Inflation Not a Friend to Bond Investors

By Wm. Michael Cody, CFA®, Director of Fixed Income Trading

For nearly a decade we have grown accustomed to the idea that inflation was off the table as a concern for the U.S. economy, even lulling the Federal Reserve (Fed) into first calling its sudden resurgence last summer a "transitory" event.

Unfortunately, the transitory prediction proved wrong. By December, when the monthly Core Consumer Price Index inflation rate reached 5.5%, the highest since February 1991, it was clear investors would have to contend with this economic headwind for months to come.

Among those concerned in particular about rising inflation are fixed income investors, who have a vested interest in how this trend will affect the fixed income portion of their investment portfolios over the long haul.

Diversified portfolios generally have some component of their overall allocations devoted to fixed income and bond investments, a time-honored "insurance policy" to counterbalance the riskier stock component of their holdings. However, fixed income investments have been adversely impacted over the last several years by steady near-zero interest rates.

Now interest rates are rising slightly in response to elevated inflation expectations. Fixed income and bond investments had been in a bear market up to this point, with most fixed income sectors producing negative returns last year. As an example, the Bloomberg Aggregate Bond Index generated a negative return in 2021, with Treasuries being the worst-performing sector of the fixed income market.

With interest rates trending upward, the bond market is off to its worst start of a new year in over twenty years. Yields continue to move higher in anticipation the Fed will be raising its benchmark rate target sooner and more often in 2022 than thought just a few months ago. The rate on the 10-year Treasury has recently been hovering around 1.75% (the increase will be reflected in higher mortgage borrowing rates) after finishing 2021 at 1.51%. The cost of energy is also not helping the inflation picture, as the price of crude has steadily increased, with the West Texas Intermediate benchmark currently crossing the $80 per barrel mark in early January.

Can we expect inflation to continue for a while, putting continued pressure on fixed income and bond returns? We believe as long as the constraining business effects of the pandemic stretch out, inflationary influences could linger through the end of 2022. Moreover, supply chain shocks are not going away anytime soon. Shipping challenges, material shortages, and labor issues are still in flux, and wages and commodity prices are on the rise.

Commerce Financial Advisors

Investments • Retirement • Insurance

Securities and Advisory services provided through Commerce Brokerage Services, Inc. Member FINRA, SIPC, and a registered investment advisor.
A subsidiary of Commerce Bank.

The roots of inflation have grown and spread more broadly across the economy. As inflation rises, the Fed traditionally pushes interest rates up with more robust monetary money tightening policies to combat the effect of rising prices. And in "Bond 101," it's important to remember the inverse relationship – bond prices go down when interest rates go up.

How will we know if inflation is waxing or waning? Generally, you can monitor two key inflation indices, Core CPI (Consumer Price Index) and core PCE (Personal Consumption Expenditures). The "core" part excludes food and energy prices because of the volatile nature of those components. So, it helps to give a better picture of where inflation is.

And as mentioned, the year-over-year number reported in December for core CPI was 5.5%, very high in terms of the last 30 to 40 years. Core PCE is just a little bit different than CPI, tending to be a bit lower number over time. Both indexes calculate the price level by pricing a basket of goods. But the baskets aren't the same, with differences in weighting and scope. For example, the weight accorded to housing is around 42% in CPI, while it is only 15% in PCE. At the start of 2021, core CPI was below 2.0%. Since then core CPI has more than doubled, so inflation is on the rise, and interest rates tend to follow.

Despite upward trending inflation that creates this unexceptional interest rate environment, we believe fixed income investments still serve their important role in an investment portfolio by offsetting volatility associated with other asset classes, essentially acting as an insurance policy against a falling stock market should one occur. Interest rate hikes have a long lead time before the economy is affected. Currently, investors believe we could see the first rate hike in the spring, and that could be a headwind for stock prices. Downside risk associated with stocks remains significantly higher than what bonds have historically experienced.

Maintaining your portfolio's value through the effects of inflation and market volatility during any stage of your life can be quite challenging. We would encourage investors to consult with their financial advisors to ensure their financial plan projections are up to date as inflation rate assumptions change. Our financial advisors can help clients with these decisions, especially those in a pre-retirement phase. We are here to address your current and future concerns and help you make educated decisions based on your goals and unique financial situation. Contact Commerce Financial Advisors today for more information regarding your options.

Securities and Advisory services provided through Commerce Brokerage Services, Inc. Member FINRA, SIPC, and a registered investment advisor.
A subsidiary of Commerce Bank.

Commerce does not provide tax advice or legal advice to customers. While we may provide information or express general opinions from time to time, such information or opinions are not offered as professional tax or legal advice. Consult a tax specialist regarding tax implications related to any product and specific financial situation.

This material is intended to provide general information only, may be of value to the reader and audience, and is reflective of the opinions of Commerce Trust Company.

Commerce Trust Company is a division of Commerce Bank. Securities and Advisory services provided through Commerce Brokerage Services, Inc., member FINRA, SIPC, and a registered investment advisor. Insurance products are offered through Commerce Insurance Services, Inc. Both entities are subsidiaries of Commerce Bank.

This material is not a recommendation of any particular security, is not based on any particular financial situation or need, and is not intended to replace the advice of a qualified attorney, tax advisor or investment professional. The information in this commentary should not be construed as an individual recommendation of any kind. Strategies discussed here in a general manner may not be appropriate for everyone.

Diversification does not guarantee a profit or protect against all risk. Past performance is no guarantee of future results, and the opinions and other information in the investment commentary are as of January 19, 2022.

Commerce does not provide tax advice or legal advice to customers. Consult a tax specialist regarding tax implications related to any product or specific financial situation. Data contained herein from third-party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed, and is subject to change rapidly as additional information regarding global conditions may change. All expressions of opinion are subject to change without notice depending upon worldwide market, economic or political conditions.

Commerce Financial Advisors

Investments • Retirement • Insurance

commercebank.com/brokerage

1.800.772.7283

Securities and Advisory services provided through Commerce Brokerage Services, Inc., member FINRA, SIPC, and a registered investment advisor. Insurance products are offered through Commerce Insurance Services, Inc. Both entities are subsidiaries of Commerce Bank.

Not FDIC Insured | May Lose Value | Not Bank Guaranteed | Not Insured by Any Federal Government Agency

Wm. Michael Cody, CFA®

Senior Vice President, Director of Fixed Income Trading

Michael is director of fixed income trading for Commerce Trust Company. His responsibilities include supervising the fixed income trading group along with managing and trading corporate bonds, Treasury and Agency positions for institutional clients and Commerce Bank. He is the author of the Fixed Income Income Commentary and contributes to the annual and mid-year Outlook. He is a co-manager of the Commerce Bond Fund and the Commerce Short-Term Government Fund and a member of the Commerce Bank Volcker Rule Committee. He spent much of his initial career as a portfolio manager with General American (a subsidiary of MetLife), managing large institutional bond portfolios and separate accounts. Prior to joining Commerce, he spent three years with Fifth Third Bank Investment Advisors where he managed fixed income and equity portfolios for foundations, trusts, and high-net-worth individuals. Michael graduated from Marquette University with a bachelor of science degree in finance and economics and earned his master of business administration degree at Drake University. Michael is a Chartered Financial Analyst (CFA®) and is a member of the CFA Society of St. Louis. He is a past president and a former board member of the CFA Society of St. Louis. Michael is currently the president of the board of directors for Trailnet, a non-profit organization dedicated to connecting the St. Louis metropolitan area with safe walking and bicycle paths.

Commerce Financial Advisors

Investments • Retirement • Insurance

commercebank.com/brokerage

1.800.772.7283

Securities and Advisory services provided through Commerce Brokerage Services, Inc., member FINRA, SIPC, and a registered investment advisor. Insurance products are offered through Commerce Insurance Services, Inc. Both entities are subsidiaries of Commerce Bank.

Not FDIC Insured | May Lose Value | Not Bank Guaranteed | Not Insured by Any Federal Government Agency