Government bond yields are too high, so time to rebalance?

CIO Essentials

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- The conflict in Iran has resulted in higher energy prices, leading bond investors to expect higher inflation and yields.
- But we think that in both a resolution and a prolonged crisis scenario, bond yields will fall.
- So, investors may want to rebalance into quality fixed income, locking in current high yields, and also diversify into other sources of income amid uncertainty.

Since the Iran war, global markets have moved sharply to price in higher inflation and higher interest rates.

Investors have become worried that oil supply shortages will push oil prices higher or keep them elevated for longer. If this happens, inflation may rise, forcing central banks to raise interest rates to dampen demand—including for hydrocarbons.

Government debt, whose yields reflect investors' views on the path of interest rates, has declined in value and yields have gone up. This has happened across the US, Eurozone, and in the UK, where government bond yields sit well above pre-conflict levels. Indeed, since late February, the yield on the 10-year German Bund has risen 35bps, a sharp move in the space of around seven weeks. And the additional yield other European governments have to pay over Bunds (the spread) has widened.

However, CIO believes these concerns are overdone.

Central banks are unlikely to react hastily to energy price spikes. If oil prices remain high, yields could actually fall over the medium term as the worry would shift to growth falling, the risks of recession rising, and central banks responding by cutting interest rates to stimulate demand.

So, we think current government bond yields in many major economies are too high and will fall as the year and a resolution of the Iran conflict progress.

This may create an opportunity for investors to lock in attractive yields by adding to government bond positions and diversifying their portfolios.

Why now?

The recent increase in benchmark government bond yields provides a compelling entry point for investors seeking diversification and income, in our view. After years of strong equity performance relative to bonds, many investors can rebalance toward fixed income, bringing allocations back in line with long-term plans.

CIO favors quality government bonds with short to medium maturities, especially in the US, Eurozone, and UK. These bonds offer elevated yields and can help stabilize portfolios during periods of uncertainty.

Even in countries like Switzerland, where government debt yields remain low and inflation is muted, some allocation to government bonds makes sense for adverse economic scenarios—government debt tends to rally and yields fall in anticipation of monetary easing, potentially delivering additional returns to solely holding excessive levels of precautionary cash.

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Looking for further sources of yield

While CIO maintains a bias for quality, a well-diversified fixed income portfolio can include some exposure to more growth-sensitive credit segments such as emerging markets, high yield, or subordinated debt.

It's important to avoid overexposure to any single segment. And it may be hard for investors to manage all the risks of holding riskier debt. So, we believe investors should focus on quality and diversification, balancing income generation with risk management.

More to income than fixed income?

For investors in countries where bond yields are already low or the additional income offered to hold riskier debt is not very large, equity income strategies may offer compelling alternatives. CIO's preferred markets for dividend strategies are Switzerland, where high-quality dividend stocks yield well above local bond yields, and Southeast Asia, where average dividend yields are similarly attractive.

With government bond yields pricing in too much inflation risk and not enough growth risks, we believe now may be an opportune time for European investors to revisit government bonds. We especially like high-quality bonds that mature in up to five years' time.

For investors seeking diversification or operating in low-yield markets, equity income strategies and diversified fixed income approaches may also deserve another look as a means of helping build resilient portfolios and provide steady, consistent income.

Global asset class preferences definitions
The asset class preferences provide high-level guidance to make investment decisions. The preferences reflect the collective judgement of the members of the House View meeting, primarily based on assessments of expected total returns on liquid and commonly known indices, House View scenarios, and analyst convictions over the next 12 months. Note that the tactical asset allocation (TAA) positioning of our different investment strategies may differ from these views due to factors including portfolio construction, concentration, and borrowing constraints.
Attractive: We consider this asset class to be attractive. Consider opportunities in this asset class.
Neutral: We do not expect outsized returns or losses. Hold longer-term exposure.
Unattractive: We consider this asset class to be unattractive. Consider alternative opportunities
Note: For equities, we have a five-tier rating system with two additional preferences
Most Attractive: We consider this asset class to be among the most attractive. Investors should seek opportunities to add exposure.
Least Attractive: We consider this asset class to be among the least attractive. Seek more favorable alternatives opportunities.
When equities are included with the other asset classes in the three-tier rating system, we collapse "Most Attractive" with "Attractive" and "Least Attractive" with "Unattractive."

Appendix

Risk Information
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