Why have my investment returns in bonds fallen?

Key takeaways:

- **In general terms, bonds are forms of debt issued by companies and governments when they want to raise money.**
- **The term 'fixed income' or 'interest' is often used instead of the term 'bonds'. This is because bonds are the most well-known type of fixed income security (a 'security' is the name of any tradeable financial asset).**
- **As interest rates change, the value of bonds will fluctuate.**

Considered safe havens in turbulent times, bonds are usually a relatively stable investment that can provide a regular income. And historically, bonds have done just this. Since 1981, the Bloomberg Barclay's U.S. Aggregate index has produced a year with a negative total return only four times.

However, global bond markets have suffered unprecedented losses in 2022. After a 40-year bull market, investors in government bonds and other fixed interest securities are now experiencing their first bear market and the biggest losses in the bond market since the 1970s. So, why has this happened?

Bond markets fall

Bond markets have borne the brunt of central bankers being wrongfooted by spiking inflationary pressures – largely caused by historically-tight labour markets, rising commodity prices due to the war in Ukraine, and Covid lockdowns in China, which have further disrupted global supply chains.

The Reserve Bank of Australia, as well as the central banks of the United States, New Zealand and Canada, to name a few, have started to increase their official interest rates to address these high levels of inflation. And, as interest rates around the world have risen, bond prices have fallen.

But why are bond prices affected by rising interest rates?

A fundamental principle of fixed income is that interest rates and bond prices generally move in opposite directions. So, when interest rates rise, the price of bonds fall.

This means that when interest rates go up, bond prices go down and when interest rates go down, bond prices go up. The reason: The price of a bond reflects the value of the income it delivers through its coupon (interest) payments.

If prevailing interest rates (notably rates on government bonds) are falling, older bonds that offer higher coupon rates become more valuable. The investor who holds these bonds can charge a premium to sell them in the secondary market.

Alternatively, if prevailing interest rates are increasing, older bonds become less valuable because their coupon payments are now lower than those of new bonds being offered in the market. The price of these older bonds drop and they are described as trading at a discount.

What may be ahead for bond markets?

The Covid environment of near-zero interest rates was never sustainable, and while this transition out of the Covid environment has seen bond markets fall, the expectation is that the outlook may improve over the longer-term.

Market indicators seem to show that an economic slowdown may be expected over the next 6-12 months. That said, market expectations also seem to demonstrate that inflation will be brought back to the target of around 2-3%.

History has shown that markets generally recover time and again. As such, many investors may choose to sit tight and not react to the cycle of market volatility, as investment, particularly super, is generally for the longer-term.

Choosing your investment strategy usually means using an appropriate mix of asset classes, rather than just bonds. Just like any investment, when you buy bonds you take on market risk, including loss of principal. Just like stocks, bonds go down also. However, year-to-date, bonds are less negative than most equities. Appropriate diversification should help to strike a balance between growing (usually via use of growth assets such as shares) and protecting (usually via more defensive assets such as bonds or cash) an investment based on your own personal situation including how close you are to retirement.

However, everyone's situation is different and depending on your stage of life, retirement plans and other specific goals, you may want to **speak to your financial adviser**.

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