



2022: MAKING HISTORY

(in all the wrong ways)

After a fantastic 2021, the stock market has had a very rocky start to 2022. At the end of the first half, the S&P 500 had registered its third worst start to a calendar year and the worst in 60 years! What has made investing in 2022 even more difficult is the inverse correlation between stock and bond prices (i.e., when stock prices go up, bond prices go down and vice versa) has broken down.

S&P 500	YTD Total Return (price & income) through 6/30	Bloomberg U.S. Aggregate Bond Index	YTD Total Return (price & income) through 6/30
1932	-45.4%	2022	-10.3%
1962	-22.2%	1994	-3.9%
2022	-20.0%	2013	-2.4%
1970	-19.5%	1984	-1.7%
1940	-17.4%	2018	-1.6%
1939	-15.1%	2021	-1.6%
2002	-13.2%	1999	-1.4%
2008	-11.9%	1996	-1.2%
1973	-10.4%	2006	-0.7%
1974	-10.2%	1987	-0.2%

Source: Bloomberg, FBT Research

Bonds, as measured by the Bloomberg U.S. Aggregate Bond Index, are off to their worst start in the history of the index (going back to 1976)!

STOCK & BOND CORRELATIONS

While certainly unusual, this sort of environment of correlation among stocks and bonds is not without precedent. In fact, there have been periods of higher correlation than what we have seen over the past six- and twelve-month time frames. However, those periods have often seen positive returns for both assets. When returns are negative for both stocks and bonds over a given timeframe, the pundits come out to proclaim the death of diversification or, as we have seen in a few headlines this year, the death of the “60/40” portfolio (60% stock, 40% bond allocation).

We believe this is nonsense. If history is any guide, these moments of both high correlation and negative returns do not last forever. For example, stock and bond monthly returns were highly correlated in 1977, 1981, 1994, and 2018 with disappointing returns for a diversified portfolio of stocks and bonds (negative for a 60/40 portfolio). The returns for both asset classes were positive the following years, including double digit returns for both stocks and bonds in 1982 and 1995. It is worth noting that these are not the only negative years for the 60/40 portfolio due to the inherent volatility of stocks. But, in other negative years for the 60/40 portfolio, in which stocks experienced steep declines and dragged the total portfolio return into the red, bonds countered with strong positive returns: over 5% in each case. This cushion allows investors to sell bonds at a gain and either rebalance into stocks at lower prices or withdraw for cash needs and allow the stock portion of the portfolio to recover.

We focus on the 60/40 portfolio's returns due to its popularity as an allocation. However, each client is different and will require a different allocation, especially those with particular income goals or extended time horizons. Nevertheless, we believe analyzing the 60/40 portfolio still shows the power of diversification even if one needs to be more or less aggressively allocated. Whether it is the history of strong returns following high correlations or the strength of bonds in periods of intense stock market weakness, we believe both stocks and bonds have a place in portfolios and that diversification will provide lower portfolio volatility.

Year	S&P 500 Total Return	Bloomberg U.S. Agg Bond Index Total Return	60/40 Hypothetical Portfolio
1977	-7.2%	3.0%	-3.1%
1978	6.6%	1.4%	4.5%
1981	-4.9%	6.2%	-0.5%
1982	21.5%	32.6%	26.0%
1994	1.3%	-2.9%	-0.4%
1995	37.6%	18.5%	29.9%
2018	-4.4%	0.0%	-2.6%
2019	31.5%	8.7%	22.4%
<i>Italics above show the bounce back after a period of correlation; below, bonds perform well when the stock market suffers more intense declines</i>			
2000	-9.1%	11.6%	-0.8%
2001	-11.9%	8.4%	-3.8%
2002	-22.1%	10.3%	-9.2%
2008	-37.0%	5.2%	-20.1%

Source: Bloomberg, FBT Research

THE IMPORTANCE OF INTEREST RATE RISK

For those needing to withdraw more money than their portfolio can produce in income, this year presents a difficult selling decision: both stocks and bonds have declined and one or the other may have to be sold at or near lows. This is a painful conundrum if your bond portfolio was not constructed appropriately. At First Bankers Trust, we are acutely aware of interest rate risk as it pertains to our client's bond portfolios. We use a similar approach to bonds as we do to stocks: we look to take less risk than the broader market while generating strong income for portfolios. Interestingly, at the time of this writing, the bond market is giving us plenty of opportunities to do just that.

Interest rate risk is a complex topic, but the simplest summary comes down to this: when interest rates rise, bond prices go down and vice versa. Why is that? Well, imagine you owned a bond with a par value (the amount you receive when the bond matures) of \$100 that was paying you 2% per year. Let's say, due to changing market conditions, a new \$100 bond was issued paying 2.5% per year. Now the bond you originally owned is no longer paying a competitive rate, but you need to sell it. The marginal buyer in this case will demand a discount to par value in order to make the total return (income plus price appreciation) equivalent to the newly issued bond. This scenario applies to any bond, but the magnitude of the price loss is driven primarily by how far away the bond maturity is. If both hypothetical bonds matured in one year, then the original bond would only have to decline 0.5% in price to make the returns equal. If, however, both bonds matured in 10 years, then the original bond would have to decline almost ~5% to make up for the 0.5% difference in coupons paid each year. Since that 0.5% is missing from the original bond every year, the price must decline further in order to compensate for many lower interest payments. This, while being a simplistic demonstration of only one facet of interest rate risk, is a key driver.



If longer-term bonds carry more interest rate risk (not to mention greater uncertainty for what can happen over a longer time period), then long-term interest rates should be higher, correct? That is normally the case. However, for a myriad of reasons (mostly related to market expectations about where future interest rates will be), the yield curve can flatten and a bond that matures in two years could have the same interest rate as one that matures in ten years. We are currently in that market environment, which has helped us gain similar income streams for clients with much lower interest rate risk. With the market presenting us this opportunity, we have been happy to deliver increasing income with lower volatility within the bond side of client portfolios as well.

Sincerely,

Your First Bankers Trust Team