VAN LIEW TRUST COMPANY

as we see it

Holiday 2023

THOUGHTS FROM OUR CHAIRMAN

When my colleague Joseph J. Healy joined our company 31 years ago his role was focused primarily on bonds or fixed income, including co-management of our Ocean State Tax Exempt Bond Fund, a Rhode Island municipal bond mutual fund. While the bond market may appear unexciting it holds many unique challenges and opportunities, much like the equity markets. In this, our Holiday issue of As We See It, Joe provides useful observations on today's bond market. This segment of the investment world has seen 16 years of unusually low interest rates and has been overlooked or ignored by many investment managers. You will find that this has changed as you read on.

Alfred B. Van Liew

Am I Crazy to be Excited about Bonds?

Joseph J. Healy, CFA

For most people there is nothing as boring as hearing someone talk about bonds. You can literally see people's eyes glaze over mid-conversation as they wish they were somewhere else. The bond investor's perspective typically approaches buying them from a defensive "what can go wrong approach", as opposed to the more optimistic equity investor's focus where "the future is always brighter." But bonds may offer real opportunity in the current investment environment.

As I write this, in early November, bond prices are rising in the wake of recent economic reports that indicate the economy may be slowing. In this current environment that fears inflation and higher interest rates more than weaker economic news, bad news appears to be viewed as good news – except the news just can't be "too bad." Based upon this, for the week of 10/30, stocks had their best performance of 2023. Interest rates and yields across all bond/fixed income assets classes are at or near the highest levels we've seen in years. The last time the 10 year treasury note yield hit 5% was in July, 2007. As an investor looking ahead at an unknown future, might it be prudent to lock in these yields for longer term?

A couple items to consider:

- Interest rates have risen so much that bonds' upside opportunity appears to outweigh the downside risk. Typically, rising interest rates are bad for bond investors. If we are at or near the end of rate hikes this might be a great time to enter the market. Studies show in periods of elevated inflation bonds and equities are more highly correlated, meaning they move to a greater degree in tandem, which reduces the diversification benefits. We expect if inflation (and interest rates) start to recede, bonds should perform as a better hedge to equities than they did in 2022.

- From a pure math standpoint bonds are appealing. Bonds are tied to the interest rate cycle, trading within

a range, unlike equities which offer both potential higher returns but also periods of potential greater under-performance. There is evidence to believe we are at or near the bottom of the price range for bonds. 2022 was historically bad for bonds - we're talking the worst bond market in 250 years bad. However, present bond levels are at the highest yields in years and investors can lock in these yields for the longer term.

- Why not just sit in cash or money markets paying 5%? Why do I need to lengthen my bond exposure? Bond returns typically outperform cash over the 12 months following the Fed's last rate hike. A higher current money market yield can potentially evaporate so there's reason to lock in longer term yields.

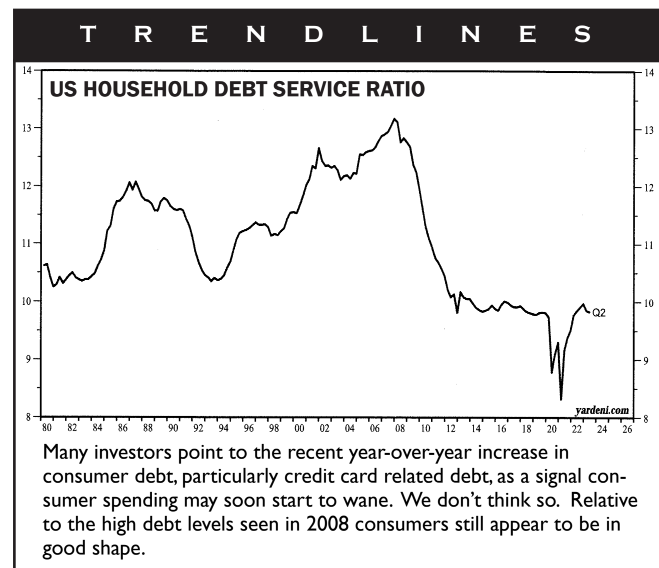
- The Fed's language indicating rates may remain "higher for longer" could be an opportunity for bond investors. Sharp rate cuts could trigger a spike up in bond values while a prolonged decline in rates could drive sustained higher bond returns over a longer time frame. We would prefer that scenario play out. However, higher structural deficits and too many fixed mandatory outlays may mean higher rates for longer.

- An Inverted yield curve, like we've had for a while now, has historically been a precursor to an economic recession. Yet, to watch equity market performance, no recession appears priced in. There does not appear to be appreciation for the potential risks. The yield curve is starting to normalize, but in all the wrong ways as longer term yields have drifted upwards while short term rates haven't budged (until this week). The persistent components of inflation have not receded as much as we'd like to see –especially in areas like services and rising labor costs. Hopefully, this soft landing scenario still comes to fruition as things slow down – just not "too slow."

- Revisit your target asset allocations. Have your equity allocations drifted upwards while fixed income exposure has slipped? For most investors bonds are meant to be a diversifier aimed towards achieving a better risk-adjusted return in a portfolio. For a long time, as interest rates trended lower bond yields were not high enough to be enticing for many investors. But looking ahead, in an uncertain future, current bond yields may be comparably attractive.

- It may be prudent to consider owning some longer term debt. Long term bonds have underperformed this year as the anticipated decline in interest rates and yields has been pushed into the future. In fact, yields continued their move higher in 2023. Longer term bonds have more price volatility to changing rates than shorter term bonds and could benefit when rates fall.

If you've made it this far - thank you. As investors we tend to project the present and future to be like the past. Our current environment offers both pitfalls and opportunities - which we may not yet see. My point is that bonds – while admittedly boring – are more attractive on a relative basis than they've been for a long while.



Many investors point to the recent year-over-year increase in consumer debt, particularly credit card related debt, as a signal consumer spending may soon start to wane. We don't think so. Relative to the high debt levels seen in 2008 consumers still appear to be in good shape.

We would be delighted to meet with you to share comments about this article, or to review your portfolio in detail.

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