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BONDS, CHRONICLE OF A COMEBACK FORETOLD

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The past year will have left a bitter taste in investors' mouths, with portfolios down 14.40%, on average, for a balanced profile in euro[1]. But it was the 18%[2] decline in bonds that really left its mark, with the spectre of inflation returning to haunt the markets, since inflation is the bond markets' worst enemy. Add to this the rise in key rates and, after years of historically low interest rates and coupons, all the elements combined to deliver the worst year for the asset class in a long time.

2023: THE YEAR OF THE BOND MARKET REVIVAL

The brutality of the unique inflationary supply shock that we experienced last year prompted central banks to drastically alter their monetary policies. While the process of disinflation seems to be under way in the United States, economic activity is also beginning to show signs of slowing down. Despite this, we expect the hawks will remain in the driving seat at the next few Federal Open Market Committee (FOMC) meetings.

Sooner or later, however, monetary policy will change to the benefit of bond investors. Bonds' risk/return ratio is already looking attractive. The stars therefore seem to have aligned to make 2023 the year of revival for bonds.

Like equities, bond markets have made a strong start to the year. Despite the recent rebound, which saw the yield on US 1-10 year corporate bonds fall from 5.33% to 4.80% (and the 10y US Treasury from 3.87% to 3.40%), the markets still seem attractive enough to support a barbell positioning, including short-term investment grade corporate debt and a long positioning on sovereign debt, in anticipation of an economic slowdown and a rise in the credit risk premium. As an example, the following yields are obtained on 1-3 yr Corporate Investment Grade in francs, euros and dollars respectively: 1.40%, 3.73% and 4.87%[3]. Such yields have not been seen since 2008. It should also be noted that after eight years, negative-yielding debt has disappeared (except for short Japanese sovereign debt).

After years of disappointing returns, will the traditional 60/40 portfolio (which on average posted a yield of 8.8% in dollars from 1926 to 2021) make a comeback? This will depend on the direction of inflation over the coming quarters. Let's just say that a multi-asset portfolio now makes sense again, and one of the priorities of the typical investor will be to (re)build a balanced and resilient portfolio while generating income and staying diversified. As for "TINA" (There Is No Alternative), it will no longer be invited to the great investment ball.

LIZ TRUSS AND ALAN GREENSPAN

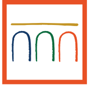
There are a few caveats, however, as looking for opportunities within the bond market is never a smooth ride. Due to its complexity and certain inconsistencies (such as interest rate futures anticipating a relaxation of the Fed's monetary policy this year while the Fed insists to the contrary), a systemic risks or risk of central bank error does indeed exist. To illustrate this, let's consider two market events. First, the debacle of UK debt, whose detonator consisted of a good dose of inflation (penalising purchasing power), a dash of current account deficit (weakening sterling) and was then shaken up with the public deficit (reducing the solvency of the national debt, which now stands at 100% of GDP). The result? The sharpest rise in long-term government bond yields on record, with the 30-year government bond yield rising from 1% in December 2021 to almost 5% at the height of the crisis at the end of September 2022. As a result, the Bank of England was forced to make an urgent decision to commit to buying GDP 5 billion in debt per day for two weeks.

To take another example, we can also recall the Tequila Crisis: in 1994, Alan Greenspan's pace of raising key rates and tightening monetary policy led to a sharp rise in long-term rates and severe corrections on the bond market. It could be argued that this was actually the great economist's intention: to "land" the bond market after excessive speculation, even it if meant provoking a brutal adjustment.

One of the main constraints for bond investors is the difficulty of fully hedging through futures, swaps or options because of the complexity of managing technical elements such as margin calls, total risk budget and exposure management.

So much for the risks and constraints; as for the prospects mentioned above, they are such that bond markets are more attractive to investors than they have been for decades!

[1] Performance Watcher
[2] Bloomberg Global Aggregate Euro unhedged
[3] Bloomberg Barclays Indices



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