On The Mark

February 2025

Two ‘I’s on Bonds

Key Takeaways

- Investing in bonds during higher inflation regimes and interest rate volatility can be a double-edged sword, and positioning needs to consider investors’ appetite for risk and investment horizon.
- While volatility in interest rates can lead to significant price fluctuations, today’s higher interest rates provide a cushion for returns.
- In higher inflation regimes, don’t just rely on bonds for diversification.

Bonds had a second tough year in 2024, with stickier inflation and continued fluctuations in interest rates. U.S. bonds eeked out a positive return while international bonds fell, hurt not only by rate volatility but also dollar moves. Should bonds still be part of a portfolio, given interest rate volatility and higher inflation risk?

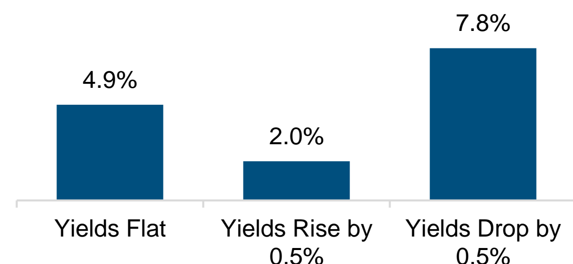
Interest Rate Volatility

Bonds are sensitive to changes in interest rates. When rates rise, the price of existing bonds falls, particularly for long-duration bonds. Conversely, when rates fall, bond prices generally rise.

When interest rate volatility is high, bond prices can see significant fluctuations, with long-term bonds and lower coupon bonds generally seeing the most change. 2023 was a great example of this, as we started from very low coupon levels and saw rates rise dramatically higher, leading to negative bond returns. In 2024, we saw bond returns move into negative territory at points during the year as interest rates bounced up and down.

As we enter 2025, a key differential to 2023 is that rates are now at a much higher level. This helps counter some of the price movement and potentially limits any negative returns. If rates do rise by 0.5%, there is sufficient cushion in yields so that bond returns do not have the same experience as in 2023, as seen in the chart below.

2025 Bond Return Scenarios: Bloomberg Aggregate



Source: Bloomberg

Current interest rates make bonds an attractive part of a portfolio, and using active managers who can dynamically adjust portfolios can be helpful in navigating the interest rate volatility.

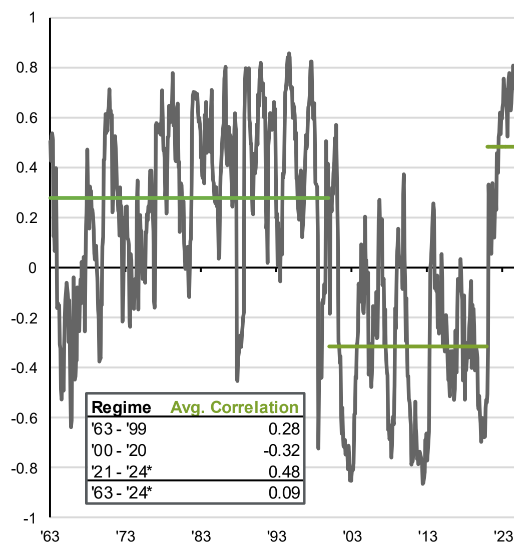
Inflation Risk

When considering inflation risk and bonds, investors typically focus on the purchasing power of the bond’s future cash flows. Will future cash flows be able to pay for the same amount of goods as today, or will inflation mean you can’t buy as much and the purchasing power is eroded?

However, there is a second concern around inflation risk, which relates to how bonds move relative to equities during periods of higher inflation.

Bonds are known for their diversification benefits and are generally thought to zig when equities zag. But in high-inflation regimes, we've actually seen bonds have a positive correlation with equities, as seen below, meaning they are not zigging but instead zagging with equities.

Rolling 12-month correlations
S&P 500 and US 10-year Treasury



Source: JPMorgan Asset Management, "Guide to Alternatives 4Q 2024," November 30, 2024.

In these higher inflation regimes, portfolios may need some additional ballast to help manage risk. Strategies, like alternatives, that are not correlated to the equity markets can be a good complement to bonds during periods of higher inflation risk.

Risk Management

Bonds are considered the ballast in portfolios and are still a sound option in a diversified portfolio, especially with the yields that are offered today. But, given the potential for higher inflation risk and interest rate volatility, investors need to consider positioning relative to their risk tolerance and time horizons

For investors with lower risk appetite and shorter time horizons, lean into bond portfolios with shorter maturities (less than 3 years) that are not as impacted by interest rate volatility. For investors with higher risk tolerance and longer time horizons, lean into bond portfolios with intermediate maturities (around 6-7 years) and benefit from higher yields and potential price movement down the road as and when rates fall.

In both cases, consider the inclusion of active bond management and alternatives to help navigate the choppy waters.

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