

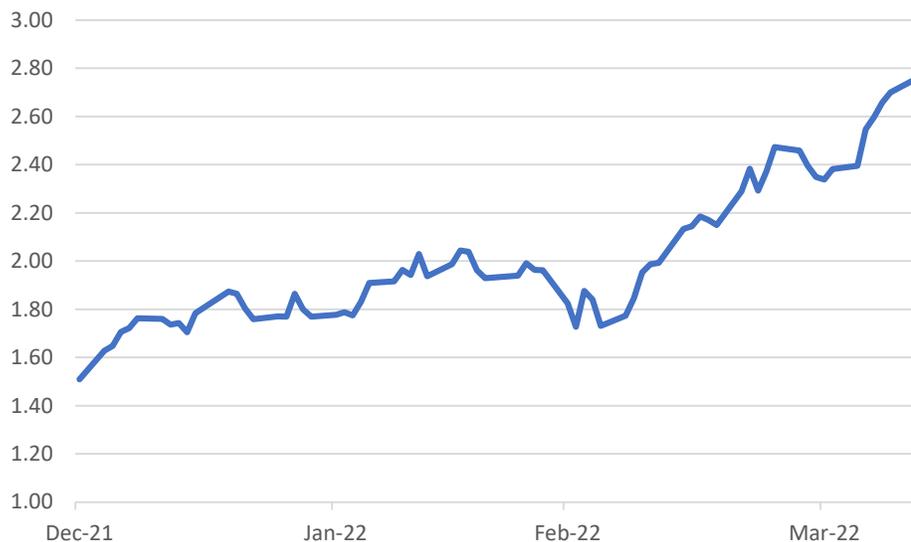
April 11th, 2022

The Bond Reset is Here. Now What?

- **The risk that persisting inflation presents is still a big deal for government bonds; the safe-haven status of fixed income as an assetclass is undermined**
- **Higher yields have brought bonds back into the conversation of income seekers**
- **There's more logic to the equity market sell-off with defensives outperforming**

The markets just can't shrug off last week's roughly 35bps rise in the US 10-year bond yields. Last week, we also noted a near double-digit inflation in the food industry. Judging by the hawkish commentary from the Fed officials throughout the week, it is evident that the Fed wants the market to know that rates will have to go up aggressively in terms of both the magnitude and speed.

Chart 1: US 10 year Government Bond Yield Soars Higher



Source: Bloomberg

It was not too long ago that a simple screenshot showing global bond yields would reveal many negative numbers. The press was full of comments lamenting the vast pool of bonds yielding below zero. It was viewed as uninvestable, apart from those with regulatory duration commitments or central banks practising the new science of quantitative easing (QE). It's an entirely different scenario now. Some small parts of the curves of some countries (Japan, for example) are still under water. For the rest, it is clear that a reset to a more normal (read: looks like before QE) rate structure is under way.

What does this mean for investors? Liquid bonds – governments, corporate, high yield and emerging debt – serve two primary purposes in portfolios, namely risk diversification and providing a provision of income streams. The recent reset in yields has brought more recognizable income back into the bond market. Bonds are usually a diversifier and safe haven in times of market stress. However at the moment it is a different matter. The distinction is important to bear in mind. In a recent poll of US economists by Bloomberg, the consensus view of the expected inflation rate for the final three months of this year has risen to 5.7%, up from 4.5% just a month ago. Compare this with the Fed's target of 2%. No serious forecast is anywhere near that target. While the market consensus has been to see a surge in inflation, what is alarming to investors is that even the previous highest forecasts have proven to be too conservative. Some analysts are calling for a recession, sensing the risk that the Fed will overreact to get a grip on the inflation threat.

Persistent inflation risk undermines the safe-haven status of bonds. Such a scenario still seriously undermines the status of government bonds as a haven for investors. If markets' main threat is that the current inflation spike will turn into a high inflation plateau, government yields could rise a lot more. The US 10-year government yield had increased to 2.7% by the close of last week. With inflation expectations hovering above 5%, it will struggle to stay that low.

For income investors, opportunities are emerging. As government bond yields commenced their reset, the performance drag was felt across all fixed income segments, including the whole credit universe. The losses in the credit universe year-to-date have been in the range of 5% to 10%, with the larger numbers reserved for the wonky bits of the Chinese property sector and those high-grade sectors with ultra long duration exposure. However, in the high yield market and among emerging markets, the entry levels for yield investors are now much more realistic. In these two markets, sensible exposures can now be crafted with forecast yields between 5.5% and up to 7% in some cases.

Chart 2: US high yield income stream up substantially from the start of the year



Source: Bloomberg

Default risk is still manageable. For the most part, the economic backdrop, for now, does not appear to carry with it the seeds of a default wave. On average, HY and EM debt runs at annual default rates of around 2% to 3%; this is roughly where most market models have the next 12 months pegged (Moody's and S&P, for example). So, while government bonds might have exited the negative territory in nominal yields terms, they are still negative in real (inflation-adjusted) terms. Credit bonds will soon offer something above inflation.

A final note on the action in credit. When all yields hover at their lows, there is little to pick between good and bad credits. Even the mild shake-out that the market has seen in 2022 has caused a dispersion between weaker and stronger credits. In such an environment, one could expect active managers to thrive.

We maintain our cautious stance on the equity markets, although there was something more logical to the market action at least last week. With technology, transport, and semiconductors under fire, the risk-on sectors took a bit of a beating last week. **Meanwhile, the more defensive sectors such as healthcare and real estate have performed better**, with robust performance from consumer staples and utilities. Healthcare was up close to 4%, and REITS have made a comeback after investors had fretted that higher interest rates would in some way damage the prospects in the real estate sector. REITs have continued to display strong rental growth and should continue to benefit from the ongoing housing shortages. The benefits of higher rents don't necessarily help housebuilders facing high-cost inflation pressures.

Higher bond yields may, in time, pull some cash away from the yielding equity assets, but investors may, for the moment, take the view that the bond sell-off is not complete given the forecasts for inflation for the back end of the year.

Gary Dugan

Johan Jooste

Bill O'Neill (Consultant)