Investment Strategy Update #111

Sovereign bonds: Offering yield and capital preservation

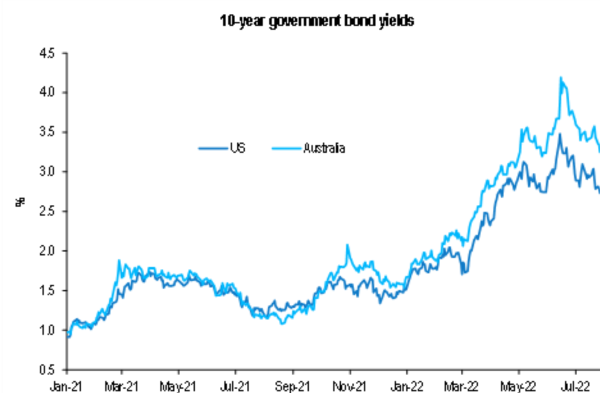
- We like long-dated sovereign bonds versus shorter-dated corporate bonds.
- Sovereign bonds are currently priced at levels not seen for much of the last decade, providing both an attractive risk-adjusted yield and strong capital protection against further growth uncertainty.
- We upgraded sovereign bonds to overweight in July (see 2H 2022 Financial Markets Outlook). Three key reasons to support this position
  1. We think we've seen the peak in bond yields for this rate hike cycle with any further inflation surprises likely to drive further inversion of the yield curve and lower long bond yield.
  2. At higher yields, sovereign bonds now offer greater diversification benefits versus growth assets. Peak inflation and a reset in short rate expectations make a repeat of 1H22 (where both bonds and equities both fell) less likely.
  3. Higher yields increase the overall return cushion available from bonds. The higher yields are at the start of a slowdown, the further they can fall in times of equity market sell-offs and/or elevated volatility. Higher yields today imply higher future returns.
- We prefer longer maturity bonds (increased duration) to short dated fixed rate exposure. Cash rates are still expected to rise, increasing the risk that short-dated bond yields rise further from here.

Bonds are attractive again

Government bond yields spiked in 1H22 driven by persistent and unexpected increases in inflation that saw Central Banks raise their cash rate forecasts from ~0% to ~3% in the space of a few months. At the same time, rapidly rising inflation expectations drove long bond yields higher as investors demanded greater returns to compensate for the higher inflation levels.

We think long bond yields of ~3.5% and ~4.2% for the US and Australia, respectively, represent the peak in 10 year bond yields for this cycle as markets shift focus from inflation to the slowdown in economic growth. Market rate hike expectations have fallen rapidly reflecting a higher probability that central banks won't be able to deliver the magnitude of rate hikes currently telegraphed without causing a recession as well as moderating inflation expectations.

Bond yields appear to have peaked



Source: Factset, MWM Research, August 2022

We are overweight sovereign bonds given higher yields increase both the income, capital preservation and diversification benefits. We recommend being overweight duration via an allocation to longer maturity bonds (sensitivity to changes interest rates) in a balanced portfolio to increase the downside protection with overall portfolios during the periods of risk-off sentiment. As well as our overweight to sovereign bonds, we are overweight real assets (for yield and inflation protection) and overweight hedge funds in Alternatives (given benefits from higher volatility and diversified return streams).

Within a balanced portfolio, we would allocate up to 25% in global developed bond investments. Given the deteriorating economic backdrop it is both appropriate and prudent for investors to tilt portfolios to longer dated sovereign bonds away from shorter-dated, lower credit quality corporate bonds or more speculative/cyclical areas of fixed income markets like high yields and emerging markets debt.

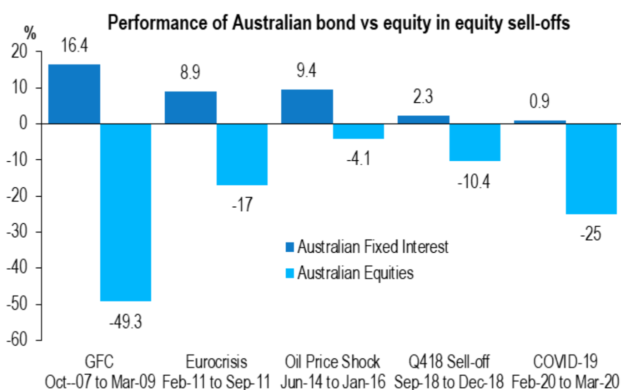
The key reasons to add bonds now are:

#1 We think long bond yields have peaked

1H22 was brutal for bond investors with global bond market performance (down ~10%), the worst since records began. Persistent high levels of inflation caused central banks to raise cash rates much faster than bond markets were initially anticipating. While at the same time, inflation expectations increased, which further drove up bond yields as investors demanded higher compensation.

We expect to bond yields to be rangebound, with the risk skewed to the downside. Long bond yields are capped to the upside by growing fears around a global growth slowdown and the risk of a move higher is limited as inflation continues to moderate.

Higher yields increase return cushion from bonds



Source: Bloomberg, PIMCO, MWM Research, August 2022

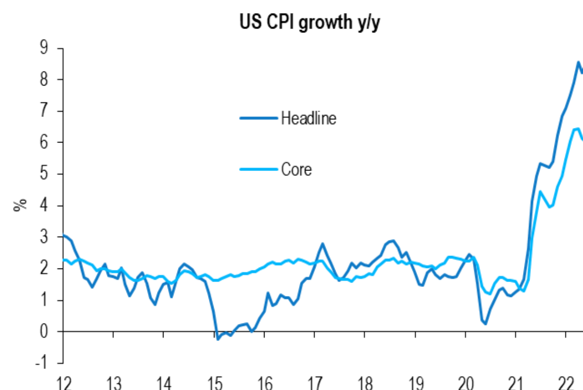
#2 Diversification potential

The role of bonds in a balanced portfolio is to provide income and diversification to equities and other risky assets. In times of economic downturns or periods of risk-off sentiment, interest rates fall (bond prices rise) providing an offset to the mark-to-market losses from the growth allocation in the portfolio and providing some protection to the overall portfolio return.

We think a repeat of 1H22 where both equities and bonds underperformed at the same time is unlikely given the rapid rise in yields was largely driven by inflation surprises which drove a rapid increase in cash rate expectations. Inflation appears to be moderating which in turn provides breathing room for Central Banks. Additionally, as the economic growth backdrop deteriorates, expectations for cash rates globally are now falling given the expectation that Central Banks won't be able to deliver the quantum of cash rate increases initially telegraphed.

Empirical evidence suggests that the *level* of inflation is key for the correlation of bond and equity market performance. Persistent elevated inflation undermines returns from both bonds and equities. Higher inflation hurts bonds as investors factor in the need to receive higher interest rates and central banks start raising cash rates in attempt to combat inflation.

Inflation appears to be moderating

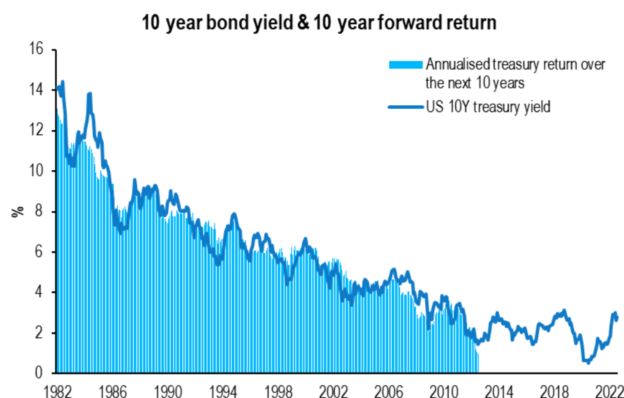


Source: FactSet, MWM Research, August 2022

#3 Higher yields improve capital preservation potential

Higher yields improve the capital preservation characteristics of bonds within defensive assets. The higher yield currently available means that even if interest rates rise moderately, total returns from bonds will remain positive. We estimate at current levels (~2.7-3%) bond yields could rise a further 100bps (which we view as unlikely) and total returns from bonds will remain positive.

Higher rates now imply higher future returns



Source: MWM Research, Bloomberg, August 2022

Macquarie WM Investment Strategy Team

The report was finalised on 15 August 2022.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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