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# Bonds' Steep Selloff Isn't Reason to Worry. How to Keep Calm.

By Lauren Foster Follow Updated Jan. 13, 2022 8:13 am ET / Original Jan. 13, 2022 12:05 am ET

Treasury building in Washington, D.C.
Erin Scott/Bloomberg

There's a well-known adage, often mistakenly described as a Chinese curse: "May you live in interesting times." This certainty rings true for bond investors who, having witnessed a tumultuous 2021, saw a steep selloff in bonds in the first few days of January.

While it is easy to be overwhelmed by the headlines, financial advisors and strategists say investors should bear in mind the context for what is happening in the market and the critical role bonds play in a portfolio: They provide diversification and help reduce volatility.

Bonds are the ballast that keeps a portfolio in check and investors should not lose sleep over falling prices, especially compared with the volatility in stock prices, said Anora Gaudiano, a financial advisor at Wealthspire Advisors.

What investors are seeing now in the market in terms of falling prices and rising yields has been playing out over many months.

"The bond market is adapting to the closing stages of the pandemic disruption to the labor markets," said Cheryl Smith, an economist and portfolio manager at Trillium Asset Management. "The bond markets have already priced in what the Fed is going to do." By reacting now, "you are shutting the barn door after the horse has already left. So stay put."

In August 2020, the Federal Reserve signaled it needed to pay attention to both unemployment, or the state of the labor market, and inflation, and that it felt that it had "privileged worrying about inflation in the past over unemployment," Smith explained.

Stubbornly high inflation changed that. "In late 2021, we began to see unemployment rates fall rather rapidly. And with the unemployment rates falling rapidly, what that meant was that the Fed then had some room and some latitude to begin to deal with what was becoming a significant issue in not just investors' minds, but consumers' minds," she added.

## Yield to Pressure

The yield on the 10-year Treasury note hit its highest in two years last week.


Source: Tullett Prebon

Peter Lazaroff, chief investment officer at Plancorp and BrightPlan, said there was a "distinct shift in market psychology" in the middle of December after the Fed's two-day policy meeting. Minutes of that meeting, released last week, showed central bankers could move earlier and faster with interest rate increases.

"The most important thing, when you're reading headlines about the bond market, is to remember what the role of bonds is in a portfolio," he said.

It's also important not to be spooked by the headlines.

"Stay the course, try and keep calm," Smith said. "If you have experienced a loss on your bond portfolio so far this year, I would still stick with it because I think that you've already seen the price movement that you're likely to see for this year."

While caution is advised, there are still opportunities. Smith said that within the credit, or corporate bond market, investors should stick with higher-quality bonds. "We would want to be in the A, AA range. I don't think you necessarily need to try and find AAA, which is very hard to find in the credit market these days."

She also advised staying away from mortgages. "In a higher-rate environment, prepayments are going to be slower. We still have some room for damage in the mortgage market, but we would be positioned in higher quality corporate bonds in the 7- to 10-year maturity range. You don't get much in the way of yield going out to 30 [years], and you do pick up a lot more volatility."

Duke Laflamme, chief investment officer at Eaton Vance WaterOak Advisors, said the firm has been, and will continue to be, underweight fixed income overall.

Within their fixed income allocation, they are short-duration to achieve lower interest-rate sensitivity, because they believe that rates will rise from here. "And to help offset that, we have been—and are currently—overweight credit to pick up a little bit of yield that you give up by being short in duration."

Normally in times of rising interest rates, one would expect to see improving economic conditions and creditworthiness, and therefore tightening credit spreads.

However, Laflamme is concerned that we could see rising rates even if there is a slowdown in the economy because the credit market is already at or near all-time lows in credit spreads. With interest rates moving higher and credit spreads widening, we could "get this one-two punch in the marketplace that you typically wouldn't get with credit."

The bottom line for guiding clients right now, he added, is "be cautious in fixed income. You can be a little less cautious around credit to get a little bit of extra yield, but that's one that you want to be watching as we move through the year."

Like Smith, Laflamme said there are options worth considering.

"You have to be pretty selective," he noted. "Where you probably can find a little bit more value right now is in some of the more credit-sensitive parts of the market. So whether that's high-yield bonds, floating-rate bank loans, even high-quality corporate bonds, there's some value there. But again, you just want to be cautious around how much exposure you're taking given how tight credit spreads are right now."

It's worth bearing in mind that decisions made in haste can be costly. "Your average investor," Smith said, "the way they lose money is by reacting in the moment."