Advisors Say Buy Bonds Before Rate Cuts

Tuesday, February 20, 2024

Clipped from: https://www.fa-mag.com/news/advisors-say-buy-bonds-before-rate-cuts-77006.html

In early February, Federal Reserve chair Jerome Powell confirmed that interest rates would be cut once inflation cooled sufficiently. Advisors reacted promptly. But with both the Consumer Price Index and Producer Price Index surprising markets to the upside last week, the question of what to do—and which bonds to buy— in light of the uncertain timing of rate cuts remains a dilemma.

“Investors should start looking to lock in at least five years [worth of interest-sensitive securities],” said Scott Barcomb of Barcomb Asset Management, part of Berthel Fisher, in Sarasota, Fla. Some yields had already dropped from their highs a few months ago, he said, but it wasn’t too late take advantage of current rates.

“It makes sense to lock in today’s interest rates,” agreed Matthew Nest, head of active fixed income at State Street Global Advisors in Boston, citing “high-quality bonds” that yield near 5%, tax-exempt municipal bonds that yield 3.5%, and even riskier high-yield bonds that yield 8% to 10%. “Those are levels we haven’t seen in 20 years,” he said.

Anne Marie Stonich, chief wealth strategist at Coldstream Wealth Management in Seattle, concurred. “We can obtain very attractive yields on relatively safe assets,” she said.

Short-Term Bonds Vs. Long-Term Bonds

Advisors vary, though, on the details.

Chris Gunster, head of fixed income at Fidelis Capital in Greenwich, Conn., said Fed rate cuts will “mostly impact short-maturity bonds.” When those bonds reach maturity, clients who roll their money over into new short-term bonds will likely face a decline in yield. “Locking in higher rates on longer-maturity bonds … avoids this risk,” he said.

Sam Burns, chief strategist at Mill Street Research in Sherborn, Mass., expressed a similar sentiment. “If an investor is only thinking about interest income from bonds held for long periods, then today’s rates are likely to look favorable,” he said.

But others favor shorter-duration instruments, which currently have a higher interest rate than their longer-term counterparts. “Retirement savers should consider snatching up CDs [certificates of deposit] and Treasury bonds now, focusing on short- to mid-term durations,” said Anthony Williams, cofounder of Galene Financial in Houston.

There’s little doubt that today’s short-term Treasurys, CDs, and money market funds “make some clients feel good,” said Nancy Corrigan at Corrigan Financial, part of the Strategic Financial Alliance, in San Francisco. “They are able to lock in returns without having to contend with equity market risk and volatility.”

Or as Daniel Wilson at Ameriprise Private Wealth Advisor in Auburndale, Mass., put it: “It is hard to pass up 5% CD rates.”

The Downside

Yet Roger Young, thought leadership director at T. Rowe Price in Owings Mills, Md., cautions against making portfolio changes based on vague Fed projections. “It’s hard to time markets—even when something is widely expected, like rate cuts,” he said.

To be sure, there are risks associated with locking in rates, even high rates. “Even though rates for CDs and Treasurys are higher than they have been in years, there is still a risk of having too much of one’s net worth in cash or cash alternatives and ultimately lagging inflation,” said Chris Zeches at Zeches Wealth Management in Phoenix.

Despite attractive rates, overreliance on fixed-income securities invariably leads to a lack of diversity, warned Kate Clark, managing partner at Cypress Capital in Tallahassee.

Yet everyone needs some cash or cash equivalents on hand for emergencies, she said. “It’s important to remember that funds meant for emergency reserves should remain liquid, with limited exposure to terms that lock-in or have penalties for accessing your funds early,” she added.

Bond Laddering

To offset the effects of future, unexpected Fed moves and market volatility, some advisors recommend laddering—that is, investing in fixed-income instruments with varying maturities. “It’s a hedge against unpredictable interest-rate changes,” explained Jeff Van Wart at King Capital Advisors in Houston.

“Laddering is a useful strategy,” agreed Rob Williams, Denver-based managing director of financial planning for Charles Schwab. Besides enabling clients to “spread the risk of changing interest rates,” he said, it helps them manage their cash flow and potentially keep other funds invested more aggressively for long-term growth.

But laddering comes at a cost. “The risks of this strategy are that of any bond strategy—the longer you bear out and lock in, the less flexibility you have,” said Michael Nakanishi of Kingswood U.S. in Honolulu.

Some experts prefer bond mutual funds. “In comparison [to laddering], bond

funds generally offer more liquidity," said Chris Tidmore, a senior manager in Vanguard's Investment Advisor Research Center in Valley Forge, Pa. "Furthermore, bond funds offer greater diversification."

Watching Inflation

Of course, the Fed chair isn't the only one who is mindful of inflation. Inflation cuts into real returns, which is why some advisors recommend inflation-indexed bonds, or "I bonds."

"I bonds are an excellent vehicle for investors who want a guaranteed investment with little to no risk," said **Janet Fox, president of ACH Investment Group in Raleigh, N.C.**

Backed by the U.S. Treasury, these bonds have payout rates that include an inflation calculation, refigured every six months based on prevailing economic data. Available online from TreasuryDirect.gov, I bonds are no longer paying as well as they did in late 2022, she said, when their rate was 9.62%. But through April 30, 2024, they are still paying a handsome 5.27%. What's more, she said, no federal taxes are due on the income until the bonds are cashed. They have a 30-year maturity.

But I bonds have several limitations, said Eric Lutton, chief investment officer at Sound Income Strategies in Fort Lauderdale. Their maximum investment is $10,000 a year, you cannot sell the bonds for 12 months (known as "the lock-up period"), and withdrawals made in the first five years are slapped with a penalty equivalent to three months' interest.

"I bonds can make sense if the goal is to earn an interest rate over and above the inflation rate with as little risk as possible," he said. "For those that don't have a financial advisor who specializes in income or fixed-income investing, I bonds can be a good way to protect against increasing inflation."

Relative Risks

Inflation is less worrisome to some. "The Fed has shown its commitment to preventing the elevated inflation numbers we saw over the last two years," said Dustin Wolk of Crescent Grove Advisors in Milwaukee, indicating the likelihood of "better forward returns" ahead, he said.

Still, Aaron Brachman, founding partner at Steward Partners Global Advisory in Washington, D.C., isn't convinced that current interest rates represent the peak. "Most of the major movements in interest rates that matter the most have already happened," he said. They "could actually rise from here."

That *is* a risk, acknowledged Jamie Tomlin, managing director of BT Legacy Wealth Management in St. Petersburg, Fla., part of Stifel Independent Advisors. "But the greater risk," she said, "lies in waiting until the Fed announces the first rate cut, and you miss the opportunity to lock in rates where they stand now."