Investment Insights

How to think about bonds in this new world

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Marketing communication

How to think about bonds in this new world

Key takeaways

- Ultra-loose central bank monetary policy over the past decade led to bond yields falling significantly. This meant investors had to take on increasing levels of risk to get the same amount of yield as before. Benign inflation also enabled central banks to focus on delivering financial stability.
- But policy is now normalising. Central banks have broadly moved away from the era of quantitative easing (QE) and zero interest rate policies into one where interest rates and market volatility are now both higher. In this environment, portfolio diversification will become an increasingly important component of portfolios.
- The key attributes that enable fixed income to play such a core role in portfolios: capital preservation, diversification and income all exist on a spectrum. The area of the market that best combines these attributes, the 'sweet spot', is currently global investment grade credit.

After the global financial crisis (GFC) in 2008, investors reduced their allocation to bonds, and broadly remained underweight the asset class for more than a decade. In 2022, the long period of accommodative central bank policy came to an end as inflation accelerated. The shift in the macroeconomic environment means that for the market cycles ahead, it is important for investors to look at fixed income allocations differently.

In this paper, we share why we believe in the value of fixed income in portfolios, and how bonds should be viewed in this different world.

A decade chasing yields

In the aftermath of the GFC, the world's major central banks cut policy interest rates in an effort to stimulate their respective economies. However, with growth remaining stubbornly depressed and inflation low or even negative, central banks were forced to adopt increasingly innovative programmes such as QE.

These policies had three clear consequences on financial markets:

1. **Investors had to take on increasing amounts of risk** as QE led to yields moving lower and lower. In turn, this meant assets not directly within central bank purchase programmes such as equities and private credit rallied.

2. **Bond yields became very low.** For a time, the entire German yield curve was negative, and the German government was able to issue negative yielding bonds. For bond investors this meant there was only a very small income buffer to absorb any negative bond price volatility.

3. **Inflation remained stubbornly low, leading to the idea developed economies had entered an era of secular deflation**. Against this backdrop, central banks' focus was perceived to shift towards ensuring financial stability.

The combination of low returns on defensive assets and a perception central banks had investors' backs all but removed the need to maintain a truly defensive allocation within an overall portfolio.

How did asset allocators use fixed income over the past decade?

As bond yields fell, many fixed income investors felt that the risk and return trade off to hold 'traditional' fixed income had become too unbalanced and that increasing credit exposure offered the better opportunity. Investors therefore tended to maintain overweight allocations to credit while underweighting duration despite the drag the latter position often placed on results as yields grinded ever lower.

2022 – what changed and what it means

As the global economy transitions from a backdrop of QE and zero interest rate policies to one where interest rates and volatility are both higher, asset allocators need to rethink their defensive strategies. What worked in the 2010s is unlikely to be as effective in the 2020s and beyond.

The return of and persistence of inflation has raised the challenge for central banks seeking to balance price and financial stability. The bar for central banks to intervene when the economy slows, and financial markets fall is now much higher.

Central banks massively expanded their balance sheets during the 2010s and COVID era, as they sought to stimulate their economies and halt deflationary pressures. Today, they are reversing this process and reducing their balance sheets through quantitative tightening (QT). The withdrawal of such large purchasers of bonds from the market removes an important factor that has helped suppress yields since the GFC.

These changes represent a normalisation of policy away from the extraordinary period of central bank intervention and financial repression of the 2010s and early 2020s. We anticipate therefore that this new regime is here to stay and unlikely to revert for the foreseeable future. In this environment the defensive attributes of conventional fixed income mean the asset class is potentially well placed to meet investors' defensive needs.

Revisiting the roles of fixed income

1. Capital preservation

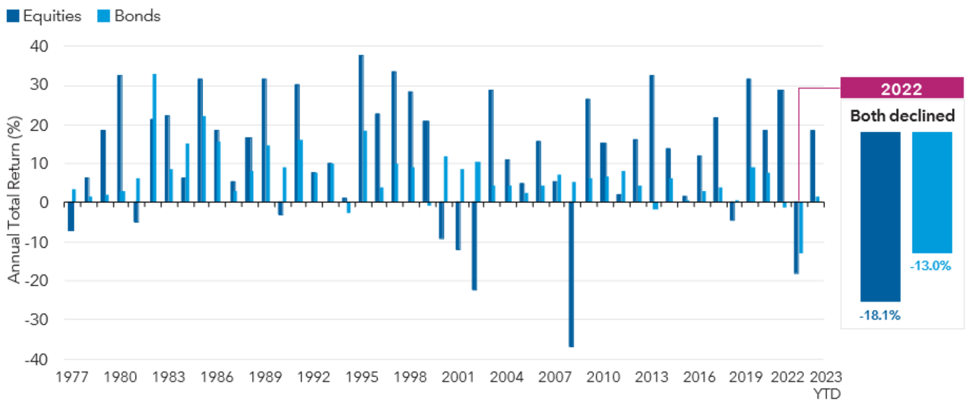
A fundamental aspect of investing in the bond market is whether an issuer will meet its commitment to pay interest and return the principal as outlined in the bond documentation. This credit quality is determined by both the underlying fundamentals of an issuer and the seniority of the bond within an issuer's capital structure.

The rise in bond yields since 2022 means that investors can now hold higher quality credits while still achieving their income objectives. This greatly improves the defensive qualities of their bond allocation. It is important however to not simply rely on the underlying credit rating, but to undertake in-depth research to gain a comprehensive understanding of the issuer.

2. Diversification from equities

Investors expect fixed income to rally during periods when equities come under pressure. An increase in the correlation between equities and bonds has however led to questions over the latter's role in a portfolio. While it is true that there have been periods when the correlation between the two asset classes has been positive, it is important to understand that these are the exception and not the norm, particularly during a falling market. As the below chart highlights, 2022 was the only year in the past 45 years when both bonds and equities were positively correlated in a falling market and delivered negative results for investors.

2022 was an exceptional year of positive correlation between equities and bonds



As at 31 Aug 2023. Equities: S&P 500 Total Return Index. Bonds: Bloomberg US Aggregate Index.
Source: Bloomberg

One reason why bonds provide this diversification in returns is their duration. When an economy slows, equities might be expected to come under pressure, however, at such times central banks typically look to ease monetary policy, and so because of their duration – a measure of interest rate sensitivity - bond prices appreciate. This relationship also typically applies during periods of market stress. At such times, high quality bonds, particularly longer dated ones, have generally provided downside protection in a flight-to-quality, even when yields have been very low or negative.

Conversely, when inflation rises excessively (which might occur during periods of very strong economic growth) central banks may look to increase interest rates. This would be negative for bonds, but in normal market conditions, the negative impact on the bonds price is offset, at least in part, by the yield.

This relationship did not hold in 2022 because starting yields for bonds were extremely low, and the increase in interest rates was so fast that bonds were unable to offset the losses with coupon income. This was an exceptional situation and as we approach the turn in the cycle, duration should switch to being a tailwind for the asset class and correlations normalise.

In our view it is therefore important that your bond portfolio has sufficient duration to provide this defensive role.

3. Income generation

Unlike equities, bonds typically offer more explicit and predictable income streams in the form of coupon payments. While the yield will fluctuate with the price, coupons on fixed rate bonds typically do not change and are therefore a potentially steady source of income for investors.

Following the global sell-off in fixed income since the beginning of 2022, starting yields are significantly higher. These higher yields suggest higher returns going forward – mainly driven by income, which could also offer a greater cushion against any future price depreciation. This also reduces the risk investors overreach for yield to achieve their income objectives. Instead, they can reduce the overall risk of their bond portfolio.

Central banks could pause and leave policy rates high, in which case bond investors will continue to earn the current high level of yield. Alternatively, they could pivot towards cutting rates, meaning bond holders would benefit from both the high initial starting yield and the duration tailwind from falling interest rates.

Building a new core

Given the importance of capital preservation, diversification and income in building the defensive allocation of your portfolio, we believe that the best combination of income, credit quality and duration can be found in the global investment grade corporate bond market.

This is not only because investment grade corporate bonds typically offer a higher yield relative to high quality government bonds, but also because the market structure has slightly changed. The duration of the global investment grade corporate index has increased over the last couple of decades (see chart below). The pronounced lengthening over the last decade in particular has resulted from companies being able to issue longer dated bonds to lock in a lower yield for longer while demand was strong, given significant liquidity in the market. While the steep rise in yields since early 2022 has seen the duration profile dip modestly lower, global investment grade corporate bonds continue to offer an additional year of duration compared to levels at the start of 2010.

Global corporate bond duration has increased over the years

As at 31 July 2023. Source: Bloomberg

The global nature of the market also means that investors can draw on a much larger pool of investment opportunities. A wider group of assets can increase an investment portfolio's ability to deliver income, return, liquidity and diversification.

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