# What Happened to Bond Prices—And What Lies Ahead?

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If you're a fixed income investor, there's bad news—and good news. The bad news: so far this year, rising interest rates have caused bond prices to fall and led to declines for most fixed income investors. You may be wondering what caused this decline and what may be expected for the future (spoiler alert: there's good news on the horizon).

**The Domino Effect of Inflation**

At the beginning of the year, a rise in interest rates was the main reason for falling bond prices. This market environment was largely the result of growing investor expectations for Federal Reserve (Fed) rate hikes in 2022 and 2023 to combat high levels of economic inflation. The Fed spent much of the first quarter convincing investors of its commitment to taking inflation seriously and implementing a faster cycle of rate increases than we've seen in the past. The markets listened and adjusted rates accordingly.

In January, the markets were projecting a total of three interest rate hikes of 25 basis points (or 0.25 percent) each. Since then, we've seen expectations for additional hikes get quickly priced into markets, as high inflation and a strong labor market caused the Fed to tighten policy faster than expected.

As of April 14, 2022, markets have priced in a total of nine hikes in 2022. This would bring the federal funds rate up from virtually 0 at the start of the year to nearly 2.5 percent at year-end. Looking ahead, the Fed expects to see the federal funds rate peak at 2.75 percent in 2023, before falling back toward the central bank's longer-term target of roughly 2.5 percent in 2024 and beyond.

At this point, markets are pricing in expected Fed hikes for the rest of the year. From here, it's unlikely that we'll see rates increase significantly in response to the Fed's tightening plans.

**Diversification Is Key**

While rates rose across the board in the first quarter of 2022, fixed income returns were mixed across sectors, with longer maturity bonds seeing larger selloffs. As a reminder, longer maturity bonds typically have higher interest rate risk than shorter maturity bonds, which can cause them to suffer from larger price drops in a rising rate environment. Ultimately, the price declines for most intermediate- and long-term bonds this year are a powerful reminder that diversification remains essential when putting together fixed income allocations.

For example, long Treasury bonds are down by more than 17 percent year-to-date, while short Treasury securities have held up much better. The Bloomberg Short-Term Treasury Index is down by less than 1 percent so far in 2022. The Bloomberg U.S. Aggregate Bond Index, which is an intermediate-term index of investment-grade bonds, is down roughly 8.5 percent. Most intermediate sectors have experienced similar declines to that of the Bloomberg U.S. Aggregate Bond Index this year.

Other areas that held up relatively well include short-term corporate bonds and the bank loan sector, both of which are down by less than 1 percent year-to-date. These sectors have lower duration than typical intermediate- to long-term bond sectors, which mostly explains their better relative performance.

**The Good News About Rising Rates**

Here's the good news for fixed income investors. Historically, the majority of total return for fixed income comes from the income return you receive when you reinvest coupon (or interest) payments. Price return, on the other hand, has only accounted for a small portion of total return over the intermediate to long term. It's the price return that has caused the underperformance.

Given the importance of reinvesting income for total return, rising rates can lead to higher total return expectations for bonds over the intermediate to long term since that income can be reinvested at higher rates. With higher rates for reinvestment and much of the Fed's anticipated hikes already priced into markets, most fixed income sectors should be expected to show improvement throughout the rest of 2022.

The potential for short-term volatility still exists, however. If inflation remains stubbornly high, it could lead to more aggressive Fed action than currently expected. Markets could also react negatively once the Fed gives more details on the expected path and pace of its balance sheet reductions set for later in the year.

**A Reason for Optimism**

Even with these risks, the outlook for fixed income going forward remains more positive than it has been so far. That's not to say the recent price declines in intermediate- and long-term sectors will reverse immediately. But, with less price pressure from rising rates and the ability for reinvestment at higher rates during the year, improvements are possible by year-end.

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