Balancing Act — The Defensive Trade Off in a Challenging Fixed Income Market

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Amid difficult trading conditions, Financial Advisers face a dilemma when constructing defensive client portfolios. They need to concurrently address rising inflation, protect against capital loss, and deliver investor income.

In this piece Michael Furey (MF), Principal and Asset Consultant at Delta Research & Advisory, and Simon Mullumby (SM), Head of Australian Cash and Bonds at State Street Global Advisors, join forces to help us understand the rapidly changing market landscape and implications.

MF: As global economies recovered in the wake of the pandemic, we began to hear the term "transitory inflation", particularly from the US Federal Reserve (Fed). This referred to an accepted short-term spike in prices as activity resumed. However, the return to a more 'normal' pattern of spending wasn't as expected. What happened was a significant shift from services spending in favour of goods consumption. A persistent COVID overhang largely drove this move as people continued to avoid face-to-face interactions either through choice or because many restrictions remained in place. As a result, we saw higher demand for physical goods, which was met by supply-chain constraints and reduced output, so prices began to rise. And as increased costs became more entrenched, central banks began to view inflation as a longer-term issue.

Q1. Why have central banks quickly pivoted their approach to policy rates and targets?

Q2. We hear a lot about interest rate duration and credit spread duration, what is the difference and how do they affect a portfolio?

MF: Within a bond, there are two components: the interest rate duration and credit spread duration. Duration is essentially a mathematical calculation, reflecting the sensitivity of a bond price to any yield changes within the two components. So, the longer the duration, whether related to interest rates or credit spreads, the greater the price sensitivity.
For example, if a portfolio has interest rate duration of five years and interest rates rise by 1%, then the bond’s price will drop 5 x 1%, which is a 5% capital loss. It’s similar with credit spread. If a portfolio has a credit spread duration of 5 and credit spreads widen by 1%, investors will see a 5% decline in the credit component of the price, plus whatever happens to the interest rate movement multiplied by the interest rate duration.

Q3. At the end of last year, interest rate and credit spread duration were highly correlated. How frequently does this occur?

MF: Traditional Government bonds and Credit play different roles in portfolios. Focusing on the US as an example the green line in Figure 1 shows the movement of 5-year US Treasuries (an interest-rate proxy). The blue line shows the high-yield spread. In the most recent period we’ve had an increase in the five-year bond yield coincide with a slight rise in credit spreads which is unusual.

Taking a longer-term view, when interest rates have risen over the 25 years to end of February 2022, credit spreads have usually fallen. For instance, in calendar-month terms, the 5-year US Treasury bond yield has increased by more than 25 basis points (bps) 71 times out of the past 302 months. Meanwhile, the high-yield spread has risen by more than 25 bps in 36 of the past 302 months. However, they have both increased by 25 bps on only three of these occasions — and one of those incidents happened recently.

It is worth noting that it definitely doesn’t mean it won’t happen frequently in the future. For example, it is very possible that higher interest rates results in higher bond yields, that also increases the default probability across the market, thereby increasing credit spreads. It is this situation that has occurred during recent months as the higher interest rates have started the stagflation scenario which is a recessionary regime brought about high inflation.

Q4. What do multiple US Federal Reserve interest-rate rises mean for a bond portfolio?

MF: The Fed indicated that it could increase interest rates by up to six times this year. So the question around index exposure is this: What will happen to the yield curve?

The yield curve should be viewed in two parts. The shorter end represents what the market thinks will happen to cash rates. For example, if inflation looks like it will rise, we can expect the shorter end of the yield curve to climb because it is likely the central bank will raise rates.

However, the longer end has a different meaning. It reflects the longer-term economic impact of events, including current interest-rate rises. So, the Fed needs to be careful not to hike rates too quickly or too high because the longer end of the yield curve might view this as increasing the probability of recession so it won’t necessarily start to climb, but decrease. But if the Fed manages to tame inflation and avoid economic damage, we will probably see the longer end of the curve rise and provide a pathway for future cash rates.
If the Fed’s actions are economically harmful, and we need to bear in mind other factors in play across the global economy, such as higher food and energy prices, then the longer end of the yield curve may drop. Sequentially, index bond returns could potentially serve as a hedge to economic outlook.

Q5. What does the yield curve tell us about the outlook for corporate bonds?

MF: If we look at the US high-yield spread, it’s been near historical lows and a few themes are in play. According to a recent MSCI report, there is greater volatility among high-yield and emerging-market debt segments, particularly in Eastern Europe. This acts as a red flag warning that spreads could widen in the short term (and they did!). At the same time, high-yield bonds are currently supported by investors’ quest for the inflation-beating returns they’re unlikely to get from cash or other bonds, certainly in the US. The recent significant increase in bond yields has meant that positive real long term yields from conservative bonds are back in play, and have also coincided in a widening of credit spreads.

It’s also worth pointing out that amid global economic pressure, high-yield default rates were around 6% in 2020, whereas investment-grade defaults were much lower, close to zero. From a spread perspective, investment-grade bonds look better value than speculative high-yield issues at the moment.
Q6. Has the geopolitical environment impacted the outlook for bond markets?

MF: Core inflation in the US, excluding food and energy, is above target at 8.6%. Meanwhile, wage growth is over 11%. If we add the Russia-Ukraine war and the effect it is having on food and energy prices, then the Fed has a dilemma whereby overall inflation will remain elevated because interest-rate hikes won’t necessarily impact rising oil or commodity costs. However, these two elements will still feed through into a broader basket of prices, including goods and services. That means the Fed must focus on core inflation (ex-food and energy), which is challenging. Events in Europe are also being felt in Australia with higher shipping costs creating additional inflationary pressures on top of the COVID-related supply-chain issues that emerged in 2021.

Q7. Most investors have a reasonable allocation to Australian bonds. Can you describe the outlook for inflation and the Australian bond market?

SM: The Reserve Bank of Australia (RBA) had been among the more dovish developed market central banks until as recently as April, but took a hawkish pivot quickly, with a bigger-than-expected rate hike in the middle of an election campaign. On the 3 May 2022 the central bank lifted its cash rate target from the record low of 0.1% to a more than expected raise to 0.35%, on 7 June shocked the market with another rate rise of 50bp and again on 5 July by another 50bp to lift the official cash rate to 1.35%.

Inflation has picked up significantly and by more than expected, with headline inflation coming in at 6.1% and underlying inflation at 3.7% (over the year to the March quarter), the highest levels in more than two decades. The Bank’s business liaison also suggested that wages growth has been picking up, in a tight labour market, with the unemployment rate declining over recent months to 4% and labour force participation increasing to a record high. The RBA signalled in June that they were now expecting headline inflation to be ~7.00% by year end which is significantly higher than their explicit comfort band of 2–3%.

Cash futures markets are pricing in even more aggressive monetary tightening by the RBA over the next 12 months. As at 30 June the market sees 3.00% as an official cash rate by the end of 2022 and 3.50% by mid-2023.
Q8. What has this environment meant for fixed interest investors over the last few months?

SM: Trading conditions for fixed-income securities have been tough over the last 6–12 months. There have been some substantial losses, but these were not unexpected after 10 years of bond bull market gains. Also, we need to remember that average duration, or the level of risk in a bond portfolio, has almost doubled over the past decade. However, bond markets are starting to reprice, and it’s hard to see that tough environment abating because yields are rising from historic lows. And if you compare fixed and floating rate notes (FRNs), the latter enjoy relatively low interest-rate risk.

One key risk to consider with Floating Rate Notes is the level of credit-spread duration which is driven by the final maturity date of the floating-rate note.
Q9. How can floating rate notes contribute to client portfolios in the present environment?

SM: FRNs reset their coupons every three months, so they can adjust to any marked changes in RBA monetary policy. In times of stress, FRNs can potentially be far more palatable for a defensive portfolio as they provide a high degree of liquidity and may reduce an investor’s exposure to risk.

With the sell-off in yields and bonds facing quite extreme losses over the last three to four months, the risk, the interest rate duration of a floating rate note portfolio is very minor.

Looking at Figure 8, you haven’t seen the losses in floating rate notes that you have seen in fixed-income bonds. There is spread duration which is a risk in a floating rate note, but the interest rate risk of the note is very limited.
As mentioned, fixed income is experiencing a difficult time, but this has not been due to pricing stress or brokers stepping back from the market. It’s more to do with the continued repricing of the curve due to both domestic and off-shore issuance again moving marks wider.

In contrast we’ve seen a lot of domestic banks tap into offshore markets. And this in effect repriced secondary market bank curves and moved spreads wider. For example, the TRAXX measure of Australian investment-grade spreads has spiked in recent months yet the fundamentals for these banks have not changed. Banks remain well positioned with strong balance sheets. Wider spreads do provide an attractive entry point for investors that want to build a Floating Rate exposure.

**Q10. How are market conditions affecting portfolio construction?**

**SM:** Diversification is crucial. Interest rates are moving higher, and “short duration” is an appropriate stance. At this moment, though, duration could still pay an important role in a multi asset portfolio to hedge against equity drawdowns and economic risk. Retaining some duration and spreading risk across the fixed interest spectrum, whether it’s FRNs, asset-backed securities, or investment-grade bonds, can provide the potential for a higher level of income.
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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of March 31, 2022 and includes approximately $73.35 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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Floating rate securities are often lower-quality debt securities and may involve greater risk of price changes and greater risk of default on interest and principal payments. The market for floating rate securities is largely unregulated and these assets usually do not trade on an organized exchange. As a result, floating rate bank loans can be relatively illiquid and hard to value. Diversification does not ensure a profit or guarantee against loss.

The value of the debt securities may increase or decrease as a result of the following: market fluctuations, increases in interest rates, inability of issuers to repay principal and interest or illiquidity in the debt securities markets; the risk of low rates of return due to reinvestment of securities during periods of falling interest rates or repayment by issuers with higher coupon or interest rates; and/or the risk of low income due to falling interest rates. To the extent that interest rates rise, certain underlying obligations may be paid off substantially slower than originally anticipated and the value of those securities may fall sharply. This may result in a reduction in income from debt securities income.

Bonds generally present less short-term risk than stocks but provide lower potential long-term returns.

All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks but provide lower potential long-term returns.

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