Insights
Fixed Income

September 2021

Mindful of the Taper

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Bond yields and credit spreads have drifted lower over the summer. In September, higher levels of issuance and the realisation that the tapering of bond purchases is not far away are risks for the market.

However, the backdrop of gradually slowing growth and inflation and clear communications from central banks should ensure that there is no sharp sell-off. Strategy-wise, we continue to favour high yield and convertibles and see longer-term value in emerging markets.

Still Searching for Yield

September is often the time when there is a notable change in the investment climate. The return from the summer holidays sharpens investor focus on the final stretch of the year as a period to bolster returns and to minimise event risk so as not to undermine any gains made in the early part of the year.

After a meaningful growth rebound so far in 2021, the first question is likely to be, how long can the growth persist? There may still be some pent-up consumer and business demand to feed through, but these factors are starting to fade in many areas. Monetary policy remains very loose but this is likely to change before year-end with both the US Federal Reserve (Fed) and European Central Bank (ECB) becoming nervous about strong growth and high inflation prints. Fiscal policy is also becoming less expansionary as governments roll back their support.

Moreover, there are indications that the tax burden may rise in order to offset the massive increase in debt.[1] In other words, the phase of rapid growth feels like it is maturing and the fact that the Citi Economic Surprise indices are in negative territory in the US, euro area and UK also points to global growth being in the mid-cycle expansion phase. That said, Bloomberg consensus forecasts for growth in 2022 remain robust at more than 4% for the US and euro area and more than 5% for the UK.[2]

There are of course risks from COVID, with the Delta variant again causing a rise in cases. However, it looks like most western governments have adopted the policy of vaccination and re-opening and are willing to tolerate a rise in infections. This approach will have its limits but, for the moment, the bar for a meaningful economic lockdown seems quite high.

The other economic issue is inflation. The summer saw some big upside surprises to inflation for many nations. The buzz-word remains 'transitory' but the PriceStats® model run by State Street Global Markets highlights that inflation may take a while to pass through the system, making life uncomfortable for those central banks running highly expansionary monetary policy.

Oil prices are no longer rising, which should limit upside risks until base effects take the YoY rates lower in 2022, but there remains a considerable amount of supply chain disruption and earnings have risen. This may raise some concerns over a rise in longer-term inflation expectations and certainly the US 5-Year, 5-Year forward breakeven inflation rate has risen by around 40bp from its average levels in 2020 to 2.35%.[3]

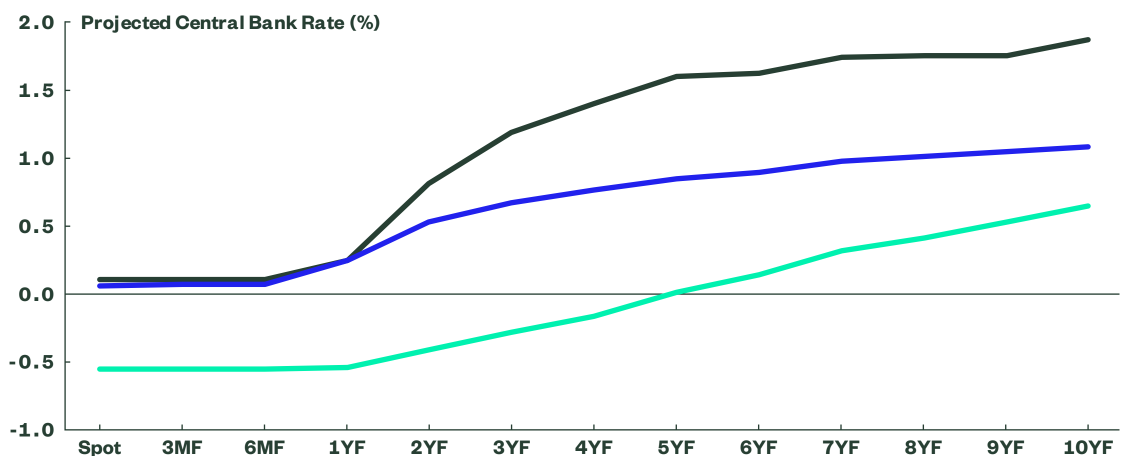
Questions Over the Central Bank Reaction Function

Every monetary policy cycle is different but the Fed is obviously keen to avoid a re-run of the 2013 taper tantrum. So far, the situation has been managed adeptly, with the market posting only a mild reaction to the suggestion made at the Jackson Hole Economic Symposium by Fed chair Powell that the tapering of bond purchases could start in 2021. Likewise, the ECB has managed market expectations well, announcing lower purchase amounts for Q4 2021, but making no commitments on what will happen in 2022.

Both the Fed and ECB are keen to reassure the market that a tapering of bond purchases does not mean that interest rates will increase any time soon. This is reflected in the money markets where the 1-month Overnight Index Swaps (OIS) price very little movement in rates over the coming 12 months — there is a 25bp rate rise from the Bank of England but only around half that amount for the Fed. It seems unlikely that there will be any signals from the Fed of an intention to raise rates before 2022, meaning front-end yields should remain low.

Figure 1
Changes in Policy Rates Priced by the Overnight Index Swaps Forwards

USD
EUR
GBP



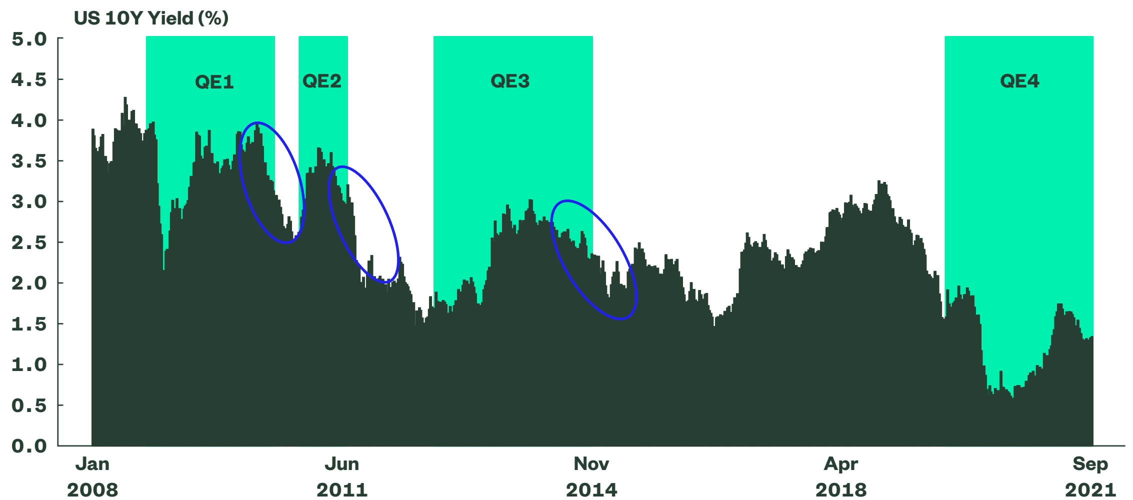
Source Bloomberg Finance L.P., as of 9 September 2021.

The bigger question pertains to yields further up the curve. With the 10-year Treasury yield having topped out at close to 1.75% in March, there is some caution that the market could be set to endure another sell-off as asset purchases are gradually phased out. However, history suggests that an end to asset purchases by the Fed does not necessarily result in higher yields. In fact, yields have declined following previous episodes of quantitative easing (QE).

As Figure 2 shows, the recent price action in US Treasuries, with a yield spike despite ongoing asset purchases, is entirely consistent with what has occurred before. What is more, following all three previous QE operations, there has been a tendency for yields to decline even after the buying has stopped.

Figure 2

US 10-Year Treasury Yields have Typically Declined After QE Purchases have Ceased



Source: US Federal Reserve, Bloomberg Finance L.P., as of 3 September 2021.

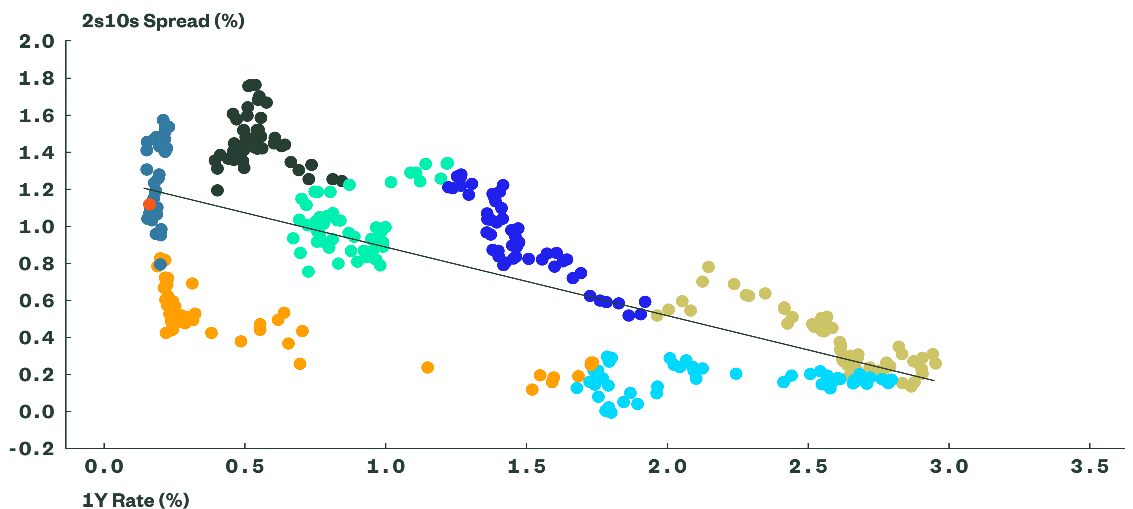
Following QE3, yields only started to climb in a sustained way in 2016 when it became clear that the Fed was about to embark on a series of rate rises.

Another concern is the low absolute level of yields but, as is clear from Figure 3, the curve out to 10 years is not unusually flat given where the front end (1-year rate) is trading. A further rise in yields would be required to bring the curve to levels consistent with the 2015–2018 period when, broadly speaking, the market had a tightening bias. However, the Fed's current rhetoric suggests that it is some way from embarking on rate rises.

Perhaps one should expect a steeper-than-usual curve given the high inflationary backdrop. However, as already mentioned, the pricing of longer-term inflation expectations has risen and, as long as 10-year real yields remain so low, there will be limits to how high nominal yields can push. Real yields could start to rise as the Fed reduces the buying of TIPS, as this is one area where issuance is not expected to decline, but any increase is expected to be gradual.

Figure 3

The Treasury Slope Out to 10 Years Looks Fair Given Where the 1-Year Rate Is



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 3 September 2021.

Positioning for the Transition into Q4 2021

Government bond yields should move higher over the longer term as monetary policy is tightened. However, as outlined above, this often does not materialise until well after the asset purchases have ceased. In addition, the current backdrop of slowing growth and inflation, coupled with the Fed's messaging, should provide some support to fixed income markets. Downside risks to growth from COVID are a further reason to be cautious. In terms of what that implies for investor allocations, we make the following points:

- The summer moves in the fixed income market have been broadly in line with the seasonal patterns (see the **Q3 2021 Bond Compass**). September is often a time when yields rise and the seasonal patterns certainly suggest caution around government strategies in particular, which can perform poorly on the back of increased issuance. While for 2021 issuance could start to decline in line with lower government spending on various support measures, it is likely that central bank asset purchases may also get scaled back this year. So while the above analysis makes us more confident in taking some duration risk, a degree of caution should be exercised around government bonds.

- High levels of corporate issuance in H1 2021 and strong earnings point to a lower need for funding during the remainder of the year. In addition, the still-strong growth momentum points to earnings remaining buoyant. This is especially evident in lower-rated companies, with the Moody's upgrades versus downgrades ratio for high yield bonds at 2.3 for Western Europe and 3.0 for North America so far in Q3 2021. Coupled with still-meaningful yields, high yield strategies should remain a key building block for portfolio returns.

- For those investors concerned that there remain risks of a taper-led sell-off, investment grade credit is a relatively safer place. The taper tantrum of 2013 saw spreads on US investment grade credit blow out by 25bp against more than 100bp for high yield. While spreads may be historically tight, we still see advantages to the yield pick-up provided by US credit in particular (see the Strategy Espresso, **Position for Tapering with US ESG Investment Grade Credit**).

- Regulatory changes in China have made Q3 a bumpy ride for convertible bonds. They remain well positioned for a continued recovery while bringing convexity to portfolios in case of market fragility, especially against a COVID wild card. Being heavily weighted toward technology names, a resurgence of COVID has typically benefitted tech stocks, which are less impacted by the work from home/lockdown environment. While regulatory risk remains in China, the loosening of credit has restarted and this should support activity.

- Emerging market local currency debt still offers a relatively attractive yield[4] but returns continue to be dominated by currency moves. This weighed heavily on performance in June and July and fears over a resurgence in COVID, hitting the currency, remains a risk. August returns were positive and the basket of currencies that make up the Bloomberg EM Local Currency Liquid Government Index remain 5.7% undervalued versus the USD, according to the model used by State Street Global Advisors.[5] So there continues to be longer-term potential for currency gains, not least because many emerging market central banks are ahead of the Fed when it comes to raising interest rates. Indeed, flows into emerging market debt continue, with the Institute of International Finance suggesting more than $200 billion has flowed during the first eight months of 2021. Around half of this amount has gone into Chinese bonds.

Endnotes

1 For instance, the UK government is proposing a rise in national insurance contributions in order to fund the health service while the US government is trying to pass its spending bill, which would include tax rises to fund it.

2 These forecasts are based on certain assumptions and analyses. There is no guarantee that they will be met.

3 Source: Bloomberg Finance L.P. Average for 2020 is 1.95% and for 2021 year to date is 2.35%, as of 9 September 2021.

4 The yield-to-worst on the Bloomberg Emerging Markets Local Currency Liquid Government Index is 4.6%. Source: Bloomberg Finance L.P., as of 8 September 2021.

5 As of 31 August 2021.

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