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Where Next for Bonds?

Is there a deeper secular change on the horizon?

Summary of a webinar with **Jonathan Gregory, Head of Global Fixed Income** and **Alex Wise, Fixed Income Investment Specialist.**

A momentous year for fixed income

- With yields at the highest levels we've seen for many years, there are potentially attractive opportunities in fixed income. We believe this may be a good time to reengage with fixed income, but one must do so in a thoughtful way. What worked before is not likely to work going forward, because the world has changed.
- In the period since the financial crisis, fixed income investors generally did well because inflation rates were low and central banks were keeping policy rates supportive. But we don't believe the world is going to return to that type of environment.
- For validation of that idea, look at what happened in the UK. Over the last 20 years, investors in UK government bonds did well, with stable returns around 5% annually from 2000 to 2019. Inflation averaged around 2% during that period. Then suddenly, in 2022, UK gilts were down around 30% at the worst point, and are currently down about 25% for the year to date. That happened because three things changed:

   1. The inflation story changed,
   2. The politics changed, and
   3. The central bank policy-making changed.

- Those three changes combined to deliver a difficult outcome for investors. While many of the particulars are relevant only to the UK, some of the broader themes about changing central bank policies are relevant globally.
- What happened in the UK could be a feature for other markets coming up. Investors need to be thoughtful to manage around that, and take a different approach than they did in the past.

A return to the pre-pandemic world will be difficult

- We believe that what worked before might not work again, for several reasons.
- The choice between deflation and devaluation: Central banks in many developed markets are acting aggressively to combat inflation. Large rate hikes have happened, and more are coming. Central banks are determined to get inflation back to the 2% target, and have said they are willing to risk pushing economies into recession to achieve that 2% target. That's the deflation story.
- However, the policies central banks are adopting are quite procyclical. Most central banks expect to be fighting inflation in a period of high growth. But they are currently fighting inflation in a period of low growth. And there are additional growth headwinds on the horizon, such as high energy costs.
- The challenge will be when that hawkish stance meets the reality of a recession. It will be difficult to maintain high rates even as economies are moving into a weaker environment and households are under pressure.
- At some point in the coming months, we believe there will be a difficult choice for central banks around whether they can accept somewhat higher inflation for longer than they want, because the collateral damage of hiking rates will be too difficult for the broader economy. The focus will switch to high unemployment and weak growth and away from inflation.
- Any investor contemplating an allocation to fixed income has to do so in a way that's completely flexible, so they can move nimbly if that's how the narrative changes.

First too cold, now too hot

- It may be more difficult than anticipated to bring inflation back to target levels. Don't forget how difficult it was for central banks to get inflation above target. In the immediate aftermath of the Covid crisis, they set policy rates at zero or even negative, and balance sheets in the US grew to $9 trillion.
- Central banks gave forward guidance in an effort to persuade the world that they weren't going to hike rates for years. It took a shocking amount of intervention in markets to get inflation back above target. And ultimately, they probably failed.
- What actually got inflation above target was the extraordinary events around the pandemic. This included the supply chain interruptions and the fiscal largess that was required to get through the pandemic, followed shortly by the war in Ukraine and the energy price shock. So it took an awful lot to get inflation to target, but external events moved it beyond that. We shouldn't underestimate how difficult it might be to get inflation back on track.
- The markets today think that the US and UK central banks will settle into peak rates around 5% next year, and the ECB around 3%. But if inflation proves stickier, those rates may have to go higher still.
- Although fixed income looks attractive right now, investors need to engage with this market in such a way that they could tolerate higher rates still, if that is what's required to get inflation back under control.
- And let's face the fact that, for most policy makers, private investors and professional investors, double-digit inflation is something they've only read about in a textbook. It's unlikely that they've had direct experience managing that kind of environment. So their view on the correct policy response and investment position is derived from textbooks.

Shorter-term drivers of inflation should start trending downward. But what about structural drivers?

- To assess the strength of the economy, the Conference Board looked at leading indicators in the US. Broad-based indicators such as new orders, building permits, credit spreads and the shape of the yield curve are trending down.
- That is a good sign that would point to inflation start trending down in the next few months and into next year. That would be fantastic news and a very pro-bond story. But we believe those are all about the cyclical factors, which are short-term in nature. While the cyclical drivers of inflation are tending to point to lower prices in coming months, we believe those aren't the only drivers of inflation.
- We believe there are also structural issues that act in the longer run – and they don't get the attention that they should. That may be because very few people can agree on what these structural issues are that actually drive inflation. Some might argue there aren't any structural issues that drive inflation at all.
- While there is not a lot of broad agreement about what these are, we believe these are the key long-term drivers:
  - Fiscal policy
  - Monetary policy
  - The labor share of income
  - Globalization
  - The green economy
- For many years after the Global Financial Crisis, these factors all worked to drive prices lower. That was why central banks really struggled to get inflation above target. Today, however, these factors have all gone in reverse, driving toward higher prices. This is likely to make the fight against inflation harder than it might otherwise have been.

Labor markets may be long-term drivers of inflation

- Starting around 2000, the emerging markets labor force joined the global labor force, which was very powerful in driving real wages lower. That helped keep inflation low. In addition, the rise of the gig economy helped accelerate the shift to labor contracts that were very cheap for employers and gave employees very few rights.
- Both those trends have gone into reverse. We all see the challenges to globalization that exist. Those trends are likely to be felt in developed labor markets. As is a pushback against the gig economy, with workers winning greater rights, which is gradually increasing labor costs. In addition, labor forces are aging and shrinking, driving wages higher.

The transition to the green economy

- This is probably the greatest challenge of our age, an existential threat to the world that has to be addressed. Whereas before the winner was the one who delivered the goods at the cheapest price, that world is disappearing.
- Whatever goods or services we are engaging with, the question now is who is the greenest provider. And that is rarely if ever the cheapest provider.
- While new technology starts out expensive and becomes cheaper in the typical cycle, the green transition is going to be very different. We can't wait for things to get cheaper before we adopt them.
- The biggest challenge will be from now until 2030. This transition is either going to show up in inflation, with the costs of baskets of goods and services going up, or it will wind up on government balance sheets as they subsidize the higher prices. Either scenario is likely to be inflationary.

Central banks and their changing approach to managing inflation

- The last time the Fed was hiking, under Janet Yellen, they certainly did things differently. From 2016 through 2018, the Fed and other central banks were pre-emptive and front end-loaded. Their actions were forward-looking based on an economic model about how the economy was behaving and what the policy rate should be. Inflation moved above target only very briefly.
- Today, we've moved from inflation being forward-looking and model-based to something that's reactive, outcome-based and based on current numbers. This is a very different country, and a bit of a challenge for all of us.
- The Fed and other central banks have been slower to react to inflation in a way they wouldn't have been at previous points in the last 20 years.
- It was one thing to underestimate the supply chain interruptions from the pandemic, but it was quite another not to react to the fiscal largess that many governments rightly deployed in the pandemic, because they were hugely stimulative to the economy and consumers. But central banks chose not to react.
- The political challenges around that would have been quite high. But the policy approach has changed dramatically, and investors need to be thoughtful about that.

Monetary policy creates winners and losers

- If you were an asset owner in the post-financial crisis world, generally you were a winner. Central banks wanted asset prices to move higher. If you owned equities or bonds, as rates were cut and central bank balances grew, you did well.
- The losers were generally people who held cash, savers and people who owned currencies that the central banks were trying to depreciate to help their external position.
- Going forward, we shouldn't expect that those winners and losers will remain the same. Political and policy goals can change over time.
- If central banks decide that living with higher inflation is helping to manage higher unemployment or the recession, that will not be a great environment for bond holders. If central banks decide they need to hike rates even further because some of those structural issues come to the fore, that won't be a great environment for asset owners.

The collateral damage of policy normalization

- Over the past 20 years or so, global debt levels have moved relentlessly higher. Whether that's relative to the global economy, where debt is around 350% of GDP, or in absolute terms, debt levels have gone up across all sectors of the economy.
- In the past, the argument was that this didn't matter, because interest rates were low and real yields were negative. Some governments felt that it was the right thing to borrow money.
- But that story doesn't hold up as well when interest rates aren't at record lows. Real yields are at the highest level they've been in years.
- Debt levels have to matter, and they will matter in two ways:
  - By definition, debt service has to get harder if rates are going to be higher.
  - The higher your debt is, the more attractive inflation looks as a policy choice.

A new world of higher inflation and lower growth

- We are probably not going back to the world we were in. Global real growth rates are declining in G7 countries, the US and the Eurozone. Economists disagree about why, but the trend is clearly lower. And IMF projections out to 2027 forecast that the trend of lower growth is still intact.
- With lower growth than we're used to and potentially higher inflation because of structural factors, as well as potentially higher rates, we need to adjust in order to survive in this world. It will require:
  - Flexibility: The ability to move across asset classes as the opportunities change and the risk changes is going to be key in the coming years.
  - A global outlook: Successful strategies are going to focus on global themes, rotating across countries as they experience headwinds, as the UK recently did. If you are too narrow in your fixed income asset allocation, it will likely to lead to unpleasant outcomes. By pursuing a broader attack, investors can harvest attractive yields and attractive opportunities across markets.

What will become of the classic 60/40 portfolio?

- We believe that investors need to cope and adapt in the face of a situation that is going to be quite challenging either way. Either structural inflation is embedded and central banks will have to do a lot more, which is horrible for equities and bonds. Or we will see deflation that tips many economies into recession, and a global recession is going to provide serious headwinds for equities from here.
- Whatever worked in the past may not again. The world has changed. The 60/40 portfolio worked well when inflation was zero and real rates were negative. Discount rates were incredibly low. Rotating out of cash into risk assets was the central banks' goal. It didn't matter what you had, you just had to have it.
- But today, any sort of concrete portfolio directive, such as the 60-40 mix, is unlikely to survive well given the uncertainty and difficulties that are coming. The next 10 years will be about coping and adapting, not hardwiring in any structural biases.

Income is very much back in fixed income

- Over the previous decade, fixed income was seen as a boring asset class, with yields restrained by central bank policy and aimed at stimulating growth and inflation.
- Today, we are in uncharted territory, with inflation across major developed economies surpassing its 40-year highs. As a result, bond yields have repriced, giving us some of the most attractive yields in the very recent past.

Global government bond yields are much higher

- The good news is that the risk-free rates are looking very attractive; the bad news is that the past nine months created a lot of pain for existing investors and allocations.
- At the beginning of the period, the starting yields were extremely low. In the UK, gilts were star underperformers and the year-to-date return has been -21%.
- Global investors have had to own negatively yielding bond markets. German yields rose, leading to a return of -17%. US Treasury yields rose, producing an equally disappointing return of -16.5%. There has been very little room to hide from this deeply negative return environment.
- The only exception is China, where the growth slowdown and property sector crisis have led to a more accommodative policy stance, in contrast to the tightening seen everywhere else. Yields fell just under 0.5%, but bonds delivered a positive 6% return.
- The US Treasury yield curve has substantially flattened since the beginning of the year, driven by the front end. This is the result of aggressive tightening to combat inflation.
- One-year yields have risen from close to 0% to over 3%, and most of the curve is in a tight band around the 4%-4.5% mark.

Aggressive tightening across most major developed market economies

- Looking at central banks sorted from doves to hawks, the ECB has only recently started tightening, and the Bank of Japan is still on hold. The furthest along are New Zealand, the Bank of Canada, and the US Fed, which tightened soonest and at a greater pace.
- It's important to note that policy rates for most of these markets are already in restrictive territory. Additional future tightening is already priced into bond yields, potentially offering an attractive entry point.
- If the central banks have to tighten more than is priced in, yields would go up during the coming year. This is where active management conveys a great advantage. A flexible approach can help investors avoid the lower yielding markets, or those places where pricing hasn't caught up to the economic reality. Instead, they can aim to hold exposures to markets where yields are already attractive and central banks are approaching the end of the tightening cycle, so the potential yield widening is more limited.

Investment grade corporate and high yield credit spreads

- Year to date, credit sector spreads widened across the board, driven by risk aversion, recession fears, liquidity withdrawal, central bank actions, idiosyncratic events such as Europe's proximity to the war in Ukraine, and property sector distress in the Asia high yield complex.
- While not at completely distressed levels, such as those we saw in the early stages of the Covid pandemic, there are still opportunities. At spread levels currently seen, the markets are still pricing in recession fears and are comfortably above the five-year historical averages.
- Outside the hard landing scenario, these are not levels that have been seen before. Investors need to remain flexible and nimble. Credit selection, curve positioning and sector rotation will be key to navigating the more choppy and volatile markets in the next several quarters.

Negative-yielding debt

- Due to rapidly rising yields, the amount of negative-yielding debt has shrunk from as high as $18 trillion to only $2 trillion now in the investment grade fixed income market, as measured by the Bloomberg Global Aggregate Bond Index.
- The total market value of this universe is $60 trillion, so the slice of negative-yielding debt went from 30% to 3% now. This gives us a much wider opportunity set when constructing client portfolios.

More developed market fixed income strategies are now yielding 2%+

- There's another way to look at this from a fixed income sector perspective. Deconstructing the entire fixed income universe, as measured by the Bloomberg Global Aggregate Bond Index, plus high yield, plus emerging markets, only 25% of the market had yields of more than 2% as of the end of 2021.
- Today, this universe has more than tripled to over 80%. Previously, clients had to reach down the credit scale in higher risk sectors and longer duration assets if they wanted attractive yields. This doesn't have to be the case anymore.
- This development allows a better starting point in achieving capital preservation and the ability to hit yield targets. Having access to over 80% of the universe means having additional advantages that weren't available previously.

Attractive bond risk/return profiles

- Higher yields have also brought excitement to bond math. With current yields of about 4% and duration of roughly 8 years, the total return for the 10-year Treasury would be close to 9% should yields fall by 50 basis points (bps) from here, and still positive at 0.2% should yields rise by the same amount.
- In other words, given a 50 bp rise in yields, investors would remain protected from negative total returns through carry. That is not a bad asymmetry to dip into. This is evidence that the asset class is in the later stages of the policy cycle, which is something fixed income investors haven't experienced in a very long time.
- At the beginning of the year, when yields were around 1.5% and duration somewhat greater at 9 years as a result of those yields, the same math would lead to a 6% return if yields fell 50 bps, and a -3% return should yields rise by 50 bps. That is a ratio of two to one versus an absolute positive return regardless.

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