Financially Speaking

Stock Prices have been volatile but Bond Prices may be the real story

"The stock market is a device to transfer money from the impatient to the patient."
Warren Buffett

So far 2022 has certainly tried the patience of investors.

While both the stock and bond markets rallied significantly at the start of the third quarter, those gains were given back during September, resulting in another down quarter for both. For the quarter the global stock market, as measured by the MSCI World Index, dipped by 6.19%, bringing its total decline to 25.42% for the year.

While the volatility in the stock market is unpleasant, it is certainly not unprecedented or even all that unusual. In fact, stock prices have historically experienced drops of more than 20% once every few years. Despite that, the average annual return for the S&P 500 index is over 10% going back to the original structure of the index in 1928. Stock prices may fluctuate, but over the long-term patient investors have often been well rewarded for owning them.

What is less talked about, but I would argue is the bigger news this year, is what has occurred in the bond market.

Bond values have an inverse relationship with interest rates because if interest rates go up – meaning that newly issued bonds pay a higher rate than the bonds that were issued in the past – the value of the "old" bonds decline. If you think about it that makes sense as you wouldn't pay the same price for a bond that is going to pay you interest of 2% a year as you would pay for a bond that is going to pay you 5% a year.

Interest rates have gone up and down over the years but typically those changes are gradual and anticipated, meaning that the bond market has time to adjust and bond values don't fluctuate much. This year has been different.

The combined impacts of the Covid pandemic and the response to it, along with Russia's invasion of Ukraine, have contributed to more persistent inflation than most economists expected. When the Federal Reserve realized that at the beginning of the year they began to raise interest rates and signaled that they would continue to do so. The bond market quickly priced in an anticipation that the Federal Reserve's interest rate target would jump from 0% to almost 4% (and now slightly more than that). The result was that bond values, as measured by the Bloomberg US Aggregate Bond index, fell by over 12% in a short amount of time. While bond prices have stabilized a lot since then, they have still crept a bit lower, ending September down 14.61% for the year.

The performance of the bond market has a big impact on many investment portfolios, especially when bonds fall at the same time as stocks. Remember that stock market corrections are fairly common but often during past declines bond values have either held steady or even increased a bit, providing some cushion to portfolio values. Let's look at a simple hypothetical to see how this year is different.

Let's assume we are looking at a fairly common retirement portfolio, invested 60% in stocks and 40% in bonds. To make it simple, we'll use the two indexes I mentioned earlier as a proxy for each and I'll round the assumed performance to whole numbers.

Hypothetical Historical Period

	Performance		% of Portfolio		Contribution. to Return
MSCI World Index	-25%	x	.60	=	-15%
Bloomberg US Aggregate Bond	0%	x	.40	=	0%
	Total Hypothetical Portfolio Return				*-15%*

2022 Hypothetical Comparison

	Performance		% of Portfolio		Contribution to Return
MSCI World Index	-25%	x	.60	=	-15%
Bloomberg US Aggregate Bond	-15%	x	.40	=	-6%
	Total Hypothetical Portfolio Return				*-21%*

While your investment portfolio most likely doesn't look exactly like this, the point is that even though bonds have dipped less than stocks this year they have generally contributed to overall declines, rather than providing the kind of buffer they have in the past.

Just because bond prices have declined this year doesn't mean that people shouldn't own them if they fit their personal investment plan. While we don't know for sure how much the Federal Reserve will raise interest rates, we do know that the bond market appears to have already accounted for the increases that are projected. The result is that bond prices have become more stable than they were to start the year and, at the same time, they are generally paying a much higher interest rate now than they have for over a decade.

As always, it is important for investors to evaluate what makes sense for them personally to own and to have a comprehensive investment strategy. Once a strategy is in place though history has shown that it is important to stay patient about sticking to it.

Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged, and investors cannot invest directly into an index. Diversification does not ensure against market risk.

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