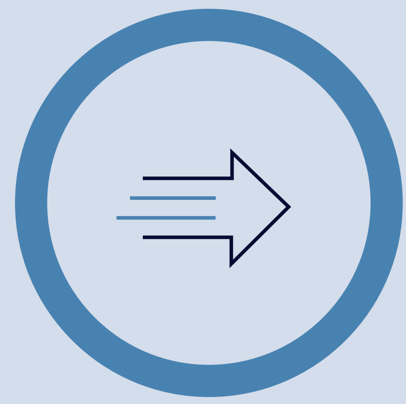
September 2022 | Investment perspectives

A positive outlook for bonds



With inflation spiralling and central banks raising interest rates, it's been a tough year for bond markets. Nicolas Trindade, senior portfolio manager at AXA Investment Management and manager of the Omnis Short-Dated Bond fund, explains what has been happening this year and why he thinks conditions are going to improve for investors.

Rates are rising

It's been a difficult year for bond investors so far. Inflation has hit a 40-year high in many countries, driven by ongoing supply chain problems, pandemic stimulus measures and the war in Ukraine. In response, central banks have started to raise interest rates to try to tame inflation.

Since the US Federal Reserve (Fed) started to hike rates, bond prices have fallen (they move in the opposite direction to yields). Meanwhile, bonds in many European countries had their worst month in decades in August, as surging gas prices exacerbated inflation. UK gilt yields have risen by more than 2% since the beginning of the year.

The good news for investors is that bond yields are likely to fall over the medium term (meaning prices will rise). That's because expectations for both inflation and interest rates are probably too high.

UK bonds are likely to recover

The reason why UK gilts underperformed in August is largely because of the uncertainty surrounding the government's fiscal policy (government spending and taxation) due to the Conservative Party's leadership contest.

Bond yields went up after markets were spooked by Liz Truss's talk about tax cuts and increased spending. Investors were concerned that these policies could push inflation higher, prompting further interest rate hikes in response. With the new government in place, we look forward to the clarity that forthcoming policy announcements on spending plans should provide.

Meanwhile, the bond market is pricing in a series of interest rate rises by the Bank of England taking rates up to 4.25% by the middle of next year. Even though it may take some time for inflation to fall back to the Bank's 2% target, we believe rates are likely to peak at around 3%.

Yields on UK government bonds should begin to fall as investors reassess the extent to which interest rates might rise. Therefore, the outlook for UK government bonds over the next 12 months is positive.

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US Treasuries should improve

It's likely US Treasury bonds will experience a similar pattern. Markets are expecting US interest rates to peak at around 4%, although we think the figure will be lower at about 3.5%.

This means markets have probably gone a bit too far again. In the shorter term we should see some consolidation in yields, which may fall slightly, resulting in Treasury bond prices going up.

US inflation has peaked and should start coming down over the course of 2023 to around 5%. So expect to see a less aggressive stance from the Fed which, having stopped raising interest rates around the end of this year, will probably start to cut interest rates towards the end of 2023. With less inflationary pressure from the war in Ukraine, the outlook for US Treasuries is arguably looking more positive than for UK bonds.

Bonds remain a good diversifier

For decades bonds have been the perfect portfolio diversifier, providing protection when market conditions are challenging. Bonds usually help to diversify a portfolio as they tend to rise when stock markets are falling. However, this year stocks and bonds have been falling in tandem at a pace not seen for many years, leaving investors with few places to hide from market volatility.

Yet we believe they still have a valid role to play in multi-asset portfolios to help mitigate the unpredictability of stock markets. As economic growth cools and inflation comes back under control, high-quality bonds will almost inevitably become a good diversifier once again.

Over the past 70 years, there have been nine individual calendar years where equities and bonds have both fallen (figure 1). However, history shows us that each time this happens, the markets have always returned to normal, and there's no reason why they will not do so again this time.

Figure 1: Equities and bonds

Calendar year returns (%)

	Years when bonds and equities fell	Years of mixed results between bonds and equities	Year when bonds and equities rose
Number of years	9	30	30
Real return of S&P500	-12.7	6.5	17.8
Real returns of US T-bills	-6.8	-0.7	10.0
			Following year returns
Real return of S&P500	11.2	9.5	7.6
Real returns of US T-bills	7.4	1.5	3.2

Source: American Institute for Economic Research (1952–2021)

What are bonds?

A bond is a loan made to a company or a government by an investor for a set period of time – usually a number of years. The deal is that in exchange for handing over your cash, you'll receive regular fixed rate of interest – known as a coupon.

Once the bond's life comes to an end and it matures, your original capital will be paid back in full. The risk is that the borrower becomes insolvent at some point during the life of the bond, and is either unable to pay the coupon or repay the capital.

Most bonds are issued by governments. Those issued by large developed economies such as the US, the UK and Germany are considered to be low risk as governments of these countries are unlikely to default on their loan payments. In the UK, government bonds are called gilts, while US government bonds are known as Treasury Bills.

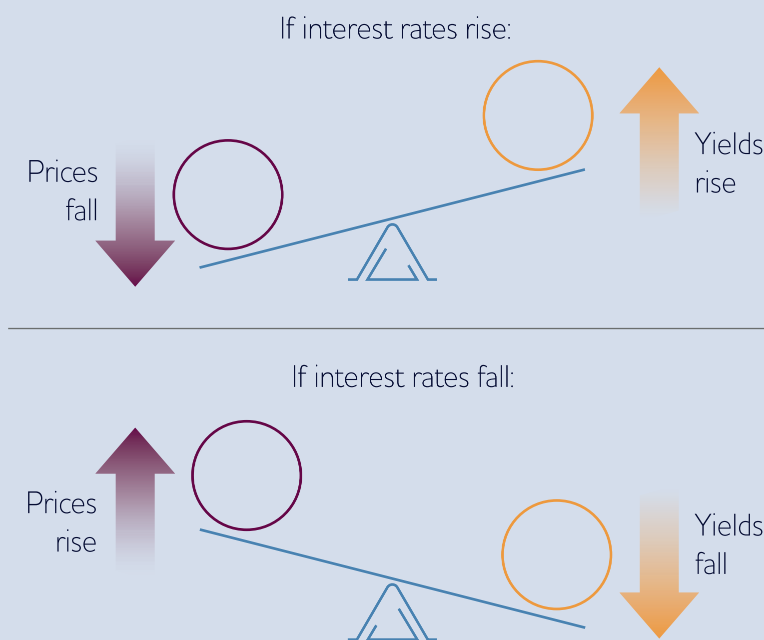
Bonds can play an important role in a well-diversified portfolio by helping to smooth long-term performance. In the past, bonds have been less volatile than equities, and have offered strong, positive returns in response to unexpected shocks or during periods of uncertainty.

Yields and prices

A bond's yield is the interest an investor can expect to receive each year over its term to maturity. Bond prices and yields move in opposite directions. This means that as the price of a bond goes up, the yield decreases. When the price goes down, the yield increases.

When central bank interest rates rise, bond prices tend to fall and the yield rises (figure 2) and vice versa. As interest rates change all the time, new bonds that are issued tend to offer different interest payments to existing bonds, which provides opportunities for investors.

Figure 2: Interest rates and bond yields



Source: Omnis Investments

Find out more

As always, the best thing to do when you are feeling nervous about your portfolio is to stay calm and speak to your financial adviser, who will be able to assess your portfolio against your long-term objectives.

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