J. STERN & CO.

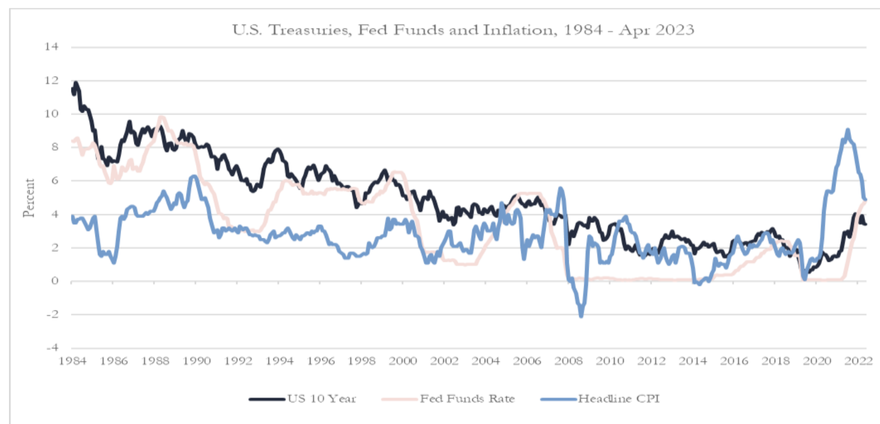
The Value of Long-Term Investing

Investment Insight

Bonds are back – five reasons to invest now

We are amidst a great reset for fixed-income assets. During 2022, bond prices moved lower and yields meaningfully higher, in the sharpest repricing in recent history. Fixed-income markets now provide attractive yields not seen since before the 2008 Financial Crisis.

Inflation and rising interest rates are the nemesis of bond investors and last year proved a case in point. Interest rates were hiked aggressively to counter the significant rise in inflation which caused bonds to sell off sharply. The stage is set for strong performance going forward and – despite global headwinds – we believe five reasons make investing in fixed-income assets attractive now.



Source: Bloomberg

Inflation has peaked

Monetary policy operates with a lag. It can take 12-18 months for interest rate hikes to be felt in the real economy. The Federal Reserve announced its first rate hike in March 2022 followed by a further 10 hikes in rapid succession, the fastest tightening since the early 1980s. We are now seeing early signs of aggregate demand slowing. Automobile prices, freight rates, housing rents, consumer savings, and PMIs all point towards inflation moderating.

These developments suggest that the Fed is reaching the end of its hike cycle and is close to achieving terminal interest rates. The Fed has a long-term inflation target of 2% – a level that is intended to be low enough to reassure consumers but sufficiently relaxed to allow the economy to grow. We believe that it is unlikely that the Fed will change its official targets. However, the Fed will be conscious of the risk that tightening conditions too much could cause the slowdown to turn into a recession. That is why we believe that it will back off if it is successful in bringing inflation down towards 3-4%.

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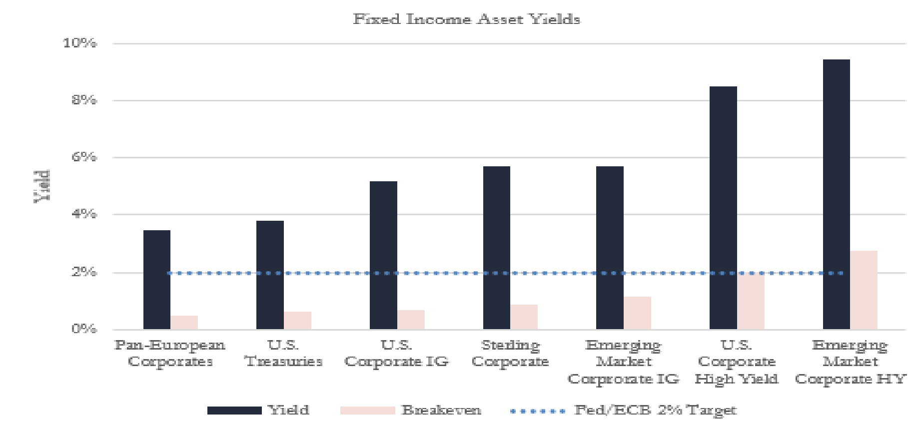
Attractive all-in yields and income

Bond yields have risen sharply to levels not seen since 2008. Bonds have discounted the rise in central bank interest rates with yields ranging from 3.7% for pan-European corporates to 9.5% for Emerging Market high yield corporates.



Breakeven reflects the assets yield divided by duration

Source: Bloomberg; JP Morgan

Starting yields are a good proxy for long-term total returns. Despite the many market-moving events over the past two decades, they have ended up in a tight range around the entry points. That is why we believe that today's starting yields are attractive.

	Period	2003-2012	2013-2022	2023-2033
U.S. Corporate IG	Starting Yield	5.0%	2.7%	5.4%
U.S. Corporate IG	Annualised Return	6.3%	2.0%	?
U.S. Corporate HY	Starting Yield	12.1%	6.8%	9.0%
U.S. Corporate HY	Annualised Return	10.6%	4.0%	?
Emerging Market Corporate HY	Starting Yield	17.6%	6.6%	9.5%
Emerging Market Corporate HY	Annualised Return	12.4%	3.7%	?

Source: Bloomberg; JP Morgan

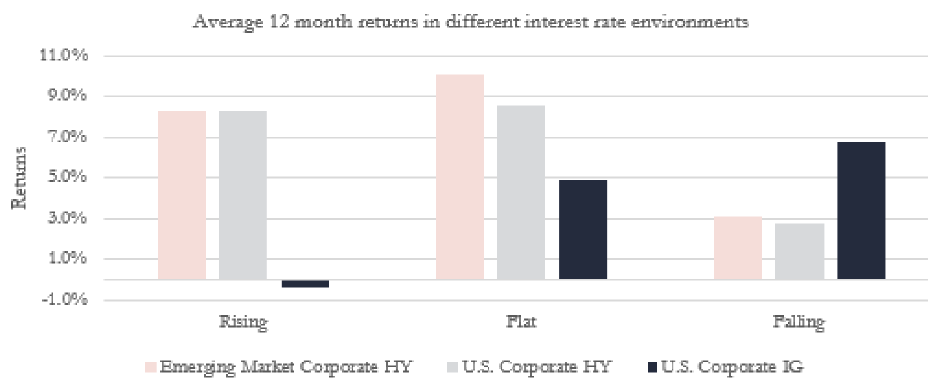
The two primary components of a bond's total return are income and price appreciation. In high-yield markets, the primary driver of returns is income. In recent years, companies took advantage of low borrowing costs for many reasons, including optimizing liability management and accretive M&A. The ability to issue bonds at lower coupons was clearly beneficial for the companies but also meant that the main driver of returns was lower.

The good news now for investors is that income is back. The repricing of interest rates means companies are having to issue bonds with higher coupons, which is positive for investors. Primary market issuance has been subdued for the past 18 months given the broader market volatility. Issuers have been mainly higher quality companies that can absorb higher interest rates.

Asymmetric risk/return

The great interest rate repricing is behind us with 10-year US Treasury yields moving from 0.5% in March 2020 to 4.0% in February 2023. Bond prices are inversely correlated to yields and a large proportion are now trading at a discount to their par value. Bonds accrete to par as they get closer to maturity, which means there is an opportunity for capital appreciation. Higher-income and upside from capital appreciation provide an asymmetric risk/return for investors prepared to hold bonds to maturity.

The return profile looks attractive over shorter time horizons too. Economic growth is the key issue and yield curves are in an adjustment phase because of the uncertainty. They appear range bound but can still have a short-term impact on bond prices. History suggests this adjustment phase offers an opportunity to generate attractive positive returns over the next 12 months, irrespective of the direction of interest rates.



The chart shows 12-month rolling return periods from Jan 2003 to March 2023. 'Falling' is defined as a decline of more than 50bps in the US Treasury 10-year yield in the prevailing 12 months. 'Rising' is defined as an increase of more than 50bps in the prevailing 12 months. 'Flat' is defined as a move of less than 50bps in either direction.

Source: Bloomberg; JP Morgan

Downside protection even in case of recession

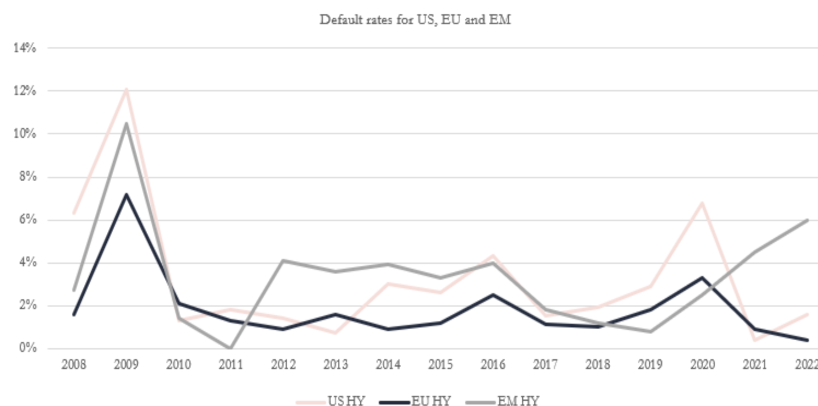
The IMF forecasts (April 2023) global growth to fall from 3.4% in 2022 to 2.8% in 2023. Advanced economies are expected to see a more pronounced growth slowdown, from 2.7% in 2022 to 1.3% in 2023. Such headwinds could lead to recessions in different countries. For example, Germany has just entered a technical recession, with a 0.3% decline in GDP in Q1 2023 following -0.5% in Q4 2022.

The severity of recessions is dependent on many variables but importantly the repricing in interest rates and current credit spreads provide protection. In a 'soft landing' scenario, interest rates could remain stable while credit spreads have room for compression. Conversely in a 'hard landing' scenario, the widening of credit spreads could be partially offset

by a decline in interest rates as witnessed in recent history. But very importantly, current bond yields provide investors with a volatility buffer and some visibility on future returns.

Robust corporate fundamentals

The macroeconomic environment is set to become more challenging with slower growth, higher funding costs and higher business costs. However, corporate credit fundamentals are robust. Balance sheets are in good shape, with leverage at multi-year lows and interest coverage at multi-year highs. During the Covid-19 pandemic, companies hoarded cash, lowered their cost of debt and proactively termed-out debt maturities which insulates them from near-term refinancing risks.



EM HY 2022 default rate ex Russia and China property at 1.8%

Source: JP Morgan

Nevertheless, we believe that headline default rates will increase from their historical lows supported by pandemic-related low-interest rates and high liquidity in 2020-22. This increase in default rates will be a reversion to normalised levels rather than a default spike because credit fundamentals are starting from a better base than previous downturns. Investors will have to be selective in picking opportunities, making the case for active management.

Charles Gélinet, CFA

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