(UBS)

Quality bonds offer an attractive source of diversification and income

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The Chief Investment Office (CIO) are positioned for further equity gains amid solid earnings growth, but also believe quality fixed income plays an essential role in portfolios.

CIO sees particular value in short-duration bonds in the current environment as they believe markets have priced in too much tightening from top central banks.

The Federal Reserve remains on track for further easing. Fed Chair Jerome Powell recently downplayed the need to tighten monetary policy in response to higher energy prices, noting that policymakers typically look through supply shocks such as oil spikes, especially as inflation expectations remain well anchored. While the US central bank is seeking further evidence of sustained core inflation declines before easing again, we still expect 50 basis points of interest rate cuts later this year. With Treasury yields well above their pre-conflict level, we see ample room for them to fall toward our year-end targets of 3.25% and 3.75% for two-year and 10-year Treasuries, respectively.

The European Central Bank should stay on hold despite its hawkish tone. ECB President Christine Lagarde this week said higher energy costs have pushed the Eurozone away from the bank's base case outlook, and that the ECB is weighing its options. Given the bank's sole inflation mandate and its projection of the Iran war having a larger effect on inflation than on growth, current market pricing is for the ECB to deliver two rate hikes by the end of the year. But the current economic backdrop is notably different from 2022 when Russia invaded Ukraine. The ECB's policy has only just recently returned to a neutral setting, and the labor market has been softening. Given the risks the conflict poses to the growth outlook and the tightening of financing conditions that has already occurred in bond markets, we believe the ECB is unlikely to rush into hiking and will likely keep rates on hold through the end of the year.

Quality bonds offer an attractive source of diversification and income. Bonds offer compelling risk-reward in the current environment, in our view. If energy flows from the Strait of Hormuz start to normalize, yields should fall as investors scale back their expectations for rate hikes; if the disruption continues for a prolonged period that weighs more heavily on growth, interest rate cuts should drive yields lower too. The appealing combination of durable income and the potential to perform well in the event of slowing economic activity means investors should retain sufficient exposure to quality bonds in their portfolio.

So, we think the recent rise in benchmark government bond yields in USD, EUR, and GBP creates an opportunity for investors to "lock in" attractive yields. Our preference is for short- to medium-maturity quality bonds for global investors. Holding some exposure to higher-beta segments such as emerging markets, high yield, or subordinated debt should also help build a diversified income strategy.

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