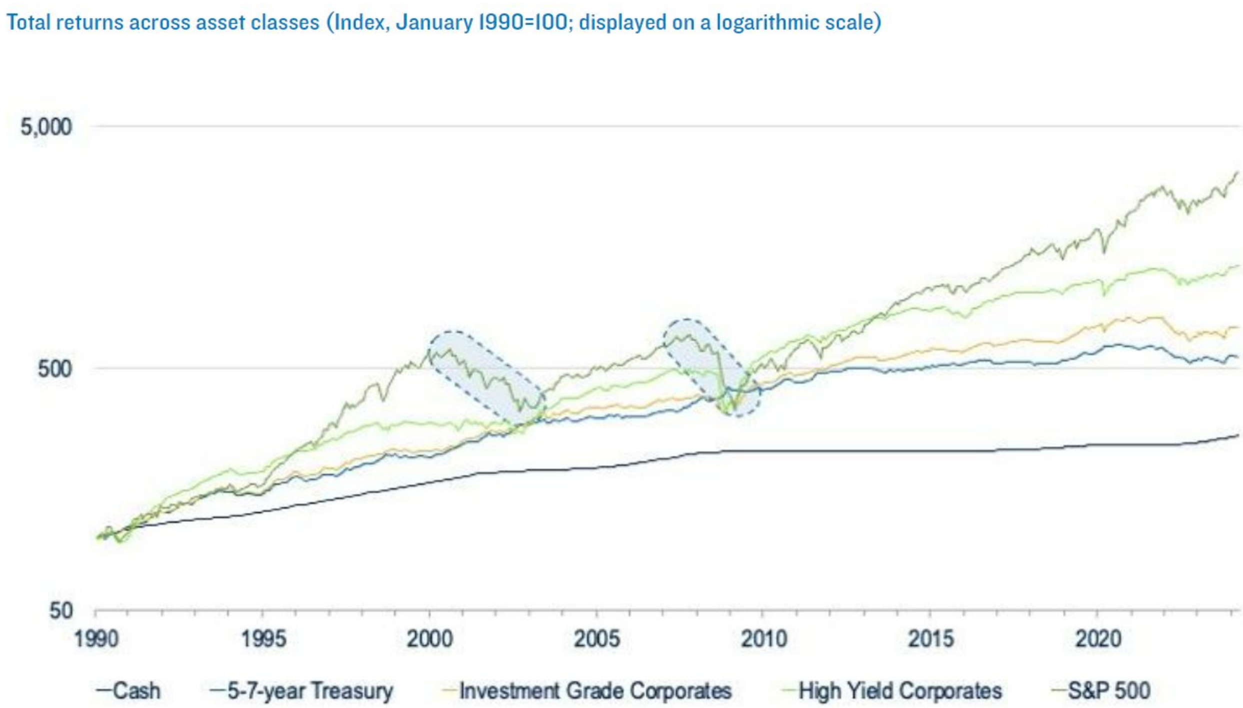


Source: PGIM Fixed Income, Haver as of May 2024. Note: Forward returns calculated by reinvesting in each instrument at a monthly frequency. Non-overlapping windows are used for each forward return horizon.

FIGURE 6: MORE RETURN, MORE RISK

Although the following chart shows that more risk has meant more return over the long run, the shaded circles highlight bouts of equity volatility. Our second asset class point is that stocks have experienced downdrafts of roughly 50% twice so far this century and recorded zero, or even negative, cumulative returns over periods as long as 10-15 years (e.g., 2000-2012).

So, while over the very long term, equities may post the highest total returns, it is worth keeping in mind that their near-term risks can be high. And as shown below, even over 10- to 15-year horizons, there may be periods when equity returns only match, or even fall short of, the returns on bonds or cash.

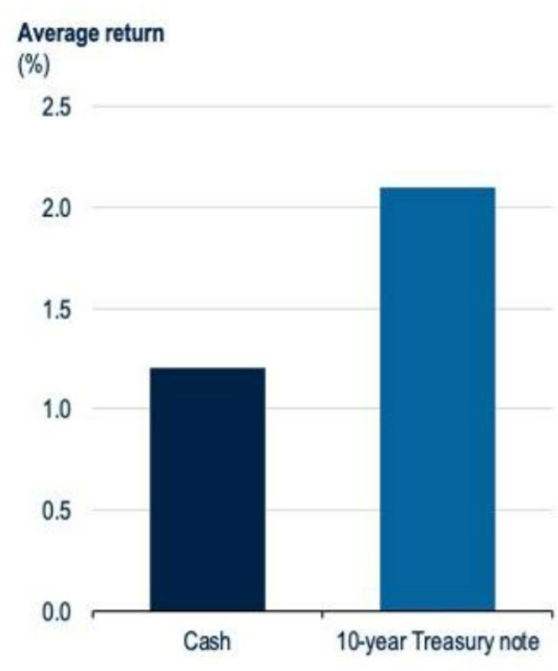


Source: Bloomberg as of March 2024.

FIGURE 7: WHEN STOCKS FALL, BONDS HAVE BEEN A BETTER SHOCK ABSORBER THAN CASH.

Which is the best shock absorber, cash or bonds? When looking at quarters when stocks were down 5% or more, bonds generally posted higher returns than both stocks and cash. Furthermore, bonds' outperformance widens when the Fed is on hold or cutting—which seems to be the kind of environment we are in now.

Cash vs. bonds during quarters when equities declined by at least 5% (1962-Present)



Returns based on Fed regime
(%)

	Hiking	Hold	Cutting
Cash (%)	1.3	0.7	1.5
Bonds (%)	-1.2	4.6	4.0
Stocks (%)	-7.9	-12.5	-14.9
# of episodes	15	10	14

Source: PGIM Fixed Income, Haver as of April 2024.

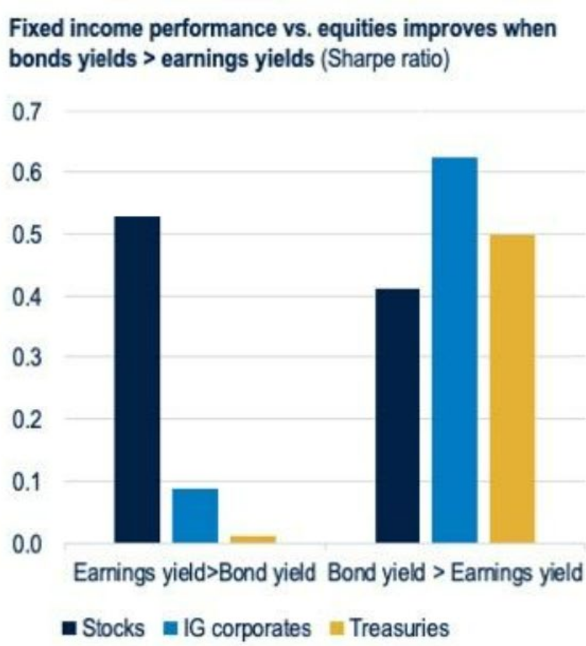
FIGURE 8: FORWARD RISK-ADJUSTED RETURNS HAVE BEEN RELATIVELY MORE FAVORABLE FOR FIXED INCOME WHEN BONDS YIELDS ARE HIGHER THAN EARNINGS YIELDS.

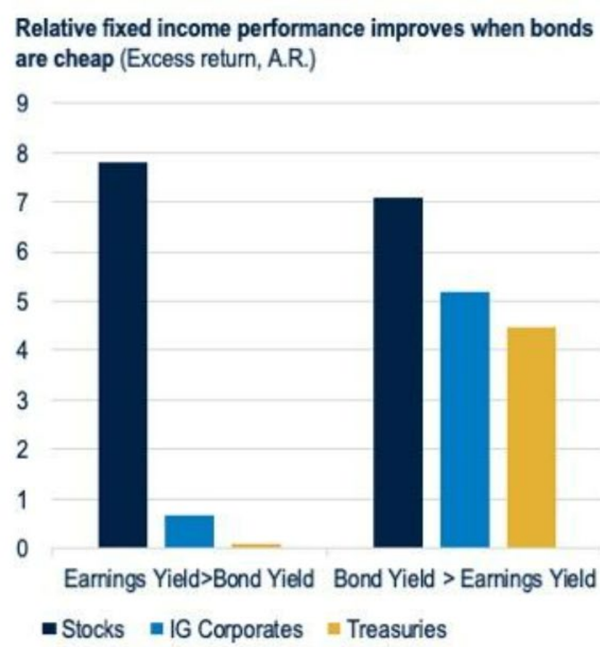
Now that stocks have lost their valuation edge, what does that imply for risk and return?

Source: Bloomberg, Haver, PGIM Fixed Income as of April 2024. Note: Sharpe ratios calculated from rolling 12-month forward excess returns (over cash) from relative starting valuation. The line on the left-hand side chart represents the 45-degree line, which delineates whether bond yields are higher than earning yields. Trailing earnings yields are used for the analysis.

A few inferences from past cycles:

- Bonds have tended to be much more efficient - e.g., higher Sharpe ratios - from the current relative yield levels;





Source: PGIM Fixed Income

- Long-term equity returns are great, but volatility and downside risks can take a bite out of returns over periods as long as a decade or more;
- and from current relative value levels, bonds have typically experienced similar volatility to their long-term averages, but with higher returns.

Source: PGIM Fixed Income

Conclusions

With the return of the "High Plains Drifter" regime of elevated bond yields (also covered here, here, and here), the investment landscape continues to shift. As a caveat, it is worth noting the obvious: we cannot rule out a bearish scenario playing out from current yield levels, in absolute or relative terms, vs. cash and stocks. But as equities scrape record highs and central bank policy rates crest, the preceding pictures support the case for diversifying into bonds as summarized in the following points:

- Cash yields are likely to drop as most major central banks normalize policy;
- this strengthens the case for moving into bonds in order to "lock in the yield" for the long term;
- the rally in stocks may have stretched equity valuations - raising an amber flag regarding overweighting equities;
- when bond yields are higher than earnings yields, as they are now, bonds have typically delivered solid risk-adjusted returns;
- and finally, given the potential volatility in stock prices, the defensive benefits of bonds as a shock absorber during steep equity selloffs are noteworthy - especially in periods, like the present, when central banks are on-hold or set to ease policy.

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