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What impact will lower yields have on my bond portfolio?

Falling yields have been a strong tailwind to bond performance this year, but investors should temper their expectations for future returns.

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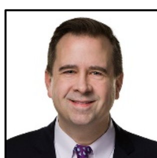

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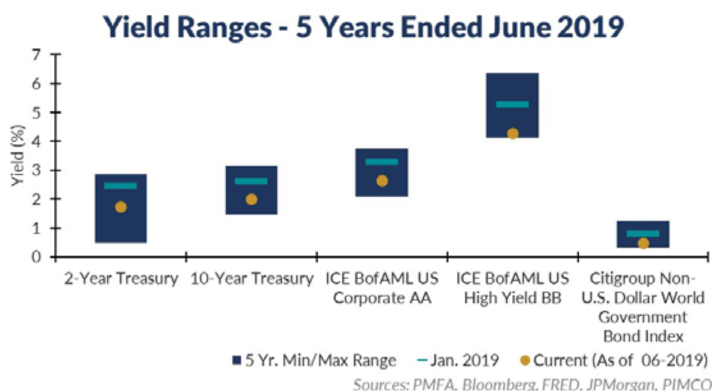

Since the start of 2019, yields have fallen meaningfully across the board, but particularly for long-term bonds. While the decrease in yields was favorable for fixed income returns this year, the contribution is likely to be less pronounced going forward.

The two- and 10-Year U.S. Treasury yields have fallen nearly 70 basis points (0.7%) since the beginning of the year. Falling yields can have a noticeable impact on bond returns in two ways. First, since long-term fixed income returns are largely driven by coupon payments, lower yields result in lower income in the future. Secondly, as seen in the chart above, current yields are closing in on the bottom of their recent ranges for a variety of issues. While rates could fall further, it's unlikely that bond performance over the rest of the year will be able to match the solid returns since January (nearly 8% for the Bloomberg Barclays Aggregate through August 9).

Bonds have had a strong run this year, and should continue to provide the same primary benefits that investors have come to expect, providing a source of income and a strong source of diversification and risk mitigation for an equity portfolio. A further decline in interest rates would also boost their returns, but investors should understand how unusually strong the first half of the year was for bonds. We will address that next.

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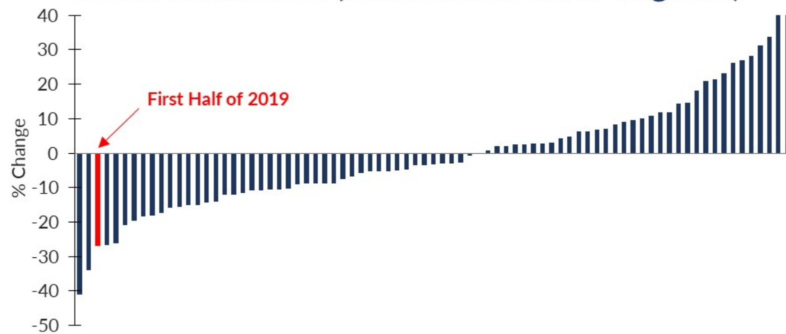
How has the recent drop in yields compared to other periods?

Both U.S. equities and fixed income markets have provided strong year-to-date returns. Such recent market conditions are not typical.

Semiannual Percentage Change in 10-Year Treasury Yields Since 1980 (Ranked Lowest to Highest)



Sources: PMFA, FRED

As discussed in our accompanying piece, global bond yields have dropped significantly since the beginning of the year. Of particular note, the bellwether 10-year U.S. Treasury yield fell from 2.83% at the end of 2018 to 2.07% halfway through 2019 — a sizable 27% reduction in the yield! This significant drop provided a boost to fixed income returns, with the U.S. Aggregate Index returning more than 6% from January 1 through June 30.

The chart above ranks the semiannual percentage change in 10-year Treasury yields since 1980 from lowest to highest. The percentage decline in yields over the first half of this year is the third largest over the period measured, though it's exaggerated given the low-rate environment, particularly compared to the lofty rates of the early 1980s.

Still, what makes this occurrence more unusual is that the outstanding return from bonds occurred alongside very strong equity market returns. Yields fell sharply on concerns about the slowing global economy, while equities were recovering from the correction that occurred late last year. The result was that both bonds and stocks registered returns in the first half of 2019 that were well above their long-term averages.

Could it continue? It's certainly possible. But the strong returns for both bonds and stocks in the first half of the year were unusual. At some point, investors should expect a return to a more normalized relationship between the fixed income and

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