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Knowledge Transfer Program
Module 2 - Back to Fixed Income

Bond Bites: is there a deeper secular change on the horizon?

Speaker: Jonathan Gregory, Head of Fixed Income UK

Will central banks be able to stick with their approach?

- There are plenty of reasons to be cautious about fixed income. Bond markets are facing some serious challenges and investors need to be careful about how to navigate these challenges.
- Whatever bond investors did in the last ten years or so that was successful, probably won't work again. The changes that the market has undergone in recent times warrant a different approach.
- The world won't go back to a 'normal' of excess savings, slow growth, low real rates and very supportive central banks.
- Central banks in many areas, including the US, Europe, and the UK, are likely to face a very stark choice: either choosing a path of a) deflation - effectively tipping their economies into recession to help tackle inflation, or b) devaluation - effectively accepting inflation running at higher levels than they might want, for longer. That's going to be a very difficult choice.
- Right now, central banks are trying to persuade everybody, and indeed perhaps themselves, that they are going to be very determined and go down the deflation route, deploying a hawkish rhetoric along with big rate hikes.
- But this is an unusual situation: central banks are tightening monetary policy, not when economic growth is strong, but as economies are already slowing dramatically and some are heading for recession. Will they be able to stick to the path of tightening or will it politically become too difficult?
- Right now, we advocate a highly flexible approach to fixed income strategies. Investors need to be able to change their approach quite quickly if central banks start to row back from hawkish rhetoric.

Don't underestimate how difficult it can be to turn around entrenched inflation positions

- Central banks spent 10 years trying to turn around economies, aiming for inflation that was close to or below target. I think many central banks underestimated how much it would actually take to get inflation back to target: zero or negative policy rates in many countries and trillion dollar balance sheets.
- Enormous policy tools were brought to bear, arguably with very little effect. It's actually very difficult to bring inflation back to target, partly due to some of the structural reasons driving inflation. Don't underestimate how much it might take this time around: it may well take more than what's currently priced into markets if central banks are really determined to bring inflation back to their target.
- For the US, with rate hikes priced in for this year and then an easing priced in for the middle of next year, it just seems highly unlikely, given the world we find ourselves in today.
- That's why our global portfolios are still underweight duration or set at the very lowest duration positions they can have.

What worked before, probably won't work again

- We should remind ourselves how central bank policy making has changed over time. The last time the Federal Reserve had a rate hiking cycle, back in 2018, with Janet Yellen in charge, policymaking was preemptive and generally model based. And so, rates were being hiked well before inflation got back to target. And in fact, it only just got above target in that period.

- It's a very different approach to the world of today. We've gone from a world of central bank policymaking that was preemptive, forward looking, possibly model based, to a policy world which is reactive, outcome-based and generally slow to react. And in some ways, that's quite deliberate.
- A couple of years ago the Fed changed the policy regime in quite an important way, where they talked about managing average inflation over time.
- So it's another factor as to why I'm skeptical about people who think once the impact of the last couple of years subsides, we will go back to the world we were in. I just don't think that's right as so many things have changed, and one of them is the policymaking world.

Winners, losers and collateral damage

- Policy makers, whether they like it or not, whether they mean to or not, create winners and losers.
- A big winner from monetary policy over the last ten years was anyone who owned duration. If you owned duration, you were a big winner. And generally, it's because central banks wanted you to be a winner - that was part of a policy tool. So, it meant pretty much everybody did well, whether in long bonds or equities, long duration assets or real estate. It didn't matter what you were in. There were losers too: savers were hit by that; owners of some currencies would have been hit by some of those policies. So as central bank policy is forced to shift, into maybe accepting higher inflation, then the winners and losers are going to change too.
- Let's think about the two main drivers of central bank policy since the financial crisis, and how they worked. The first policy tool was inflating asset values: reducing interest rates right across the curve, which reduced discount rates, and that helped valuations pretty much across asset classes.
- Policy tool number two was driving investors into other asset classes: government bonds to credit, credit to high yield, high yield to emerging markets. It's possible, therefore, as those policies reverse some of those flows are going to reverse and some of those valuations are going to unwind. And I think that's a particular risk in some sectors right now, particularly if it takes more than people think or more than is priced to get inflation back under control.
- There is always collateral damage around policy changes. We've seen a certain amount of collateral damage already. There could be more to come though, as policy evolves, which is why we've got a fairly defensive view on credit in our portfolios right now.

Global Debt Levels

- Currently, global debt levels are around 350% to GDP; debt levels have generally been increasing over the last twenty years, as have absolute debt levels.
- For most of the post-crisis world, the argument was that this didn't matter. Why? Because financing costs were generally falling around the world. Central banks were cutting rates so people could accept higher debt levels.
- But if interest rates are now increasing, if real rates and nominal rates are increasing, don't these high debt levels suddenly matter? You can't have it both ways. We think these debt levels do matter and will create a problem.
- Debt servicing is going to get harder in some sectors of the economy and is another reason why we are quite cautious on credit.
- But another reason for caution is that if debt levels go higher and interest rates are going up, then inflation becomes a more attractive policy choice as a solution.
- Overall, government debt levels have also increased. Every time we've had a crisis, leverage has generally gone up for governments: a lot of the risk has been taken on by government balance sheets.

Pay attention to the structural drivers of inflation

- In the short-term, it is possible that we have seen a peak in inflation in some markets. In the US, some of the key leading indicators have turned, pointing to the potential for a further easing in inflation later this year.

- However, it’s not so much the cyclical drivers but the structural drivers that are going to matter. Arguably, there is more evidence to support the fact that these structural drivers are starting to have an impact:
    - Fiscal policy – from austerity to deficits
    - Monetary policy – from pre-emptive and forecast-based, to outcome based
    - The labor share of income: wages are rising; a shrinking pool of workers
    - Globalization – from free movement of goods and capital, to matters of sovereignty and control
    - The green economy – from cheapest to deliver to greenest to deliver

Implications for investors

- Investors need to be careful in their fixed income allocations. In global portfolios we're still very cautious on duration and credit.
- But there are some opportunities out there. Being more flexible, seeking relative value opportunities across markets, they're going to be a key driver of returns for fixed income investors in coming years. Being mindful that central banks could be forced to change direction very quickly. Because these themes that we've talked about are global in nature, but they're going to unfold at different rates, in different countries. The policy choices in Europe are likely to be quite different from the policy choices in the U.S. in the coming years. And that's going to mean different risks and different returns for those markets. So, strategies that can exploit those different opportunities are likely to be very successful.

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