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Asset Management

FIXED INCOME OPPORTUNITIES
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Marketing Material

# Bonds beckon

Real yields have surged across all classes of fixed income. This is creating opportunities for investors not seen for many years.

## Table of contents

01 A fixed income renaissance

02 Higher for longer

03 Accidental central banking

04 We've been waiting for you Mr Bonds

05 Remain wary of risk

## 01 A fixed income renaissance

Fixed income is undergoing a renaissance. Increasingly, investors are being compensated for risk – and in some cases rewarded. This represents an extraordinary sea change: during the past decade and longer, bonds were priced at untenably expensive levels.

For example, real 10-year rates in the US have gone from minus 1 per cent to 1.5 per cent in a matter of a few months. Swings of this magnitude are generational events. And they've been even bigger elsewhere. In the UK, for instance, real rates have jumped from minus 2 per cent to 2 per cent. At any point in the modern history of investing, the prospect of locking in real rates of 2 per cent in developed fixed income markets has been attractive.

These real yields are an oasis of crystal cool water in what's long been an unforgiving desert. Undoubtedly, we'll look back in wonder at the era when some three-quarters of sovereign bonds issued by the richest countries posted negative nominal yields.

To be sure, caution is warranted in light of geopolitical and macroeconomic upheaval. Investors should perhaps ease back into fixed income rather than plunging head first. And they need to be selective. But while there are parts of the fixed income universe that remain the preserve of adventurous investors, it has also become easier to envisage the point at which they too will become attractive long-term investment opportunities.

## 02 Higher for longer

One reason for caution is that while in some respects inflation appears to be moderating, it's unlikely to fall as fast as central bankers expected a year ago. Which is why it's premature to draw the conclusion that the war against inflation has been won.

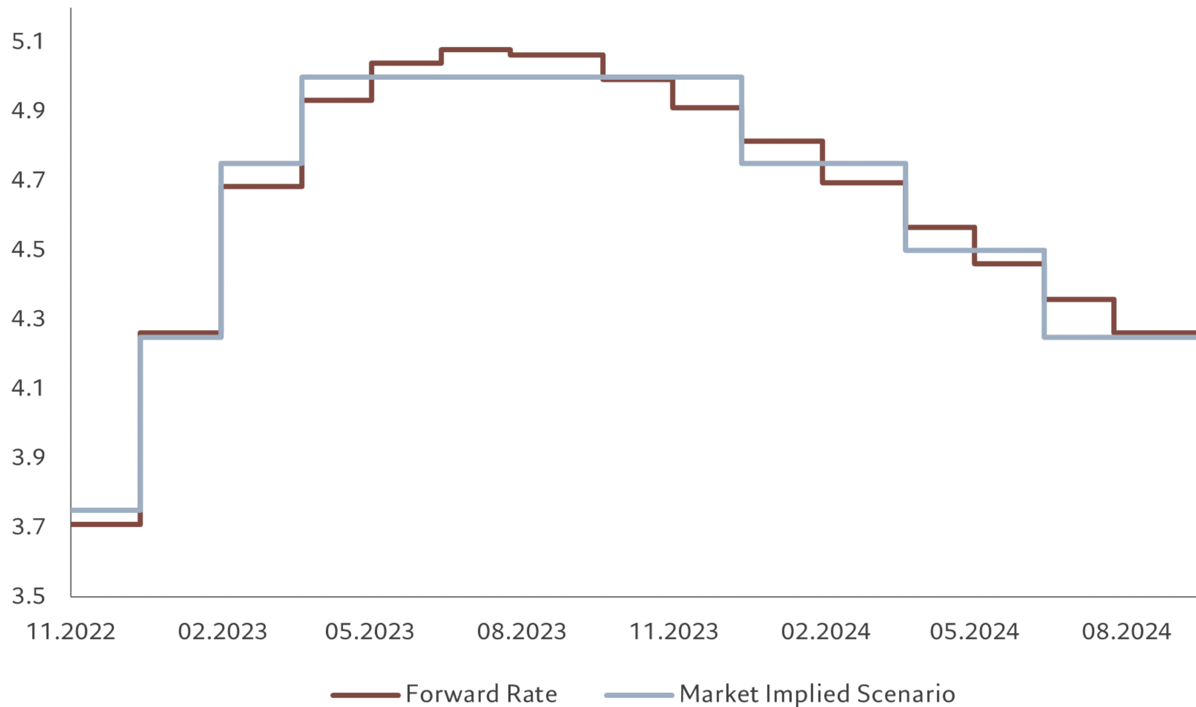
The risk is that central banks now maintain rates higher for longer. This, though, is unlikely to be a mirror of the lower-for-longer regime that persisted for roughly a decade following the global financial crisis that began in 2008 – though it will still take at least an extended period of uncomfortably high rates before inflation edges back towards central banks' original target ranges (broadly 2 per cent across much of the developed world).

For now though, markets seem to be anticipating an interest rate overshoot. US Federal Reserve Chairman Jerome Powell has recently been referring positively to his uber-hawkish predecessor Paul Volcker, best known for finally overcoming the US's last big inflationary episode of the late 1970s and early 80s. This suggests an increasing tilt towards erring on the side of excessive tightening rather than watering down policy measures before they've fully

subdued inflation. Indeed, 75 basis point rate increases at policy meetings seems to have become the new normal.

Fig. 1 - Quick up, slow down

Implied forward Fed funds rate, %



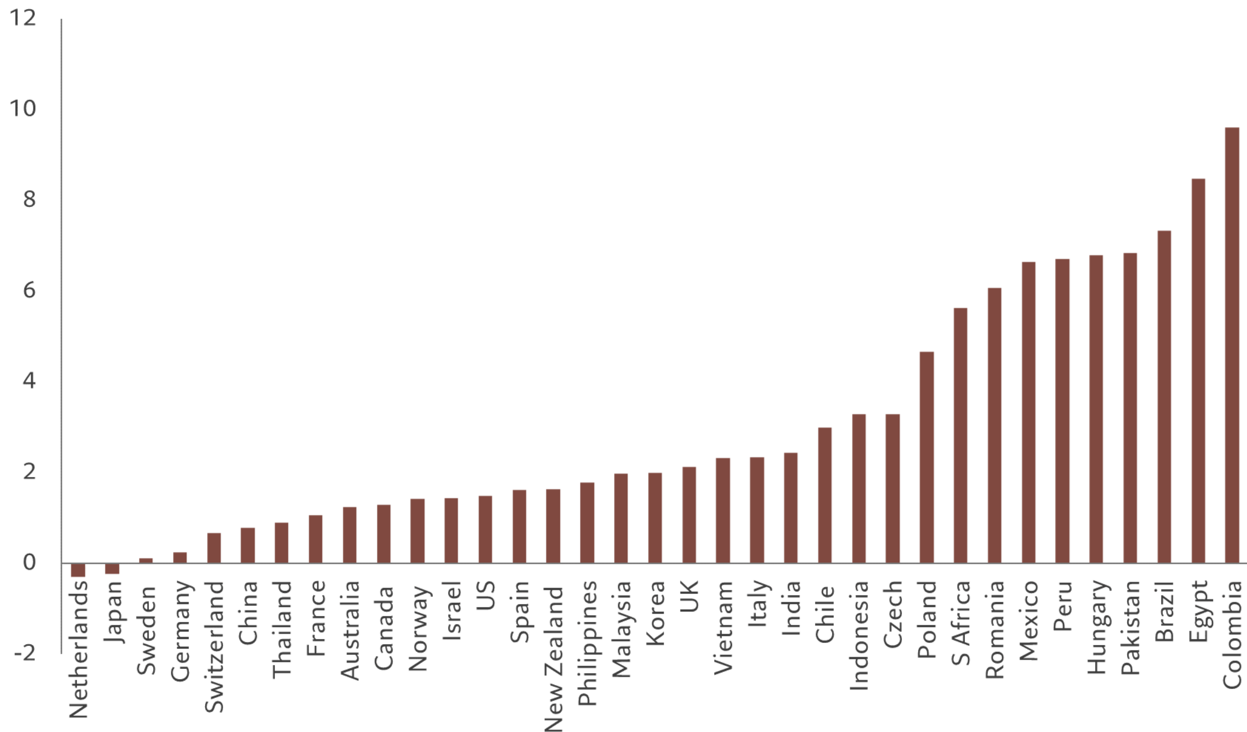

Source: Bloomberg, Pictet Asset Management. Data as at 21.10.2022.

As a result, the markets are pricing in a peak in Fed funds of some 5 per cent during the first half of 2023, followed soon after by a return to monetary easing (see Fig. 1). This seems an overly optimistic reading of how fast inflation is likely to be driven back to the central bank's target in light of persistent price pressures and a tight labour market.

But whatever happens once the interest rate cycle peaks – whether rates plateau or the Fed quickly starts easing again – the very fact that monetary tightening has run its course is a strong signal for the markets. At that point, longer-dated bonds are likely to start to look attractive, irrespective of whether the Fed starts cutting soon after or allows rates to plateau at that higher level for some time.

Fig. 2 - Sovereign attractions

Local 10-year real government bond yields*, %




*Deflated by Pictet Asset Management 2025 CPI inflation forecasts. Source: Pictet Asset Management, CEIC, Datastream. Data as at 26.10.2022.

Today, longer-dated bond yields are attractive but volatility means investing in such securities is a potential hazard. So short-duration, high quality bonds are our preference for now. Even corporate bonds with short maturities are offering attractive opportunities for investors – risks (like a sudden economic slowdown) are being balanced by unusually attractive rewards over this very short time horizon. And as we push into 2023 and clarity emerges on inflation, investors will be able to move further along the curve and particularly into government securities, where real bond yields already look attractive (see Fig. 2).

## 03 Accidental central banking

Complicating the picture is central banks' fear of causing an accident. The Bank of England was recently forced into buying UK government bonds (gilts) to stabilise long-dated yields for fear of causing a meltdown in the pension sector. Pension funds had become over-leveraged to the gilt market through derivatives as they tried to squeeze bits of additional return out of a zero-rate world. That leverage turned around and bit them as yields started to rise,

especially when the market panicked about former UK Prime Minister Liz Truss's profligate approach to public finances in the mini-budget.

The Fed, led by Powell, is less likely to blink. Not only is a degree of financial market stress proving to be acceptable to US policymakers, but it's also probably desirable as a tool in the war against inflation. It helps that the US is further away from the sort of stagflation that's beginning to weigh down euro zone economies. And with much of US demand fuelled by financial market excess, it will take some very sharp drops in asset prices for the Fed to U-turn. Indeed, it was the crisis in credit markets that caused the Fed to launch its extreme policy responses in March 2009, at the height of the global financial crisis, rather than a near-60 per cent slump in equity prices. Whereas during the time of the zero lower bound, central banks used wealth effects to prop up demand, now they're likely to use negative wealth effects to suppress both demand and inflation.

> *“ Complicating the picture is central banks' fear of causing an accident. ”*

And any emergency response could well be short of relaunching quantitative easing. For instance, should the long end of the bond market become dangerously volatile, the Fed could yet restart its operation twist, where it attempts to flatten the yield curve by buying long-dated bonds and selling shorter-dated ones. It would then rationalise such a move as a neutral measure in terms of monetary stimulus, designed to stabilise the market.

One concern is the degree to which sovereign bond markets are vulnerable to an exodus of capital. Since the advent of quantitative easing, significant slices of government bonds are held by central banks – nearly half all the securities outstanding in the case of Japan – which is essentially ‘safe’ in the sense that central banks can hold them indefinitely. Another major tranche is held by domestic financial institutions needing to meet regulatory requirements. The vulnerability of these markets then rests in the amount held by foreign investors. And that varies considerably by country.

## 04 We've been waiting for you Mr Bonds

Where, then, does that leave investors?

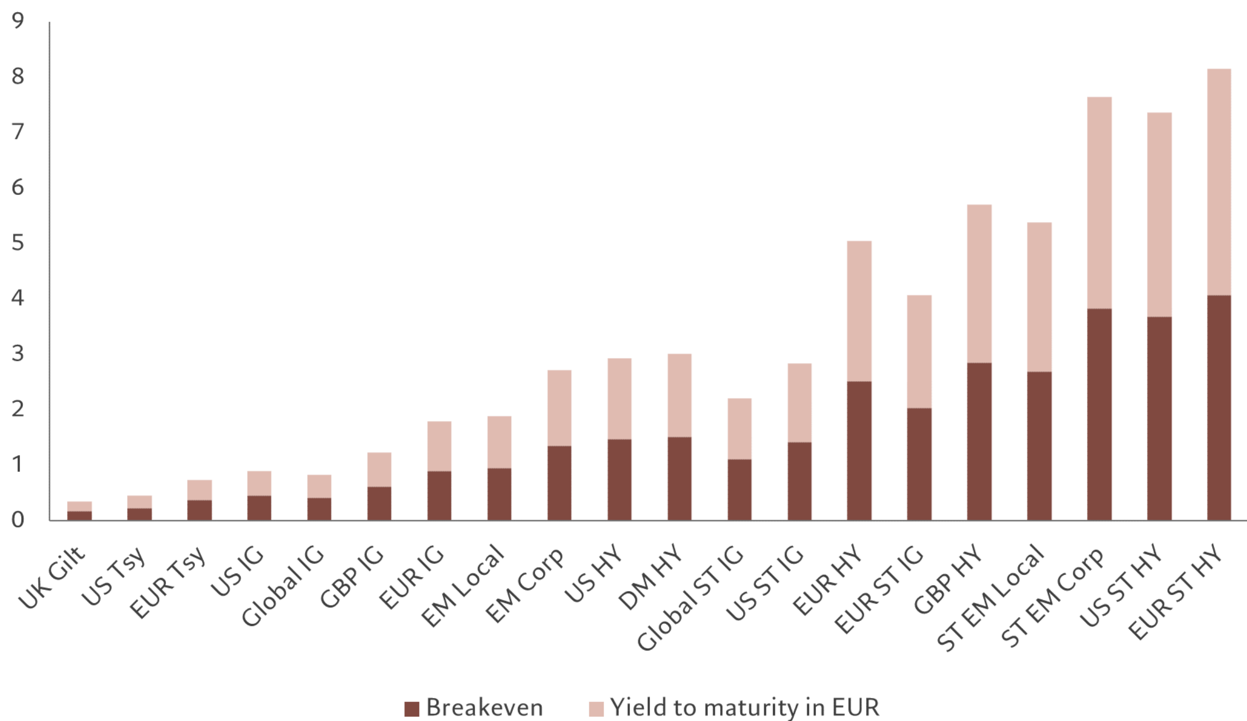
Historically, this stage of the economic cycle, where interest rates are still rising but inflation shows signs of stabilising, tends to favour developed country sovereign debt in the first instance. The appeal of such bonds will depend on real yields, the relative valuation of the relevant currency and the degree to which the market might be vulnerable to capital flight.

It can be argued that US Treasury bond yields are fast reaching the point where they are fairly priced, especially in the front end of the curve. Other G10 central banks are lagging the Fed in their tightening cycles, but by and large their domestic bond markets should also arrive at fair value in the coming quarters.

What's more, investors have a significant margin of safety. Yields have risen enough that investors can take significant further drops in bond prices and still generate positive inflation-adjusted returns (see Fig. 3).

Fig. 3 - Margin of safety

Breakeven yields relative to yield to maturity by fixed income class*, %




*Legend: IG=Investment Grade; HY=High Yield; ST=Short Term. Breakevens are derived by dividing the yield of each fixed income class by its duration. Source: ICE BofA Indices, Bloomberg, Pictet Asset Management. Data as at 21.10.2022.

## 05 Remain wary of risk

So far, equity investors remain relatively sanguine, even as credit markets have struggled. Yes, the S&P 500 has lost 19 per cent in the year-to-date, but this magnitude of decline is hardly symptomatic of severe market stress.

In part, this relative stability in equities reflects the fact that corporate profits and margins have, so far, held up well. But that is unlikely to last long. Companies are vulnerable to a combination of inflation, rising costs of debt, weakening growth and a stronger dollar – which is bound to weigh on earnings.

As an aside, it's worth noting that one other reason for the equity market's orderliness is that many equity asset allocators entered 2022 with low or no leverage and have since actively hedged away or sold their equity holdings to avoid being wrong-footed by a leverage-triggered selloff. Which is why equity volatility has been contained relative to past selloffs – but it doesn't mean it is immune to further upheavals. And that's a concern for credit investors, too. As companies face increasingly difficult conditions, equity and credit markets tend to move in lockstep: credit and stock market crises tend to coincide.

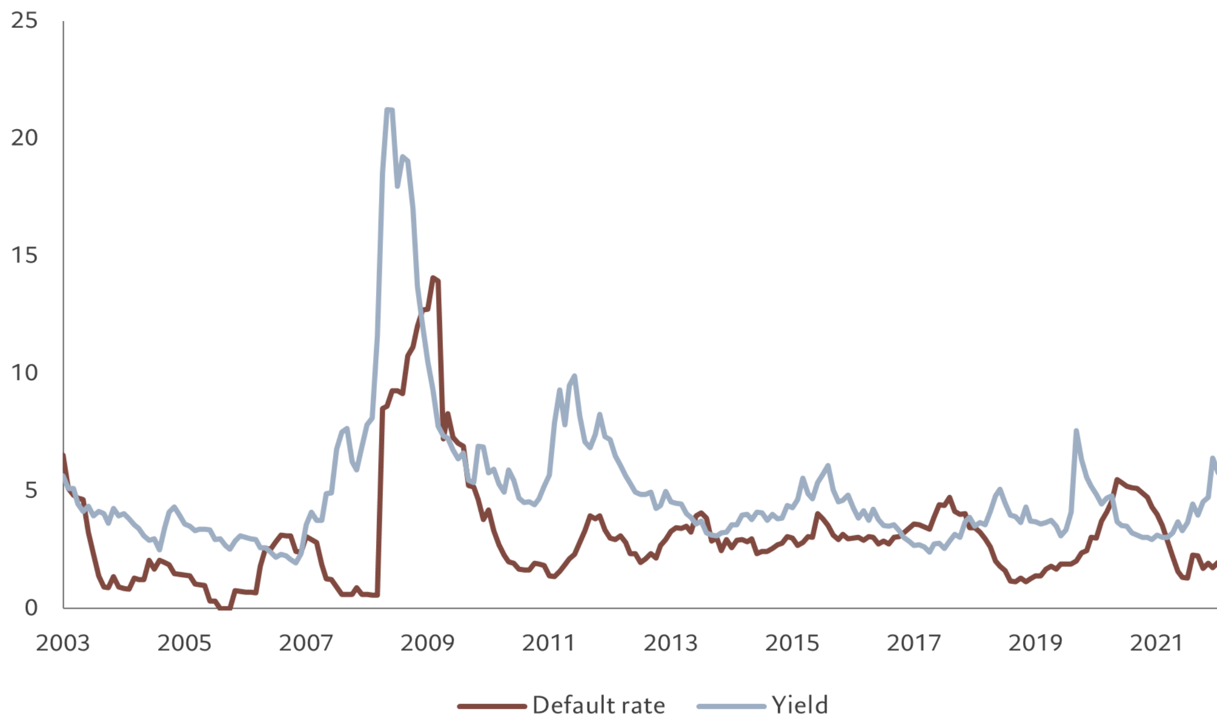
In the past few decades, equity investors have been able to rely on the so-called 'central bank put' to bail them out of difficult times. But in the face of persistent inflation, that insurance policy is likely to have expired.

Meanwhile, most people aren't yet focused on the flood of corporate debt that will need to be refinanced over the next few years – after all, it won't start to ramp up until 2024. But that ignores the fact that corporate treasurers will try to get their funding done well ahead of time, especially if they are concerned that this supply will cause spreads, and therefore borrowing costs, to increase further.

Just as investors shouldn't read too much into how stable corporate earnings and margins have been, they also shouldn't be lulled by very low corporate default rates. These tend to lag developments in credit spreads by six to 12 months (see Fig. 4). And credit spreads have been rising. All of which is to say prepare for some tough times ahead in the credit market, even if there are attractive opportunities at the short end.

Fig. 4 - Mind the lag

US 12-month trailing default rate and high yield spread, %

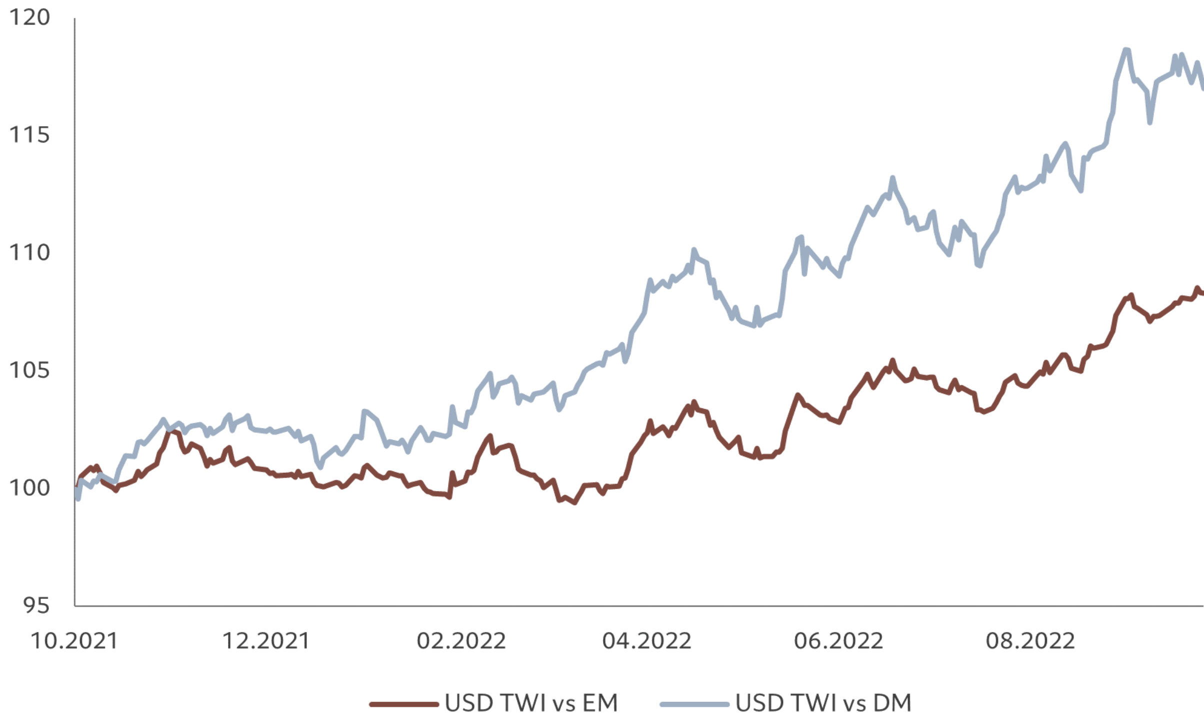



*Methodology detailed in Moody's Special Comment: "Introducing Moody's Credit Transitions Model" and "A Cyclical Model of Multiple-Horizon Credit Rating Transitions and Default," August 2007. Source: Moody's. Data from 31.07.2003 to 31.08.2022.

Emerging markets are potentially an intermediate investment. The US dollar has strengthened considerably against all currencies and particularly notably against the likes of sterling, the Japanese yen and the euro. But unlike previous risk-off periods, emerging market currencies have been relatively less of a casualty (see Fig. 5). And already more than 80 per cent of emerging market real yields are higher than those in the US.

Fig. 5 - Emerging stability

USD trade-weighted index vs developed and emerging market currencies, 27.10.2021 = 100




Source: Pictet Asset Management, US Federal Reserve, Bloomberg. Data from 27.10.2021 to 21.10.2022.

Part of that relative strength is down to the fact that emerging market central banks have been ahead of the inflationary curve, acting considerably more aggressively to recapture price stability than G7 central banks. As US interest rates start to stabilise, the dollar should also begin to edge back from its current highly overvalued state, which would be a boost for emerging market local currency debt. Meanwhile, the emerging market corporate bond sector is in a generally healthy state – leverage is relatively low, the companies issuing debt are by and large high quality and more of this debt is being held by domestic investors than in the past and therefore is less subject to panic selling. Both dollar denominated and local currency emerging market debt are well worth a closer look even if many investors are sceptical that this time really is different.

It's still early days, but bond markets are more attractive to investors now than they have been for years, in some cases decades. Volatility and the risks of widespread and stagflation spreading are still a hazard to all risky assets. And the risk of accidents caused by policymakers can't be discounted. But there are compensations for the risks investors face – and also rewards.

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