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Observations and Perspectives:

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Traditional Bonds = Risky Parachutes

During the short nine days of trading from late January to February 8, the S&P 500 fell like a skydiver leaping out of a plane: fast and down. In a classic flight-to-quality response, investors pulled their parachutes, socking billions into the largest ETFs tracking the widely-watched Bloomberg Barclays U.S. Aggregate Bond Index (the "Barclays Aggregate"). This time, though, it didn't work.

What if, when skydiving, your parachute fails to open? In a flop of financial engineering, both the broadest U.S. stock benchmark and the standard fixed-income one declined during this first correction of 2018.

Conventional thinking says that stocks and bonds tend to behave in opposite ways, when one goes up the other goes down. This "negative correlation" offers a parachute of safety and easy diversification over time, making a default to a 60/40 (60% stocks and 40% bonds) portfolio a nice way to invest over time.

No longer.

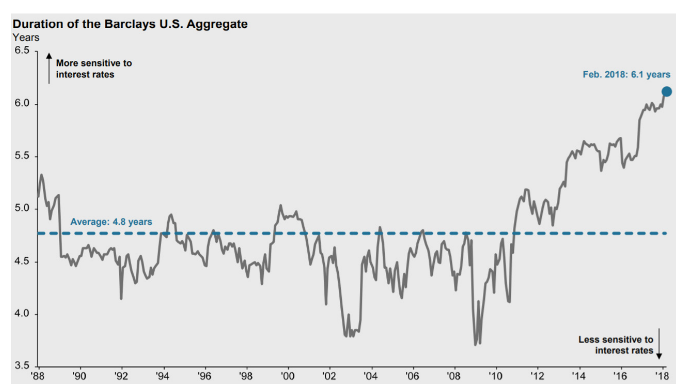
The delusion that a 60/40 portfolio protects an investor has to be smashed. For the past roughly twenty years, stocks and bonds have generally demonstrated negative correlation. During the 1970s into the mid-1990s, though, the exact opposite was true, so holding the Barclays Aggregate as a shield against risky stocks just didn't work.

Tightening Fed policy, inflation, rapidly growing deficits and their impact on rates can sometimes move bond prices violently. July 2016 marked the lowest level in rates I will likely see in my lifetime. If interest rates continue the climb up from that level, traditional bonds and the 60/40 will continue to die, as foreshadowed during the first correction of 2018.

The pace of rising rates may be a "known unknown." Adding to the risks, though, is the sharply higher interest rate sensitivity of the Barclays Aggregate, where duration is now at a 30-year high (see chart below). Think of it this way: a 1% rise in rates knocks about 6% off the price of the benchmark and takes 28 months to recover, at current yields. Ten years ago, that same 1% rise in rates clipped only 3.75% off the price with less than 12 months to recover (at prevailing rates at that time). Most investors are not aware of the current riskier profile of this "low-risk" benchmark.

The U.S. bond market is twice as big as the U.S. stock market, but bond portfolio construction garners far less attention than stock construction. In fact, there were plenty of fixed-income "parachutes" during the first correction of 2018, but they aren't components of the Aggregate. Floating rate loans, for instance, held up in positive territory, but have a zero allocation in the parachute benchmark.

Managing risk is harder than ever and the occasional positive correlation between stocks and bonds doesn't help. In all likelihood, you own a fund that follows the Barclays Aggregate, but life isn't passive. Your bond manager shouldn't be either.



Source: FactSet, J.P. Morgan Asset Management
https://am.jpmorgan.com/blob-gim/protected/1383426387662/83456/MI-GTM_1Q18_March_1.pdf?segment=AMERICAS_US_ADV&locale=en_US

Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

The Standard & Poor's 500 Index (S&P 500) is an index of 500 stocks seen as a leading indicator of U.S. equities and a reflection of the performance of the large cap universe, made up of companies selected by economists.

Past performance does not guarantee future results. Investors cannot invest in an index and unmanaged index returns do not reflect any fees, expenses, or sales charges.

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