CIO thinks bond ladders and structured investment strategies with capital preservation features can help investors manage liquidity. (UBS)

Bonds offer benefits of diversification, outperform cash over the long term

30 July 2024, 4:37 pm CEST, written by UBS Editorial Team

Bond yields have continued to decline, particularly in the front of the curve as market expectations of a Federal Reserve cut in September build. Over the past week, the yield on the two-year US Treasury fell around 12 basis points, while the 10-year US Treasury dropped 4 basis points.

A larger fall in the front end of the yield curve ahead of a potentially imminent policy rate cut is expected, as the curve gradually normalizes and steepens with monetary policy entering an easing cycle. However, the recent movement in longer-term rates has also been affected by volatility in the term premium—the compensation that risk-averse investors require to hold a long-term bond rather than rolling over a series of short-term bonds.

We acknowledge the risk to our view that expects the 10-year US Treasury yield to fall to 3.5% by mid-2025, given the term-premium volatility amid US election uncertainty and the fragile fiscal position of the US government. Pandemic-related fiscal stimulus has increased US government debt to over 120% of GDP from an average level of a little over 100%between 2010 and 2019, and an elevated interest rate environment has nearly doubled debt service costs. Estimates for the US fiscal deficit have continued to be revised up. If markets started to price in the fiscal trajectory more aggressively, term premiums would likely widen, as unsustainable fiscal dynamics should eventually lead investors to demand greater compensation for holding more duration risk, thus exerting upward pressure on the 10-year yield. In addition, uncertainty about the impact of a second Trump administration on inflation and growth could also add to term-premium volatility.

However, we do not have strong conviction that term premiums will continue to widen in the run up to the US presidential election, and believe that macroeconomic fundamentals will remain the main driver over the next six to 12 months. With falling inflation, moderating growth, and the Fed's likely pivot, we continue to expect interest rates across the entire term structure to fall, benefiting quality bonds.

- **Bonds offer benefits of diversification, outperform cash over the long term**. High-quality bonds are among the safest investments we recommend for an investor's portfolio, as they can help preserve capital, reduce equity volatility, and stabilize portfolios. We also note the rising probability of bonds outperforming cash with longer holding periods—from 65% over 12 months to 82%, 85%, and 90% over five, 10, and 20 years, respectively.

So, we continue to forecast and position for lower rates. This means deploying excess cash into high-quality corporate and government bonds, particularly in the front to middle part of the curve. We also think bond ladders and structured investment strategies with capital preservation features can help investors manage liquidity.

For more details on term premium volatility, read our latest interest rates strategy report **here**.

Main contributors - Solita Marcelli, Mark Haefele, Daisy Tseng, Frederick Mellors, Vincent Heaney

Original report - **Prepare for lower rates despite term premium volatility, 30 July 2024.**