In addition to appealing yields, CIO sees the potential for capital appreciation, as they expect inflation to recede, growth to slow, and the Fed to cut rates this year. (UBS)

Rising yields offer entry point to quality bonds

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The US Treasury's biggest-ever auction of five-year notes on Monday met with lukewarm demand, with a bid-to-cover ratio for the USD 64bn worth of bonds below the average from the six prior auctions. This followed an auction of USD 63bn of two-year notes that also showed tepid interest. By the close of US markets on Monday, US Treasury yields rose across the curve, with the 10-year yield up almost 4 basis points to 4.30%.

Recent volatility in the interest rate market has been a function of stronger-than-expected inflation and jobs data, as well as significant supply through US Treasury auctions. Earlier this month, the US Treasury sold USD 25bn of 30-year bonds and USD 42bn of 10-year notes. Following a repricing of the Federal Reserve's rate cuts, fed funds futures now point to around three quarter-point cuts this year, in line with our view and the US central bank's projection.

But with yields now close to their year-to-date high, they offer a good entry point into quality bonds, which remain most preferred in our global portfolios.

We expect yields to fall. The current risk-reward proposition for quality bonds is especially attractive, in our view. In addition to appealing yields, we see the potential for capital appreciation, as we expect inflation to recede, growth to slow, and the Fed to cut rates this year. We expect the 10-year yield to fall to 3.5% by December in our base case scenario, implying 10%returns for current holders of 10-year Treasuries.

Quality bonds are safe and liquid investments that offer reliable income and higher returns versus cash. High-quality bonds are among the safest investments based on the creditworthiness of their issuers. That makes them an effective way of preserving capital, reducing volatility, and stabilizing portfolios, in our view. They also offer a steady stream of income and have historically delivered higher returns than cash over the long term. In fact, their probability of outperforming cash rises with longer holding periods—from 65% over 12 months to 82%, 85%, and 90% over five, 10, and 20 years, respectively.

The benefits of diversification are clear. Bonds have historically helped insulate portfolios during periods of equity turbulence, and they should serve as a good hedge if economic growth slows more abruptly than we expect. In a hard-landing scenario, we would expect the 10-year US yield to decline to 2.5% by the end of this year.

So, we continue to recommend investors act soon to lock in currently attractive bond yields. We particularly like the five-year duration segment of quality bonds, as this part of the yield curve offers the best combination of high yields, stability, and sensitivity to falling interest rate expectations. We also like actively managed fixed income strategies for better diversification and the breadth of opportunity in the asset class.

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