Capital Market Review

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Why Did Bonds Perform Poorly in 2022?

Last year was full of market-moving headlines, from the war in Ukraine to midterm elections, and even a crypto fallout; there was never a dull moment. However, inflation and interest rates hold the title as the biggest market-moving factors of 2022. The two combined led the S&P 500 Index to a loss of 18%, its worst calendar year since the Great Financial Crisis in 2008.

Although the S&P 500 Index entered a bear market last year, it was the bond market's negative performance that provided investors a surprise. Typically, bonds and stocks are negatively correlated, meaning they tend to move in opposite directions. During past stock bear markets, bonds moved higher and offset some of the losses on the equity side of portfolios. Last's year's rising rate environment (bond prices fall as rates rise) reversed this trend and only compounded equity losses in investment portfolios.

2022 was the U.S. bond market's worst year on record falling about 13%. It was also the first time the index finished consecutive calendar years in the red since its 1976 inception. Let's look at a bond index with a longer history. This is only the third time since 1926 the bond market has had two consecutive years of negative returns; neither of those periods experienced a third year in the red.

During difficult periods, investors often wonder what changes should be made to portfolios. For starters, the best place to start is to take a step back to look at why portfolios did not meet expectations. Currently, we are experiencing an event in the bond markets that has never happened in the 46 years of the Bloomberg Aggregate Index's existence.

We also need to consider why bond markets did so poorly in 2022. The obvious reason is rising rates caused by multidecade high inflation forcing the Federal Reserve to raise short-term rates at the fastest pace ever, paired with record low yields exacerbating the situation. When rates have risen in the past, yields have been much higher and provided income to offset some of the decline in bond prices. We did not have this benefit in 2022. Now, higher rates mean higher yields, so even if rates rise from here, we have income to offset a portion of the price decline.

After a decade of relatively low volatility, we have experienced a pandemic-induced drawdown, an ensuing growth rally, followed by inflation and rising rates. Just as the massive up markets of the past two years were considered abnormal, 2022 was also unusual. Outlier markets will always occur but building portfolios around those outliers is not the best process for long-term success. We will only know the next abnormal event once it has happened. Although this is a difficult period, we remain convicted in our process of strategic, diversified portfolios with a long-term outlook.

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