September 2022 | Fund focus

Omnis Global Bond Fund

We spoke to the team at Western Asset Management who manage the Omnis Global Bond Fund. They explained what's been happening to bond markets and how things are likely to improve for investors when the pace of inflation starts to subside.

As the name suggests, the Omnis Global Bond Fund is invested in fixed income assets from around the world – which brings some diversification to portfolios. The fund aims to achieve a return consisting of a combination of income and capital growth that exceeds the global bond market (measured using the ICE Bank of America Global Broad Market Total Return Index) over a five-year rolling period after all fees and expenses.

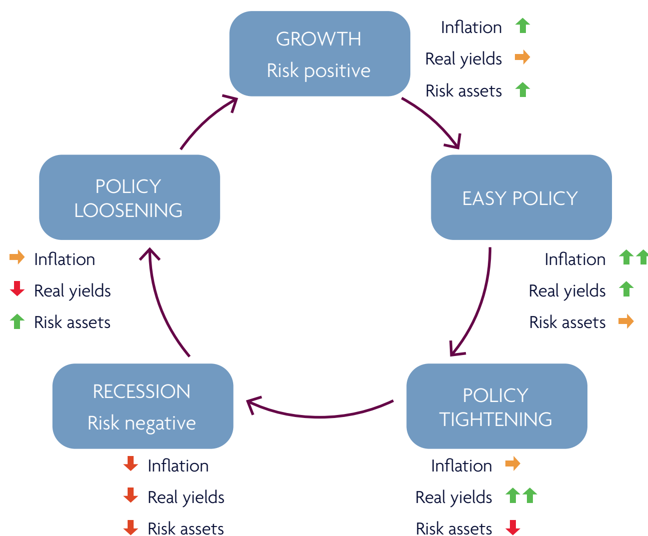
The real yield cycle

Key to the manager's asset allocation strategy is the real yield cycle, (figure 1). This explains the relationship real yields (the yield you get on a bond taking into account inflation) have with inflation and other assets, and how they are affected by central bank policy.

Stage 1. The cycle starts with the growth stage. As growth picks up, inflation begins to rise gently with little intervention from central banks. Assets that carry a degree of risk (such as equities) perform well.

Stage 2. In the easy policy stage, inflation begins to pick up more and real yields begin to rise gently. This stage is also good for equities.

Figure 1: The real yield cycle



Notes: Risk assets includes equities and corporate bonds
Source: Western Asset

Meet the manager

Western Asset Management Company is one of the world's leading bond managers and has focused exclusively on bond investing since it was founded in 1971. It is owned by US-based Franklin Templeton and manages over £358 billion on behalf of clients (as at January 2022). It has more than 130 investment professionals who work in nine offices across five continents.

The company uses a team-based approach across all levels of the organisation. This allows teams around the globe to share investment ideas and collaborate on investment strategy that then feed into the Omnis Global Bond Fund.

The fund is run by co-head of global portfolios Gordon Brown and portfolio manager Richard Booth, who both have over 25 years of investment experience. They are supported by Western Asset's broader investment teams, which includes portfolio managers, economists, research analysts, traders and quantitative analysts.

Stage 3. During this stage, inflation is rising. If inflation rises above central bank targets then they have to start raising interest rates , which is when yields really begin to start shifting higher. When yields rise, bond prices fall. This is the stage we are currently in. When inflation was rising earlier this year and central banks responded with interest rate hikes, real yields rose sharply. These conditions are also usually negative for equities. If real yields are rising quickly and sharply, equity volatility increases and assets underperform.

Stage 4. Central banks look to increase interest rates – this is when you can get a recession. It helps bring down inflation, but also leads to negative job growth. This is probably the worst time for equities, but also the best time for bonds. This is because as inflation falls and interest rates come down, bond prices rise.

Omnis INVESTMENTS

Stage 5. In the final stage, central banks start policy loosening, which involves cutting interest rates or increasing the money supply to boost economic activity. Inflation will drift sideways, equities will perform well and real yields will come down.

The real yield cycle in practice

Figure 2 shows how the real yield cycle works in practice using the performance of the 10-year US real yields since 2020. As the pandemic struck, this initially caused a shock to the market and real yields rose sharply. The Federal Reserve then stepped in with a broad range of economic actions to limit the economic damage from the pandemic, which brought real yields down into negative territory (so your real return is negative), where they stayed until earlier this year (stage 1).

In April this year, inflation became more entrenched and the Russian invasion of Ukraine pushed energy prices up further. The Fed started to raise interest rates and real yields moved into positive territory (stages 2 and 3).

A brighter outlook

Western Asset says that while a global recession is unlikely, the pace of economic growth will be weaker in most regions. The manager believes there is the potential for a recession in the UK and Europe, which will depend on what happens to energy prices, and the degree of government support packages to shield consumer incomes. To some degree, the scale of each country's monetary policy response to combat inflation will be a key factor.

Central banks have implied they will have to continue raising interest rates to bring inflation under control. While policymakers are still signalling an aggressive path of interest rate hikes, the manager believes they will be talking about more measured approach to interest rate hikes towards the end of the year.

With rising energy prices feeding through to higher food prices, retail sales are coming in lower than expected as people have less money to spend. With global economic growth slowing, this should reduce the pace of inflation. This means as inflation starts to moderate, the pace of interest rate rises will slow. Bond yields mirror this move, which in turn means the prices of bonds should start to recover.

What are real yields?

The rates, or yields, you see on long-term government bonds, such as a 10-year US Treasury bond, are nominal rates (interest before taking inflation into account). Real yields are the returns that a bond investor earns from interest payments after accounting for inflation. For example, a Treasury bond that pays 5% in nominal interest per year when inflation is 3% would have a real yield of 2%.

When bonds are offering higher interest rates, those yields can make them more attractive to investors. At the same time, when yields are higher on safer bond investments, shares (which are considered a riskier investment) need to offer higher returns to compete. When real yields move higher, stocks are less attractive.

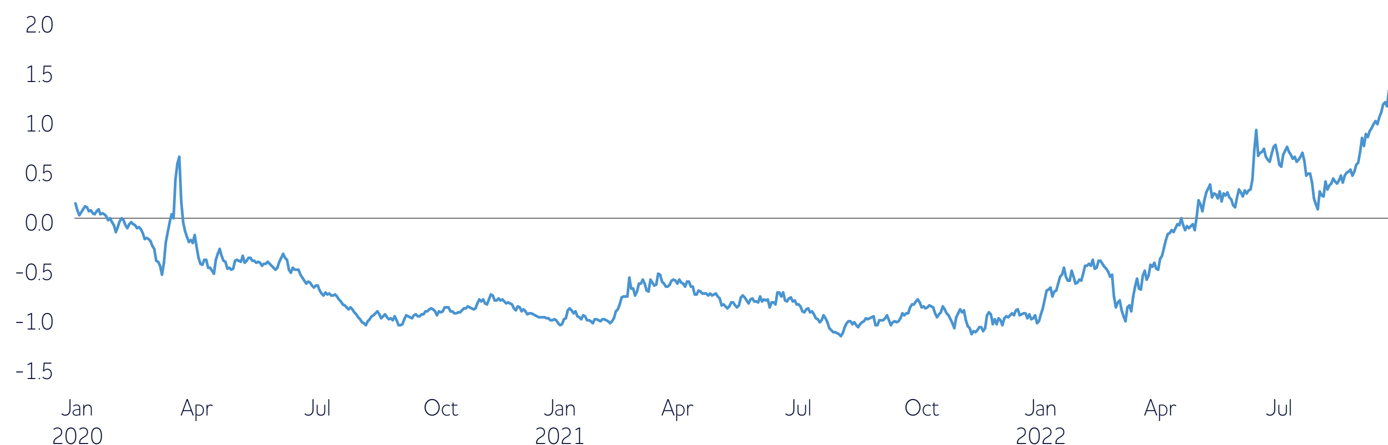
Prices and yields move in opposite directions. This year there has seen a massive decline in bond prices across the entire market, which has led to a huge rise in bond yields. US real yields have soared to the highest level in over a decade, further eroding the appeal of stocks for investors.

Both input (which measure the price of materials and fuels bought by companies) and output (which measure changes in the prices of goods produced by companies) price indexes are also beginning to fall, which suggests the rate of inflation will start to move lower.

The manager expects inflation to stabilise in the fourth quarter, although this doesn't mean it will come down. Inflation in Germany is likely to rise sharply in October due to reduction in VAT on fuel and a cut in the price of public transport fares but this should be the peak in this cycle.

It's a similar story in the UK, where the government's £2,500 energy price cap freeze should have a substantial effect on the headline inflation rate as people spend more on energy bills. As the US is not reliant on Russian gas, inflation there appears to have peaked and is now stabilising.

Figure 2: 10-year US real yields



Source: Western Asset

While industrial production and consumption are falling, the jobs market remains strong globally and in the UK. The manager says that the markets are fearful about a global recession, so that when we get to the policy loosening stage (stage 5), it will be a much better environment for bonds and equities. These conditions should be even more favourable if a recession is avoided.

Normal service should resume

Traditionally, bonds have protected mixed-asset portfolios from falls in the stock market. So when equities drop, bond prices tend to increase because during stock bear markets investors seek the safety of government bonds. However, this year bonds have been impacted by a toxic combination of rising inflation and higher interest rates, which means this hasn't happened.

As we move from the policy tightening stage (stage 3) through to the recession stage (stage 4), we are seeing increased volatility in the markets, but the manager says things will improve. Periods of volatility in markets tend to "come and go", particularly as you move to a new stage in the real yield cycle.

There is still anxiety in the markets about recession and the response by central banks to inflation. The manager believes that when inflation begins to turn lower, markets will begin to price less policy tightening, which should calm the markets. With lower volatility, bond prices should rise (stage 4).

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.

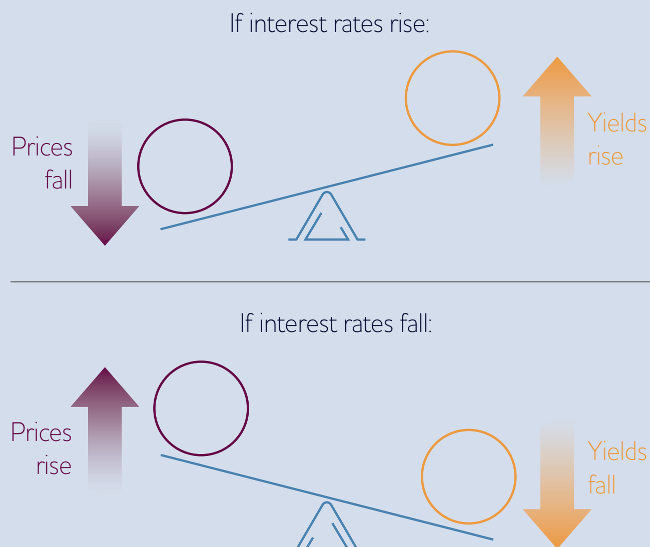
Bonds, yields and prices

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.

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 3) 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 3: Interest rates and bond yields



Source: Omnis Investments

www.omnisinvestments.com

Issued by Omnis Investments Limited. This update reflects the views of Omnis and our investment managers at the time of writing and is subject to change. The document is for informational purposes only and is not investment advice. We recommend you discuss any investment decisions with your financial adviser. Omnis is unable to provide investment advice. Every effort is made to ensure the accuracy of the information but no assurance or warranties are given. Past performance should not be considered as a guide to future performance.

The Omnis Managed Investments ICVC and the Omnis Portfolio Investments ICVC are authorised Investment Companies with Variable Capital. The authorised corporate director of the Omnis Managed Investments ICVC and the Omnis Portfolio Investments ICVC is Omnis Investments Limited (Registered Address: Washington House, Lydiard Fields, Swindon SN5 8UB) which is authorised and regulated by the Financial Conduct Authority.

Omnis INVESTMENTS