Fixed income
Investment insight
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The case for redeploying cash into bonds

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Key takeaways

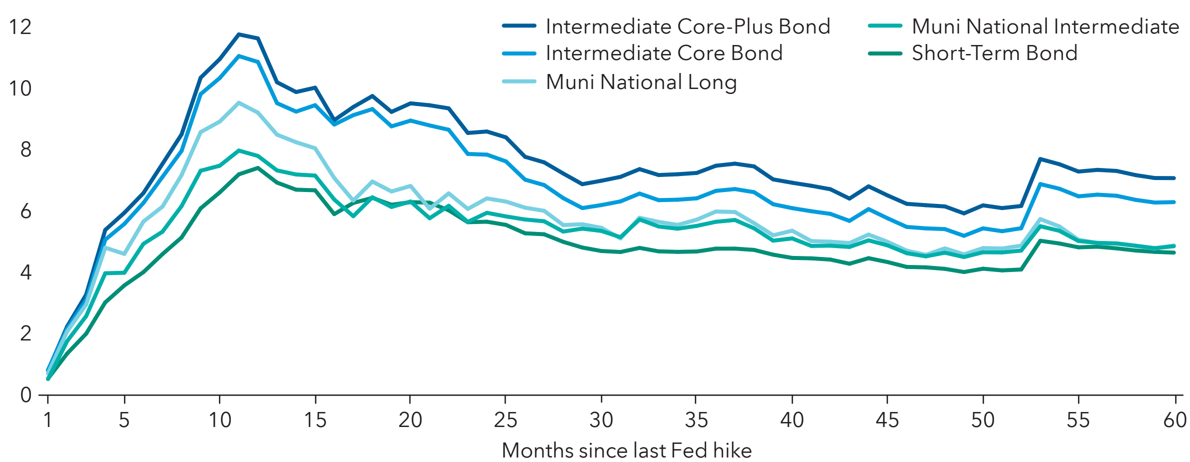
- Bonds have historically benefited as the Federal Reserve ended its hiking cycle, with the best returns coming in the months leading up to and immediately following the last Fed hike.
- Investors who waited for the Fed to cut missed a good portion of results.
- Investors should consider redeploying cash into bonds as the Fed shifts to a normalized rate environment.

Bonds have benefited as Fed neared the end of rate hikes

Investors who wait may miss out on an opportunity to benefit as the Fed's rate-raising cycle ends. Historically, the most profound benefit occurred in the months leading up to and immediately after the last Fed hike of the cycle. These opportunities tended to coincide with the end of an economic cycle, when slowing growth and possible recession lead central banks to loosen monetary policy.

Maximum bond sector returns have been front-loaded as the last four Fed cycles transitioned

Return (%)



	Maximum return after the last Fed hike of the cycle (%)	Portion of maximum return delivered in months after the last Fed hike (%)											
		Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12
Intermediate Core-Plus Bond	11.76	6.82	19.01	27.86	45.80	50.55	56.01	64.13	72.28	88.00	93.15	100.00	98.89
Intermediate Core Bond	11.05	7.45	19.55	28.11	45.85	50.49	56.68	64.37	72.03	88.79	93.53	100.00	98.27
Muni National Long	9.53	7.44	21.79	31.02	50.45	48.32	59.36	64.49	75.26	89.98	93.57	100.00	96.63
Muni National Intermediate	7.97	6.57	22.05	32.31	49.83	50.05	61.86	66.84	77.30	91.76	93.81	100.00	97.81
Short-Term Bond	7.41	7.27	18.27	27.05	40.84	48.29	54.14	62.08	69.40	82.21	89.24	97.18	100.00

Source: Capital Group, Morningstar. Chart represents the average returns across fixed income sectors in a forward extending window starting in the month of the last Fed hike in the last four transition cycles from 1995 to 2018 with data through 3/31/2023. Results less than one year are cumulative and annualized after one year. Table values shown indicate the percentage of the maximum returns achieved in each month after the last Fed hike.

Waiting may mean disappointment

In the previous four transitions from the last Fed rate hike to a rate cut, bond sectors including: core, core-plus, short-term and munis posted positive returns. In the first year after the last Fed hike, returns ranged from 4% to 12% on average. These bond sectors continued to gain as the Fed lowered rates.

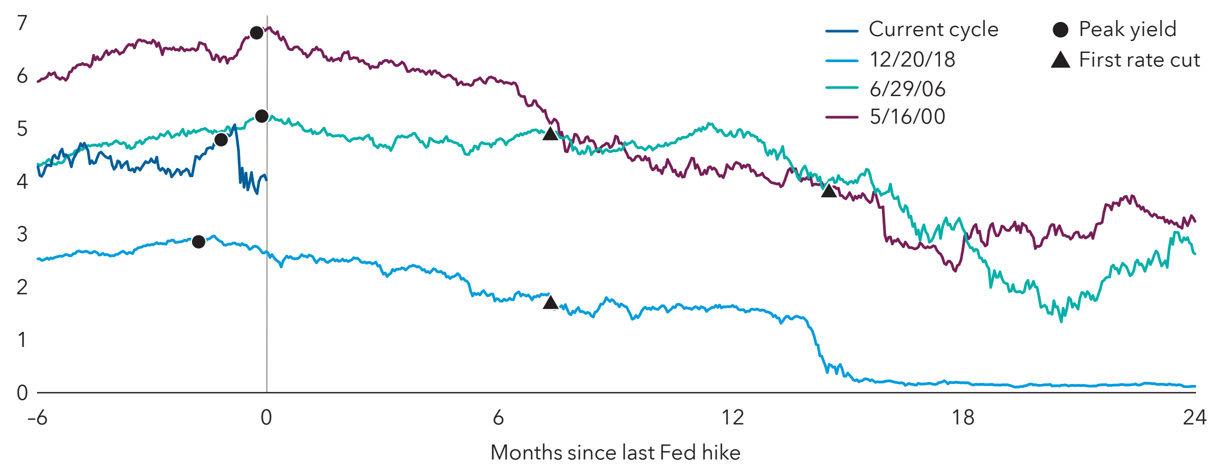
The average time between the last Fed hike and first rate cut has been nine months in the prior four hiking cycles. Given this, investors waiting for the Fed's first rate cut may be missing a chance to benefit from a potential initial upswing.

Yields have peaked slightly before the last Fed hike

The past four Fed hiking cycles also show yields often peaked prior to the last Fed hike of the cycle. The chart below shows the yield on the 2-year U.S. Treasury peaked on average a month before the final hike. This suggests that trying to time the last Fed hike as an entry point may have limited benefit as yields may have already begun to fall at that point and price gains have happened.

Yields peaked prior to the final Fed cycle hikes and declined before cuts began

Two-year Treasury yield (%)



Sources: Capital Group, Bloomberg. As of 3/31/23.

Bottom line: Consider allocating to bonds over cash

As the Fed considers a normalized rate environment, it will be important for investors to think about returning to a more balanced, long-term asset allocation. We believe that trying to time interest rates is difficult and that the Fed is near the end of its hiking cycle. Investors should determine if they might be better served by allocating to bond funds now rather than holding onto cash.

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