INVESTMENT OPPORTUNITIES POST PEAK IN INFLATION AND RATES

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After dropping 17.5% in 2022, its worst performance on record, the US 10-year treasury bond shed a further 1.3% in 2023 as surging inflation prompted the US Fed to embark on one of its fastest paces of rate increases in recent decades. The yield curve has since adjusted to this new reality and the risk reward of owning bonds versus equities has tilted towards the former. With recession risks looming and the inflation outlook having stabilised, fixed income looks set to regain its "safe haven" crown.

HIGHER FOR LONGER

Striking a balance between overtightening and not restricting monetary policy enough is a major challenge facing the Fed. After reaching a peak of 9.1% in June 2022, the US CPI printed a much lower YOY reading for 12 consecutive months thereafter, closing in on 3%.

But inflation risk remains. Buoyed by strong consumer demand, high oil prices and a stubbornly low unemployment rate, the CPI is now ticking back up just shy of 4%, well above the Fed's 2% target, reason enough for it to indicate in its last policy meeting that high interest rates are here to stay.

A look at 10-year real US yields (2.4% at the time of writing) indicates that we are in a sufficiently restrictive monetary environment., making it unlikely that the Fed will continue pushing rates further. With the odds of a rate hike dissipating, bonds should start to perform well in the short to medium term.

The fact that inflation is proving difficult to tame means that we will have to get used to a new normal of high interest rates, at least in the current macroeconomic environment.

INVEST ACROSS THE CURVE IN QUALITY

Timing the market is a question of luck rather than skill. Investing requires patience and a long-term view, hence it is difficult to know exactly when things will shift. It is crucial to diversify across asset classes, while for bonds, duration positioning needs careful planning.

Long dated maturities tend to be more volatile than shorter ones, but the latter pose re-investment risk. Should the "soft-landing" scenario fail to materialise, interest rates could drop faster than the market anticipates. Even if we do manage to avert a recession, the yield curve is already pricing this scenario. In either case, when we look at long dated real yields or short-term nominal yields, both look attractive, with short duration protecting against volatility and long dated locking in long-term returns.

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High yield spreads are trading at around 400 bps above the US ten year, and we expect these to increase since we know low quality companies are already feeling the pinch of high financing costs and tighter lending standards. Because monetary policy operates with a lag, we typically start seeing defaults rise within the year after interest rates have peaked. In such a cycle we recommend investing in high quality, cash rich issuers.

RETURNS EXPECTATIONS AND RELATIVE VALUE

15 years after having touched 5%, the yield on the two-year US treasury bond is again flirting at those levels. The returns expectations of various asset classes are measured against the so-called "risk-free rate".

Equities, hedge funds and alternative investments, to name a few, must now compete with attractive deposit rates and high-grade short duration bonds, both of which offer better risk adjusted returns. With the dividend yield on the S&P 500 at 1.6%, and given where valuations stand, the equation is not in favour of holding stocks.

Hedge funds, which aim to achieve 5 to 7% absolute returns, come with liquidity constraints, and are equally not an easy sell. Private debt propositions which have seen tightening spreads over the last year don't offer enough pick up to justify an allocation. So, when we factor in risk free returns, volatility, and liquidity, everything seems to point in favour of underweight positioning in those asset classes.

ECONOMIC CONDITIONS VARY, HUMAN BEHAVIOUR NOT SO MUCH

If history is a guide, the signs are pointing towards a peak in the cycle. The turning point could come from anywhere: the real estate market, consumer demand, a debt crisis or even geopolitical risk.

What we know with reasonable confidence is that elevated interest rates eventually achieve the goals they are set out to do, albeit at a cost. However, the good news is that even under challenging market circumstances, there are always tools that generate returns. They say someone's loss is another's gain. That gain could very well come from the good old high grade bond market.

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