Bond Bites

UBS Asset Management | Fixed Income views

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Into the unknown

Marooned in a northern-hemisphere bleak mid-winter for a second year, my mood darkens further as I ponder how long it might be before we can travel anywhere free of the paraphernalia of a global pandemic. But as I fret about travel hardship, greatly bothered by PCR-tests, face masks and quarantine hotels, perhaps I should dwell instead on travellers a thousand years ago who crossed the North Atlantic from Scandinavia to Iceland, then Greenland and into Canada, in an open boat, with oars and a single sail. Let's face it; the Vikings were a tough bunch.

But 'Canada?', you ask. As long ago as the 1960's archaeologists discovered evidence of a European presence on the North American continent, extant many hundreds of years before Columbus. While the found artifacts were clearly Norse in origin, pinning down an exact date for the colony proved problematic – the great Norse sagas of Erik the Red and Leif the Lucky were not written down for at least 200 years or so after their adventures.

Until recently, radiocarbon dating gave only imprecise results for the settlement's age. But new scientific methods can detect an upsurge in carbon-14 created when waves of high-energy sub-atomic particles from a solar storm collide with the earth's atmosphere. Spikes in the abundance of this radioactivity from cosmic storms are recorded in the rings of all the trees then alive. Known as a "cosmic radiocarbon events" the phenomenon has only happened twice in the last 2000 years; AD 775 and AD 993. By detecting a spike in carbon-14 in an ancient tree-ring sample it becomes possible to determine the exact felling year and season of the tree.

Which is how researchers recently established that the small colony of Vikings inhabited Newfoundland in precisely the year 1021.[1] Logs excavated from the site showed the year 993 carbon-14 spike and then, counting the number of rings to the bark, they could determine the exact felling season. The logs themselves had been cut by metal tools evidenced by clean, low-angled cuts that were not found in tools from the indigenous people at the time.

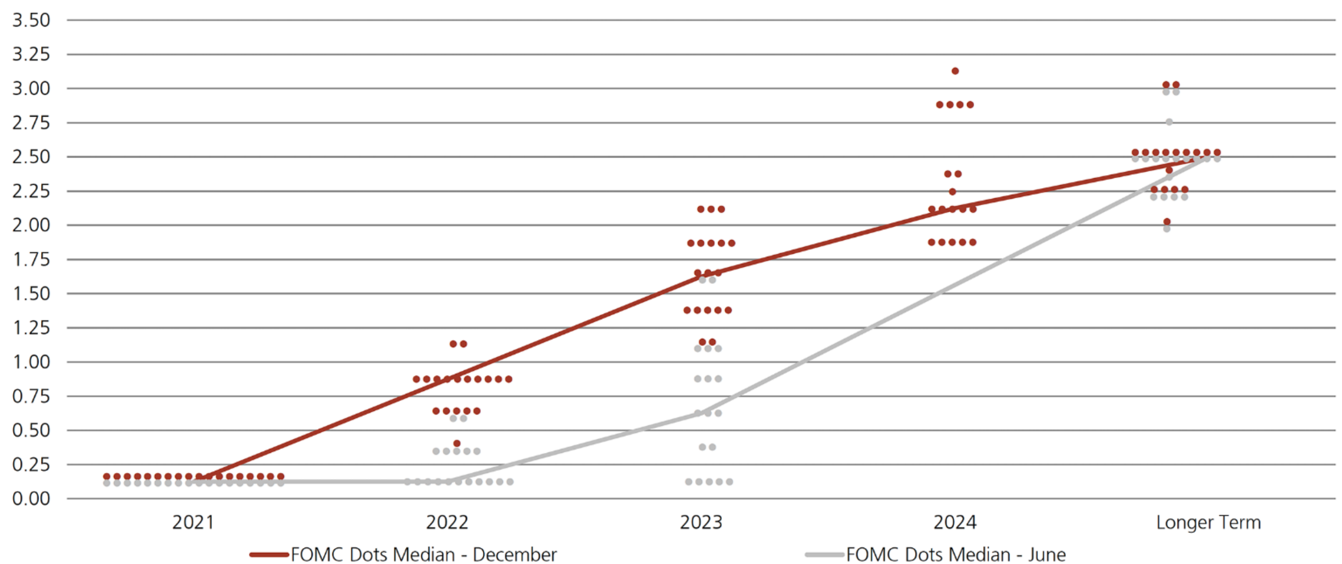
So, a solar storm, archaeology, forensic examination of old logs, hard science, simple math and suddenly we can talk confidently about events a thousand years ago. But where will bond yields be in just three months? Ah, hmph. Not so easy. Struggling with my own efforts to make accurate predictions even a few months ahead I admit to serious 'science-envy' of those able to make sound pronouncements about human events that occurred a thousand years ago.

It feels wrong, but it is the nature of reality in human affairs. When it comes to accurate predictions about financial markets, science cannot help you. It is the main reason why we advocate an active investment approach that is designed to cope with and adapt to changing circumstances. Diversification and investment flexibility are the keys; investment strategies that ask for year-after-year of precise predictions about the ultimately unknowable are doomed to failure.

Which is not to say that forming a view around what lies ahead is not important – discussions about likely future states can help identify risks and opportunities. At our recent quarterly Fixed Income Investment Forum it was striking though how poor many participants viewed the prospects for government bonds in the early months of 2022. A key factor is the shifting attitude of many central banks that I wrote about last month.2 Many now see inflation as the problem, and an aggressive stance to counter it is the policy choice du jour. The US Federal Reserve is a case in point.

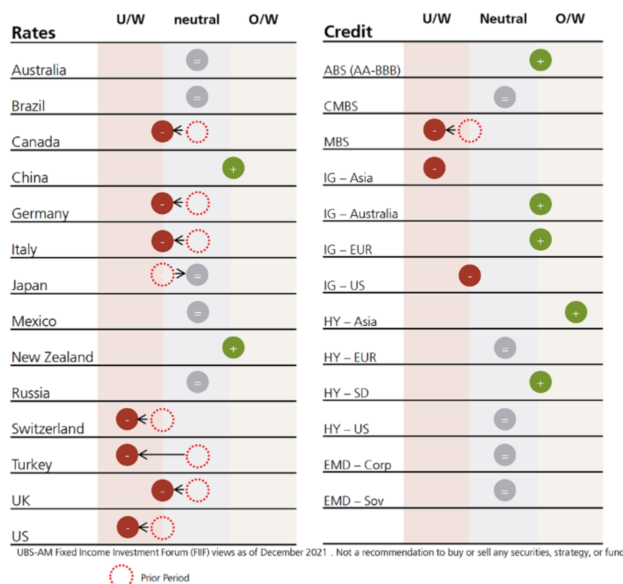
Just over 6 months ago the Federal Open Market Committee (FOMC) members' median projection for their policy rate expected by the end of 2022 was effectively zero – or no change from 2021. But by the time of their recent December meeting those projections had jumped to three expected rate hikes in 2022. See Chart 1. In fact, the narrative for bond markets is rather more hawkish than that. Until very recently asset purchases under the quantitative easing (QE) program totaled USD 120bn a month. It has long been expected that asset purchases would be scaled back as the economy recovered in 2022, but views around how quickly this might happen have evolved a lot. Mid-2021 the consensus had been QE would fully end by the close of 2022, then expectations were brought forward to mid-2022. But recently the Fed has jumped to March '22 as the expected conclusion of the program.

Chart 1: FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



As my colleagues at our Investment Forum pointed out, relatively sudden and large policy reversals often prove problematic for bond market returns, and this is a key driver for our expectations in the first quarter of 2022. Chart 2 is a stylized high-level summary of our views – clearly, developed market government bonds (the left- hand 'Rates' column) look unattractive.

Chart 2: Active positioning summary



But before one starts tossing government bonds overboard to help stay afloat this is the right point to consider the implications of an unknowable future – a set of forecasts, even from as august a body as the Fed – come with no guarantees that this is what will actually happen. There are some obvious reasons for caution; fiscal policy, which had supported consumer and business spending since the onset of the pandemic, is going to be much weaker next year and households are already dealing with the growth tax from higher inflation and higher energy bills. While a hawkish policy stance now may be justified in the face of very high inflation prints today, these factors could just as easily tip growth and inflation onto a weaker than expected path. And these effects will unfold at different rates in different countries.

In global strategies our preferred way to balance these risks is to be underweight duration3 but skew our investments toward countries where the downside risks appear less severe. This certainly now includes countries like Australia and New Zealand where bond yields moved sharply higher well ahead of the US, and therefore offer a more attractive risk-reward profile.

Chart 2 also highlights our other preferred positions outside of government bonds (the right-hand 'Credit' column). It identifies our preferred allocation to asset classes such as short duration high yield in the US, which offers around three times the spread of most investment-grade sectors and with much less sensitivity to the upward move in yields we expect. For global investors who are not able to invest in HY, investment grade markets in Australia and the Eurozone look a better bet than the US. Some asset-backed markets in the US also look more attractive relative to vanilla credit.

This is just a snapshot of some of the high-level ideas deployed in our global strategies. In a complex and uncertain world our tactics are necessarily adaptive and we cannot stress enough the need for constant reappraisal of new information.

The key driver for monetary policy (and hence bond markets) this year will be how closely the path of realized inflation matches the forecasts. Any undershoot could trigger a sharp rally in bond markets, because expectations for central bank rate hikes will look too aggressive. But a continuation of very high inflation prints will raise fears of an even more aggressive policy response than is already priced in, and bonds will continue to do poorly. As central banks around the world embark on a coincident effort to crush inflation, the start of 2022 feels like a journey into the unknown. Vikings landed in a new continent following a chain of events that started after being blown off course on a journey to the Faroe Islands. The gap between outcomes and expectations can be very large indeed.

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