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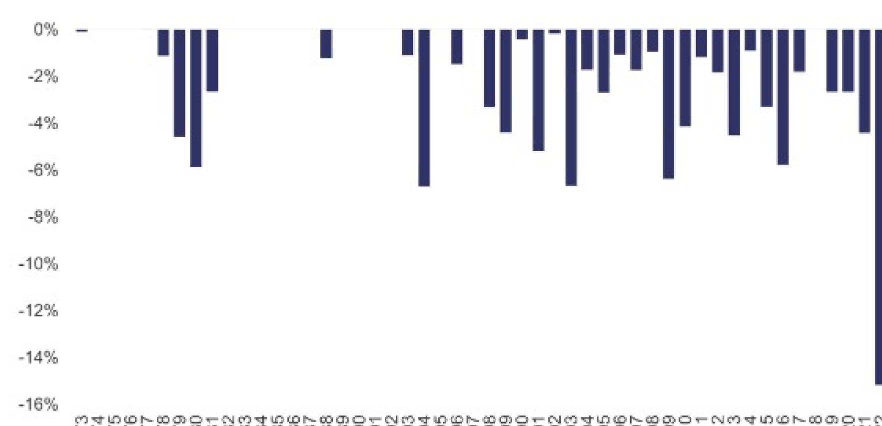
Is it safe to buy bonds?

Whilst most investors are fully aware that equity markets have been disappointing in 2022, what is less reported is the dramatic losses in the perceived haven of government bond markets.

The chart below illustrates the extent of the pain in bond markets this year - the worst drawdown in forty years.

US Treasury annual drawdown



Source: Lombard, Thompson Datastream, 24 October 2022

The core reason for bond market underperformance is elevated global inflation and central banks' determination to moderate price rises in parallel.

Central banks hope to do this by tightening monetary policy via the hiking of short-term rates, the ending of their Quantitative Easing (QE) programmes, and the beginning of their Quantitative Tightening (QT) plans.

Bond market underperformance is now raising the question for investors as to whether fixed income instruments look like an appealing investment from a valuation perspective. Based on the yields on offer over the last decade, today's government bonds certainly look attractive.

Is now the optimal entry point?

In the period post the Great Financial Crisis (GFC), bond yields had been distorted by central banks' QE programmes. These monetary institutions were an indiscriminate and mostly non-discerning buyer of any available bond issues.

The consequence was that bond yields were suppressed at artificially low levels. It had been our belief that these artificially low levels of bond yields meant that it was not safe to invest in bonds as there was no return and plenty of risk. This has begun to change as bond prices are falling (yields rising) with the perceived danger of entrenched inflation.

As bond prices are falling, so is our view on whether the asset class is investable.

We recently made a strategic decision to add fixed interest bonds to our multi-asset portfolios for the first time in over five years. We added European government bonds with a duration of c.3 years.

Whilst we are willing to accept some of the yields on offer, we still don't believe that the whole bond market is investable today.

Our belief that inflation over the next cycle will be higher than the decade that followed the GFC is becoming a consensus call but nobody can say for certain where inflation will settle down.

It is for this reason we believe that long-term bond yields may have more room to climb as investors price in this "inflation" risk.

The forthcoming economic cycle may also see more conflicts between governments who wish to ease fiscal policy and Central Banks that want to control inflation.

Situations like the recent debacle in the UK may play out in other countries and would be negative for bond prices.

There is a valid argument that US long-term bond yields, which are much higher than in Europe are reflecting more of the risks and are therefore more investable.

From the point of view of a US investor, this may be correct. However, from our perspective, as European investors, all investments in US bonds must take currency risk into account.

An environment where US bond yields are going down is likely to be one that is bearish for the US dollar, therefore the risk with US Government bonds is that any gains on the investment get more than wiped away by the falling currency (which is strong today because bond yields are high).

What about corporate bonds?

Based on current credit spreads, it seems that a broad but mild recession has been priced into the corporate bond market. Whilst this may be attractive to some, we believe that many parts of the equity market are pricing in a worse economic environment than that of the corporate bond market, thereby making equities a more attractive investment.

If central banks end up pursuing quantitative tightening (selling bonds back into the market), there is a chance that corporate spreads will move out further, creating an investment opportunity.

Our bond weighting today across our multi-asset funds stands at 10% - allocated to European inflation-linked bonds (5%) and to short-duration European government bonds (5%).

We don't believe the risk reward is there in other parts of the bond market today. However, further opportunities may arise as government bonds move to fully price in the risk of higher levels of inflation, and looser fiscal policy.

There will also be ample opportunities in corporate bonds as they start to price in a more negative economic environment.

The trigger for lower bond prices and the full pricing of these risks would be quantitative tightening by central banks which would allow the bond market to participate in full price discovery.

Please visit our website for further information.
The latest views and insights from the team can be found here.

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