15 NOVEMBER 2022

Bonds are back in the game

Summary

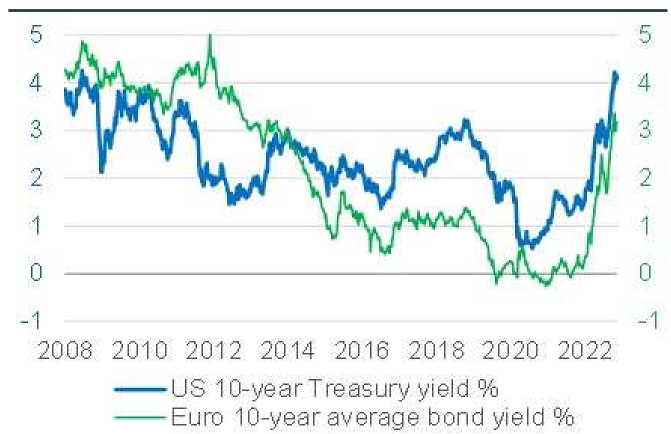
- This year has been one of the worst years on record for bond investors. In 2022, US long-term Treasury bonds are registering their worst annual performance in over 230 years (according to Bank of America data).
- The explanation lies in the sharp reversal in formerly loose central bank policies. They have hiked policy interest rates sharply as inflation has surprised with its vigour, reaching levels not seen since the 1970s.
- The value of existing bonds falls when inflation and interest rates rise. In addition, most existing bonds pay relatively low coupons and thus offer little income offset to the negative price effect linked to rising interest rates.
- We expect bonds to rebound in 2023. Policy interest will reach their highs for this cycle early 2023. Inflation is expected to peak and then decline in the coming months, allowing central banks to pause soon. We expect rate cuts to start in early 2024.
- Bond yields should thus stabilize and gradually fall in 2023, benefiting existing bonds.
- **Our Preferences:** We favour US government and investment grade (IG) corporate bonds for USD-based investors. For EUR IG corporate bonds, we are more selective and prefer high quality investment grade issuers. We also like Emerging Market sovereign bonds, both in hard and local currency.

Bond yields return to 10-year highs

As recently as January of this year, the German 10-year government bond yield was negative, reflecting the ongoing zero interest rate policy by central banks including the European Central Bank. Since then, investors have seen a radical shift, with the average Eurozone 10-year bond yield today over 3% (the highest level in 10 years), while US 10-year Treasury bonds offer around 4% (the highest yield since 2008).

The stock of global bonds with negative yields had touched nearly USD18 trillion in value by the end of 2020; today, this has shrunk to less than USD1.8 trillion-worth of negative-yielding bonds today.

HIGHEST US 10-YEAR BOND YIELD SINCE 2008, HIGHEST SINCE 2012 IN EUROZONE



Source: Bloomberg

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Central banks shift course sharply

Interest rates and bond yields have witnessed a rise rarely seen in history. In the US, the Federal Reserve policy rate is expected to reach 5% by early 2023, compared to almost zero at the beginning of this year. 10-year government bond yields are currently around 4% in the US and 2% in Germany. At the beginning of the year, they were around 1.5% in the US and below zero in Germany.

The value of existing bonds depends on the expected path of interest rates. When interest rates rise unexpectedly (often in response to surprisingly strong inflation, as has been the case this year), new bonds will be issued with higher coupons and yield to maturity. This yield to maturity represents the total return to an investor who holds the bond until maturity, at which point the bond is redeemed.

Existing bonds have lower coupons and will only become attractive again when their price falls. Indeed, if the price falls sufficiently, the combination of a lower price and lower coupon can be such that both existing bonds and new bonds can have the same yield-to-maturity.

This explains why bonds have witnessed such poor performance this year. It is also important to notice that bonds have a different interest rate sensitivity to interest rate movements. Other things equal, bonds with a longer maturity witness a bigger price fall for any given interest rate rise.

Worst performance in decades

Over 2022 to date, US 10-year Treasury bonds have returned -19.2%. The next worst year over the last 95 years for bonds was 2009, when US 10-year Treasuries returned -11.1%. On average, over these 95 years US 10-Year Treasury bonds have delivered an annual 5.1% average return. Note that even during the inflationary 1970s decade, US bond returns were relatively healthy. Note too from the chart below that it is very unusual to have two negative years of bond returns in a row - this was last seen in the 1950s, but even then, the bond returns were only modestly negative each time. Nothing like the scale of the losses experienced today.

Poor annual US bonds returns were followed by substantial rebounds the following year. Between 1928 and 2021, there have only been 6 occasions when annual US 10-year Treasury bond returns were -5% or worse. On each occasion, the following year saw a rebound of at least +8% in US bonds returns.

Note, moreover, that the stagflationary 1970s period does not feature at all in this short list of the worst annual US bond returns. Even back then when inflation was anywhere between 4% and 14%, nominal bond returns were nowhere near as bad as in 2022. Given our expectation for falling US growth and inflation in 2023, this all suggests a good chance of positive bond returns next year.

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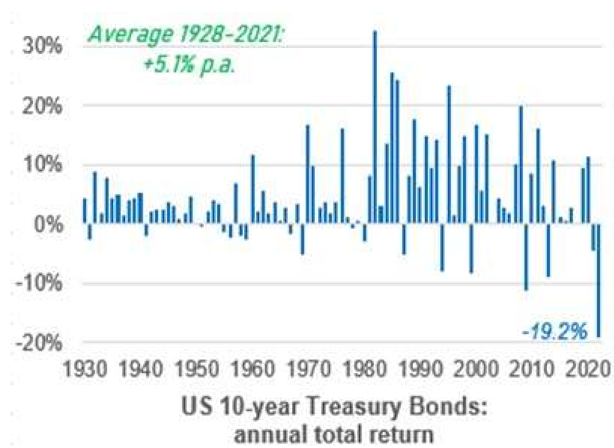
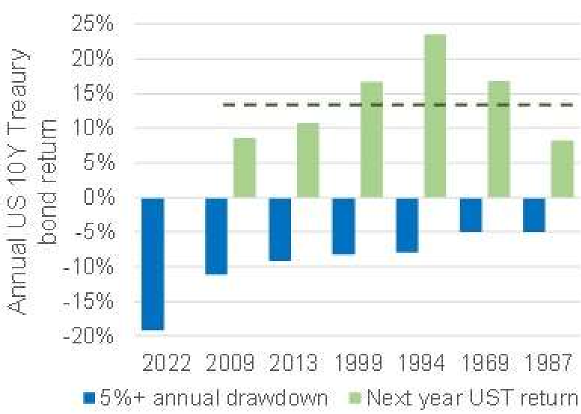


Source: Bloomberg

ANNUAL 5%+ DRAWDOWNS IN US TREASURY BONDS HAVE BEEN FOLLOWED BY REBOUND



Source: Bloomberg

Peak inflation, lower bond yields

Central banks have been forced to hike rates much more than initially expected. Inflation was expected to peak earlier this year, but the sharp worsening of the energy crisis linked to the war in the Ukraine brought a renewed spike in prices. We expect inflation to peak this quarter in the US and with a few months delay in the eurozone. Energy prices have stabilized, and supply chain constraints are easing rapidly. We expect a moderate recession both in the eurozone and the US. This suggests that the Fed and the ECB are close to the end of their rate hike cycle. We expect the Fed to reach a terminal rate of 5% in February and the ECB 2.75% (deposit rate) in March 2023.

Given the lessons of the 1980s when the US central bank cut rates too quickly, we expect first a pause for the rest of 2023. Monetary authorities would only start cutting rates early 2024. We have a 12-month target of 2.5% for the 10-year German yield and 3.5% for the 10-year Treasury yield.

Also note that this major shift in yields has led us to increase our long-term (10-year) expected return for government and Investment grade corporate bonds by around 1.5%. We thus see a long-term buying opportunity. It is too early to come back on High-yield corporate bonds.

Bond market opportunities

As both inflation and interest rates are expected to peak in the coming month, it is logical to expect bond yields to fall gradually over the coming year. Indeed, the yield of a two-year maturity government bond mainly reflects the expected path of interest rate over this period. As we expect the Fed to cut rates early 2024 this will impact two yields even before the central bank will cut rates. Same logic for longer maturities. Bond yields generally peak 1 to 2 months before the last rate hike of the central bank. As explained in section 1, bond prices are sensitive to interest rate movements. If they fall, the price of existing bonds should increase as new bonds are issued with lower coupons and investors prefer existing bonds. This suggests that if our scenario plays out, bond prices should be rising in the coming year. What is even more important is that yields offered by bonds today are generally 2% or 3% higher compared to last year. It is currently possible to find high quality corporate bonds that offer a yield to maturity around 6% in the US and 4% in the Eurozone even for maturities less than 5 years.

We are Positive on US government and IG bonds for USD-based investors. We stay Neutral on German government bonds due to a possible modest further increase in long term rates in 12 months. For EUR IG corporate bonds we need to be more selective, and we prefer higher quality issuers within investment grade bonds. We are positive on EM bonds, in hard and local currency. Risks seem largely priced in now. Many central banks are close to the end of their rate hike cycle. We also expect a weaker dollar in 2023 and this is a positive factor for issuers in these countries (the burden of the debt issued in USD is expected to fall in such a scenario). We prefer commodity exporters and quality issuers.

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