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CIO continues to favor quality bonds in their global portfolios, and recommend investors manage their liquidity, limit cash balances, and lock in yields. (UBS)

Bonds should remain a core portfolio holding

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The minutes for the Federal Open Market Committee's (FOMC) January meeting will be released today, with investors looking to find further clues on where policymakers stand on their rate-cut timeline. Held on 30–31 January, the meeting came before the stronger-than-expected inflation prints last week that have significantly shifted market views on Fed cuts this year.

While the minutes may not fully reflect the central bank's latest thinking, we continue to believe the Fed is ready to move this year. This macro backdrop underpins our favorable view on quality bonds in investment portfolios.

Cuts are on the way, albeit on a potentially smaller scale than previously expected. Since the meeting in January, Federal Reserve Chair Jerome Powell and other officials have pushed back against market expectations of an immediate cut. But what's more important is that the Fed is now biased toward rate cuts, in our view, and that markets believe the central bank will step in if growth data weaken sufficiently. Last week, after the January consumer price index release caught markets off guard, Chicago Fed President Austan Goolsbee said slightly higher inflation data for a few months would still be consistent with a path back to the Fed's 2% target, and that it's important not to judge the inflation trend from one month's number. We now expect 75 basis points of rate cuts this year, likely starting in June.

Yields are expected to fall. With rate cuts still on the table, we expect the 10-year US Treasury yield to fall to 3.5% by December in our base case, from just below 4.3% today. A tapering of the Fed's bond-selling program (quantitative tightening) should also reduce the upward pressure on real rates, driving the next leg lower in yields. We think the current risk-reward proposition for quality bonds is attractive, and we see the potential for capital appreciation as inflation and growth slow.

Quality bonds offer diversification benefits, with better returns than cash over the long term. Bonds have historically offered diversification benefits in a portfolio context. Based on data going back to 1999, a 60/40 portfolio of stocks and bonds would have experienced only about half of the drawdown in the S&P 500 index. Separately, US government bonds have outperformed cash in 83% of five-year periods since 1925. If we look at all five-year periods since January 1977, US government bonds have outperformed about 90% of the time. With rate cuts on the horizon, we believe the reinvestment risk of holding too much cash has become apparent.

So, we continue to favor quality bonds in our global portfolios, and recommend investors manage their liquidity, limit cash balances, and lock in yields.

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