How Bond Rallies Help Investors Amid Market Pullbacks

After weeks of reaching one new record high after another, the U.S. stock market has begun to pull back. Investors are reacting to headlines on the spread of the novel coronavirus around the globe, now officially known as COVID-19, as well as recent mixed economic data. After a relatively calm year for the markets in 2019, it's important for investors to maintain perspective and stay disciplined.

This is because gauging the potential economic and market impacts is difficult, a fact that adds to market uncertainty. For investors and economists, the past is still the most useful guide to the future. The fact that COVID-19 is unique and has spread quickly makes it difficult to compare to past episodes.

However, even if we can't directly compare COVID-19 to previous SARS or Ebola outbreaks, we can compare this market decline to previous ones. At the moment, the U.S. stock market has only pulled back about 1.4% from recent peaks. The stock market has made many new record highs this year and has returned 3.6% with dividends. Stock market futures do suggest that this pullback may worsen as coronavirus spreads. However, it is not unusual for much worse market declines to occur each and every year before the underlying situation stabilizes. And whether it takes weeks or months, markets eventually tend to recover.

Over the past week, however, the more important market reaction may be in interest rates. The 10-year Treasury yield is now under 1.4%, plunging below its 2019 low of 1.45%. In fact, this is one of the lowest levels for long-term Treasury yields since before the 2016 presidential election. At this point, the 10-year rate has not been above 2% since summer 2019 and has not been above 3% since 2018.

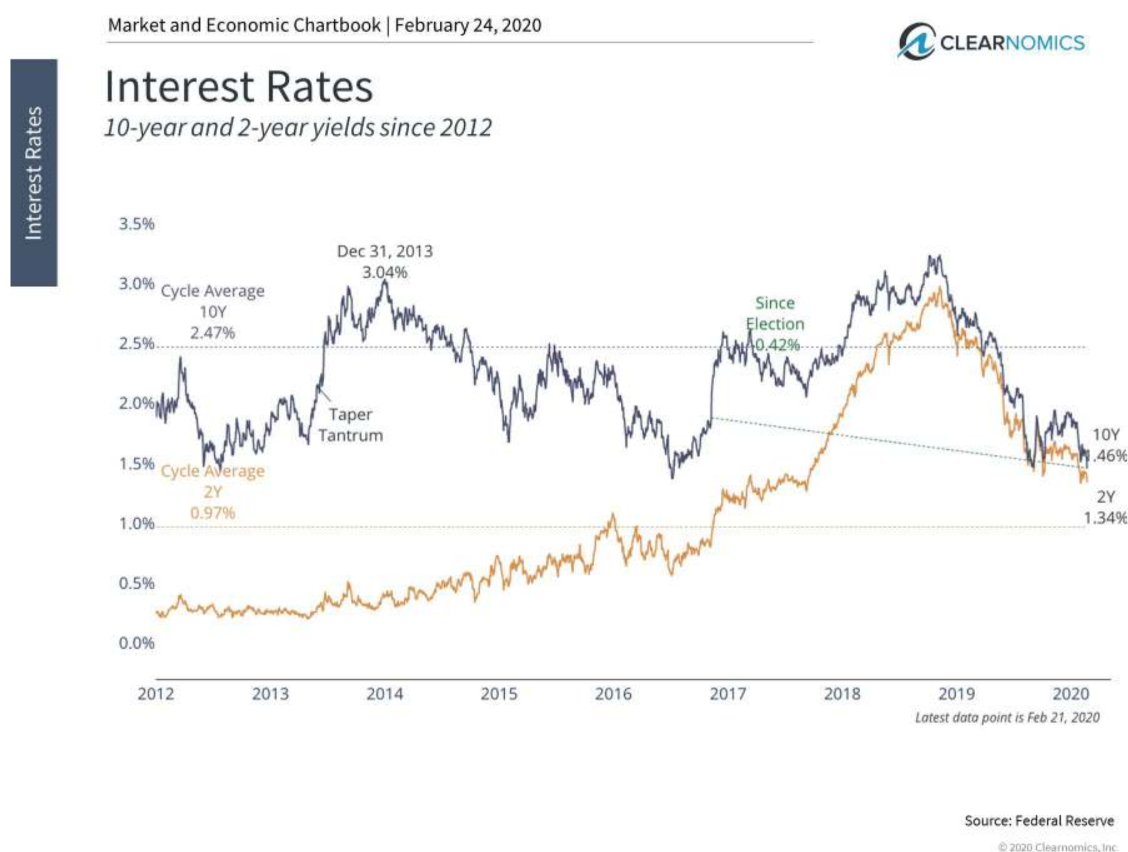
A central reason for such low interest rates is that the Fed has kept its policy rates low. As coronavirus fears grow, expectations that the Fed will step in to support the economy and the market has also increased. This is referred to as the "Fed put" since it is akin to a put option contract that protects investors from downside risk. Whether or not investors *should* expect this or not, fed funds rates currently expect a rate cut in the second half of 2020.

Fortunately, low interest rates at the start of 2020 are less about the possibility of an economic recession. In fact, the other side the coin when bond yields fall is that bond prices rise. Thus, bonds can help investors who have diversified portfolios weather this period of volatility, no matter how long it lasts.

It's important for investors to not get caught up in day-to-day headlines or market reactions. Instead, investors should focus on staying invested and diversified. Those who are worried about market pullbacks should focus their attention on maintaining an appropriate bond allocation. Below are three charts that put these trends in perspective:

1. Interest rates have fallen and bonds have rallied

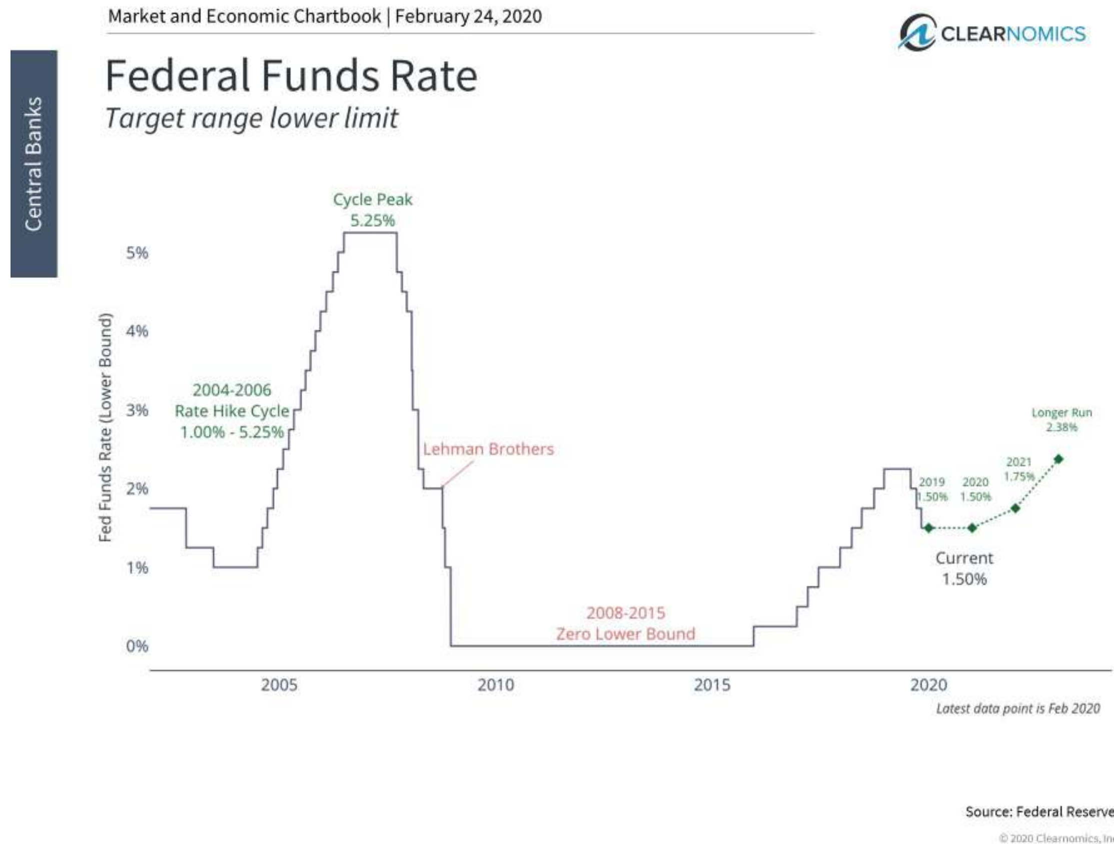
Interest Rates
Find this chart under "Interest Rates"



Interest rates have fallen due to recent global headlines. They are now below their lowest level in 2019, and about as low as before the 2016 presidential election. The flip side of lower interest rates is that rising bond prices help diversified portfolios by offsetting stock market volatility.

2. The Fed is one reason interest rates could remain lower

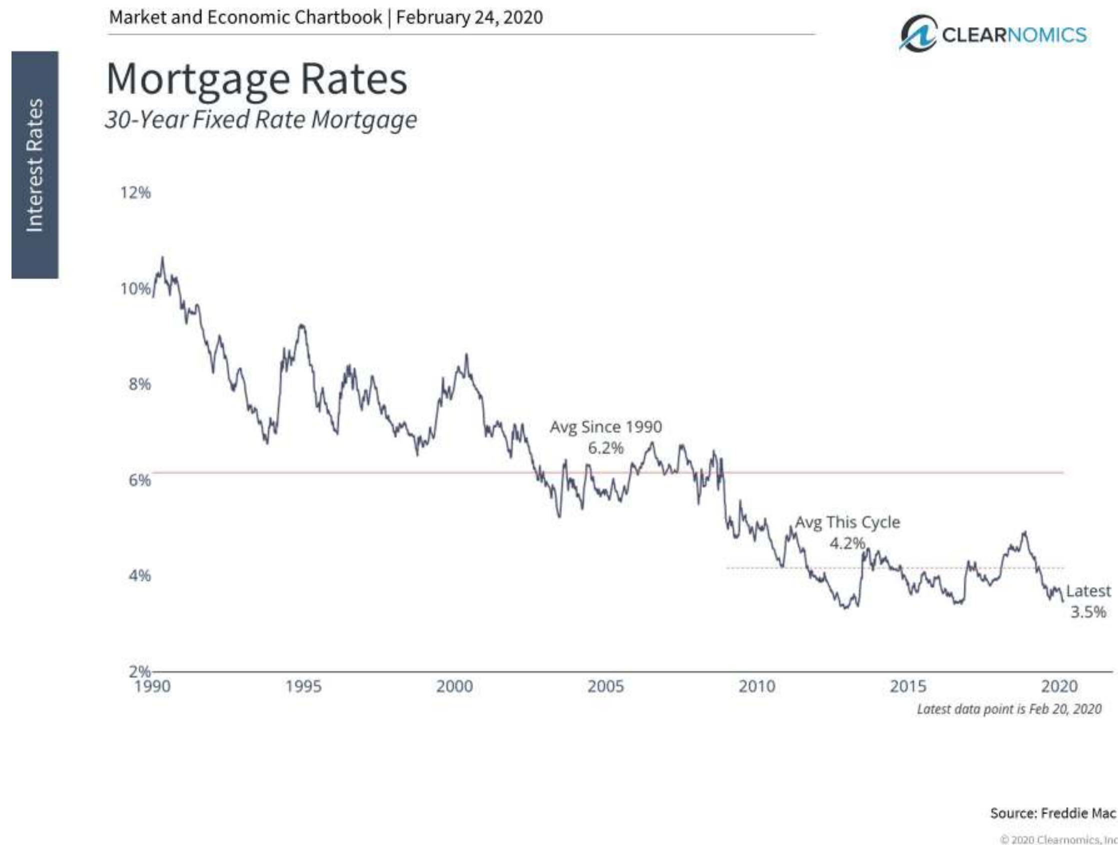
Fed Funds Rate
Find this chart under "Global Central Banks"



The Fed is one reason that interest rates have remained low. In fact, the probability of a Fed rate cut in 2020, based on fed funds futures, is rising. The market is expecting at least one rate cut in the second half of the year.

3. One positive outcome is that mortgage rates could remain lower as well

Mortgage Rates
Find this chart under "Interest Rates"



Lower interest rates still help some parts of the economy. The 30-year fixed mortgage rate is still extremely low. So, while the spread of coronavirus and other scary headlines may hurt investment portfolios and portfolio income in the short run, low interest rates could boost investor returns in other areas.

The bottom line? Investors should stay disciplined and diversified as the market continues to be choppy. Holding an appropriate allocation of bonds in a portfolio can help to offset some of the volatility investors may experience from stocks.