Insights
Fixed Income

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Brighter Times for Bonds?

Where to Look, What to Do in 2023

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- As policy rate cuts come into view we expect yield curves to move from inverted to flat and ultimately to steepen over the coming quarters.
- US Treasury market is more advanced on this journey, while European markets may take longer as central banks deal with more intractable inflation. European investors can take advantage of relatively attractive rates and short-end yields.
- We prefer sovereign exposure to credit and favour investment grade over high yield for now. Emerging Market Debt may be at a turning point for those with the risk appetite.
- The policy trade-off between controlling inflation and inflicting unnecessary economic pain rages on — expect choppy bond markets.

Flatter and Then Steeper Yield Curves, Just Not Everywhere Yet

We expect the current disinflationary trend to gain momentum as the year progresses. Naturally the process will evolve at a different tempo in individual countries and regions, with the US and Canada somewhat ahead of their European counterparts.

In the US, the annual rate of headline inflation appears to have peaked last June and has declined every month since then while core inflation has been on a downward path for a number of months. Both measures are now confirming the powerful disinflationary trend evident for some time in leading inflation indicators.

Another encouraging sign can be seen in average hourly earnings where the annual rate of change has fallen back to 4.4% from 5.9% in the spring — a welcome development given earlier concerns of a wage-price spiral in very tight labour markets. In fact, the same report points to a broad decline in average weekly hours worked — indicating less intensive use of existing labour resources. Inflation certainly appears to be turning sharply lower.

Central Banks Will Broaden Focus

This easing in price pressures will ultimately allow central banks to broaden their focus beyond the immediate priority of taming inflation and anchoring inflation expectations. As evidence builds further that inflation is under control, central banks can then pay closer attention to the potentially unnecessary pain that may follow one of the most aggressive rate-hiking cycles in decades — the Fed led the charge by delivering 450 basis points of rate hikes in just 11 months while others — notably the Bank of Canada and the Bank of England — have been equally resolute.

We know that monetary policy transmission works with a lag so the full impact of last year's rate hikes has yet to be felt. Slightly worryingly, central banks have made it abundantly clear that there's more to come, particularly so in Europe. We believe this is likely to be too much given the strong disinflationary dynamic already under way and ample evidence of a widening slowdown.

For us that means that rate cuts are likely in the US and perhaps Canada before the end of the year and in turn this will allow yield curves to flatten and then shift to steepening as the short end of yield curves prices in those rate cuts.

The European Picture

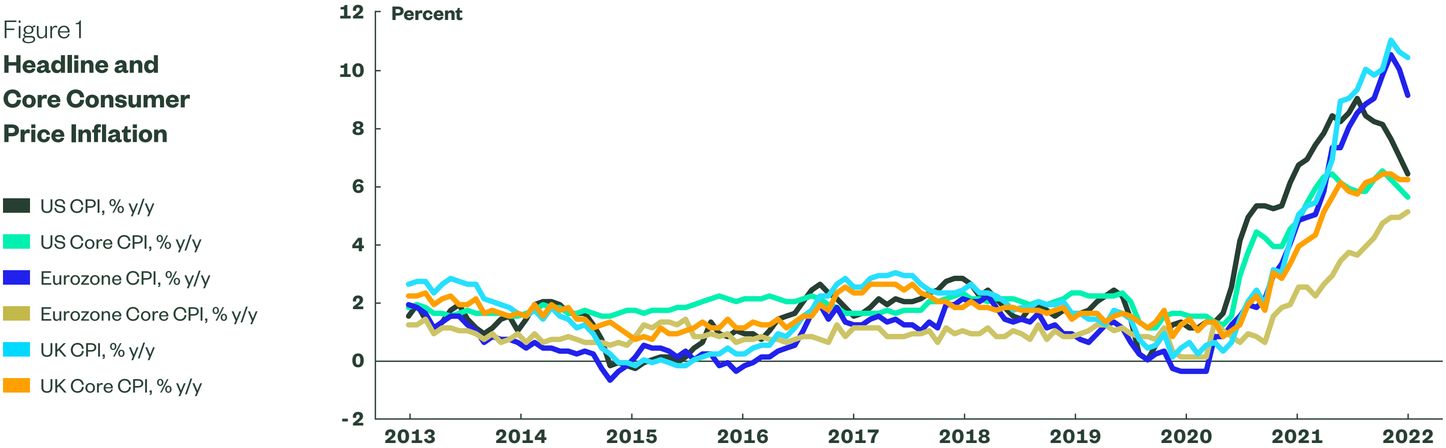
Europe is a bit earlier in the cycle and faces some added challenges which push out the timeline for an ultimate move to steeper curves. While central banks across Europe have lifted rates meaningfully in recent quarters, they have not been as aggressive as the Fed in terms of pace and scale of policy tightening. Further rate increases have been well telegraphed by individual central banks even if the scale and timing remains a matter of intense debate.

The European picture is complicated by a few factors on the inflation front: first, while there's been a welcome fall in the annual rate of inflation across the Eurozone it still remains very high and is particularly susceptible to energy price shocks; second, core inflation in the euro area has not yet shown signs of peaking — hitting a record high of 5.2% in December — remaining well above the ECB's tolerance. Finally, the ECB expects strong wage growth in the coming quarters. All this means that the timing of a rate cut is further off for many European markets and the move from inverted to ultimately steeper curves will take longer to materialise.

The UK Challenge

Although the UK faces its own unique set of challenges it is in a broadly similar position to that of the euro area. A strong labour market — unemployment at 3.7% and average wage growth running at an annual pace of 6.7% with no immediate signs of softening — combined with a recent rise in longer-term inflation expectations[1] — means there's still some way to go before the Bank of England can be confident that it has managed to tame inflation expectations. That said, there is evidence of significant weakness in areas of the UK economy — the plunge in mortgage approvals (35,600 in December compared with an average of almost 73,000/month over the past twenty years) certainly raises an eyebrow. So, similar to the Fed, the Bank of England will face the unenviable task of balancing enough pain to rein in inflation with going too far and inflicting unnecessary pain. A truly thankless job as the right balance will only be known after the fact. So we see the UK at a broadly similar point on its journey as its mainland neighbours i.e. some way behind the US market on the trip from inversion to flattening to steepening.

Figure 1
Headline and Core Consumer Price Inflation



Source: State Street Global Advisors. As of 31 January 2023.

So, Where to Go in the Meantime?

For strategic investors we may be getting close to a buying opportunity in bonds — especially in those markets more advanced in the rate cycle. However, with policy rates still firmly upward bound and a more complicated inflation outlook, investors in European fixed income may need to take a cautious stance on duration in the near term. The technical position is also challenging with the prospect of quantitative tightening and an elevated net borrowing requirement across the Eurozone.

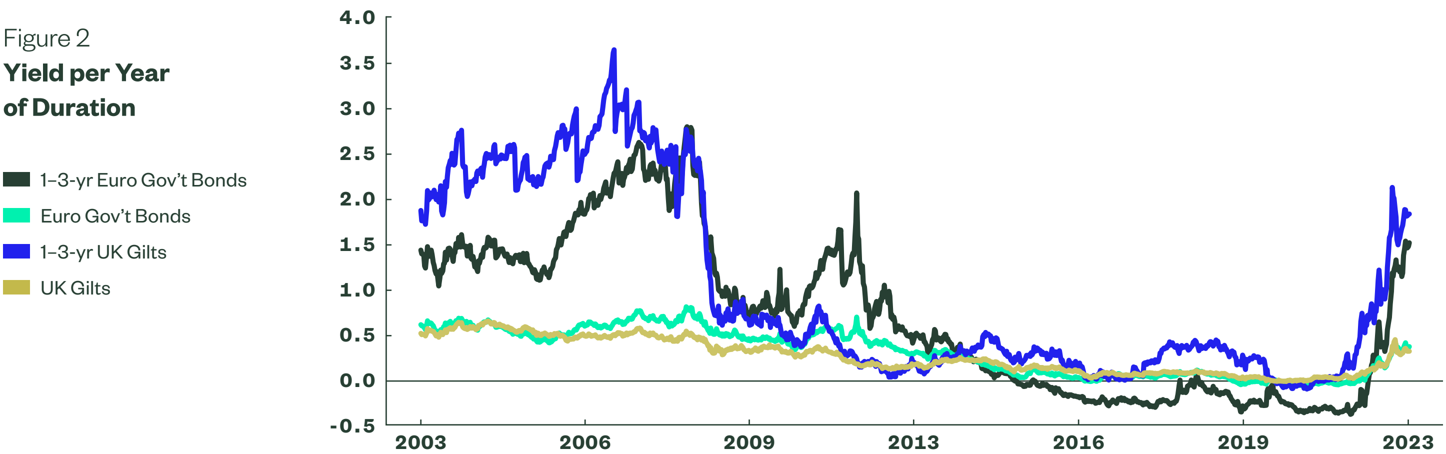
Stay Shorter on Term Structure

Nevertheless there are opportunities for investors in this environment. Much higher short-dated sovereign yields and the prospect of further rate hikes offer euro and sterling investors (among others) one of the best yield-duration trade-offs in some time. This means that investors in short-dated sovereign and corporate debt can start to capture a much improved yield per year of duration as the cycle progresses.

The journey to those peak policy rates may well involve some modest price losses given the sensitivity of short-dated bonds to rising rates but, importantly, they will be capturing much better ongoing yields than before — in absolute and duration-relative terms. And, as the prospect of rate cuts becomes more widely priced-in, those improved yields are likely to be accompanied by price gains. Fixed income investors can take advantage of this by tactically adding to or overweighting maturity buckets such as 1–5-yr Gilts, 1–3-yr EMU government bonds etc.

For those with the desire and capacity to tactically lighten up further on duration, a money market fund can further help build a barbell approach. These offer a more direct link to the rate cycle as many of the underlying instruments are linked to policy rates and therefore returns are positively correlated with rising rates unlike many fixed-rate exposures.

Figure 2
Yield per Year of Duration



Source: State Street Global Advisors. As of 31 January 2023.

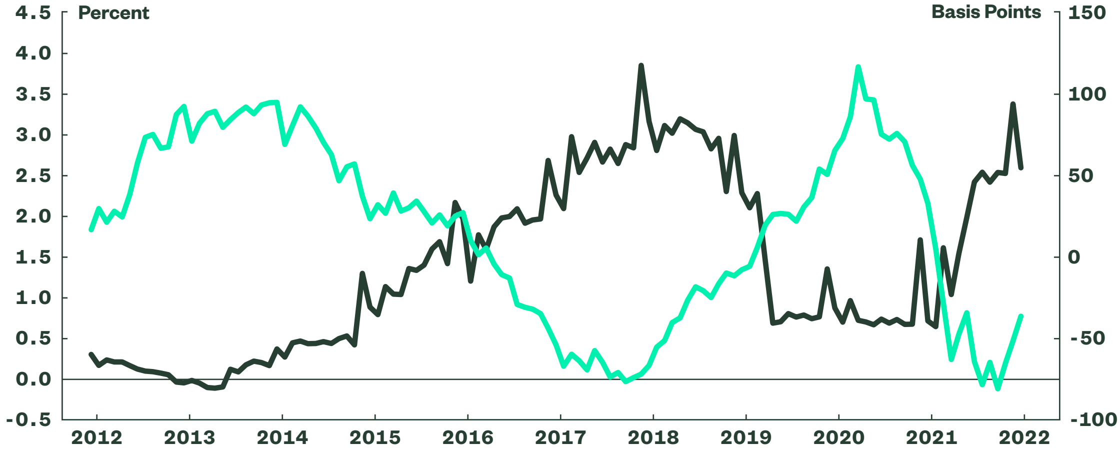
Consider US Treasury Exposure

As noted above some markets such as US Treasuries are at a more advanced point in the rate cycle and perhaps close to offering an attractive entry point. European investors might wish to consider these markets as they bide their time on the duration front but will need to take account of the higher hedging cost for euro and sterling investors at this point in the respective rate cycles. However, if the rate cycles evolve as we expect, those hedging costs can become more palatable or even reverse while steeper curves (in US for example) could provide a welcome rolldown effect most likely still absent in home markets. For yen and Swiss franc investors the very elevated US dollar hedging cost make this unattractive at this time.

Figure 3
Yield Curve Steepness & US Dollar Hedging Cost

Estimated Annualised USD Hedging Cost for Euro Investors (LHS, Percent)

US — Germany 2/10s Slope Difference (RHS, Basis Points)



Source: State Street Global Advisors. As of 31 January 2023.

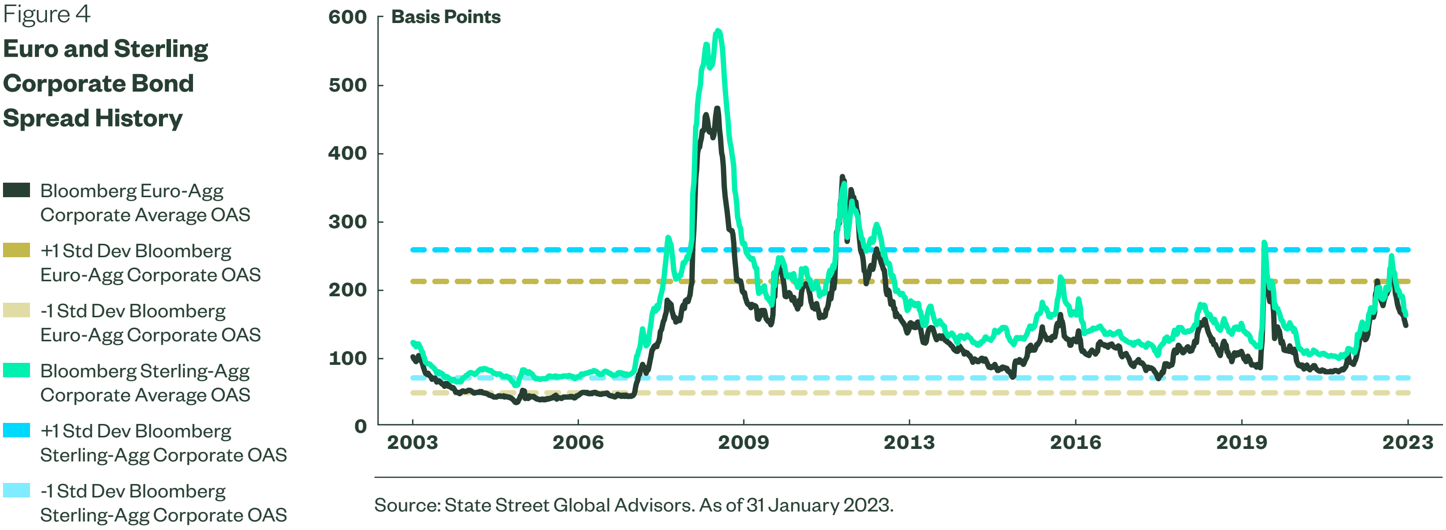
IG Credit Depending On Positioning

We also believe that investment grade credit warrants consideration but investors will need to pay attention to timing the entry points. For investors concerned with absolute yield levels they will need to factor in the likely rise in underlying European sovereign yields and possible stagflation tail risks. As noted above it may suit some to take on a lower duration exposure in 0–3-yr euro corporate or 0–5-yr Sterling corporate bonds until the duration headwind abates.

Those aiming to capture spread may also need some forbearance — credit spreads have compressed sharply since mid-October when they were clearly pricing-in recession risk with spreads trading about one standard deviation above long-term averages for both GBP and EUR corporate debt.

At time of writing spreads are much closer to long-term averages. For some this may not be sufficient compensation: investment-grade fundamentals are weakening (admittedly from solid levels) while the macroeconomic backdrop is more challenging. Those investors may wish to hold off for more attractive entry points — the full impact of last year's rate hikes and those yet to come may well provide some opportunities in the coming months or quarters. However, other investors — those underweight credit for example — may take the opportunity to move back towards neutral given the attractive carry and the emerging visibility on the rate and credit cycle.

Figure 4
Euro and Sterling Corporate Bond Spread History



Source: State Street Global Advisors. As of 31 January 2023.

Global High Yield — Something for Later

Global speculative grade debt posted a very solid performance in Q4 as significant spread compression boosted returns. As a result spreads are now close to long-term averages at a time when the outlook has become more opaque and the credit cycle is turning with the ratio of upgrades to downgrades continuing its decline.

For Western Europe, downgrades outnumbered upgrades by more than 2 to 1 while in North America the number jumped to almost 4 to 1 in the fourth quarter according to rating agency Moody's. In other words the risk premium received by investors has diminished at a time of increased uncertainty.

For now it seems a little too early to wade in. That said, our base case sees a mild recession for the global economy i.e. an environment where high yield defaults rise to manageable levels — perhaps around 3 to 4% in both US and euro markets.

As we get greater clarity on the impact of the recession on earnings and spreads more fully reflect a moderate rise in defaults, we believe high yield debt is likely to offer a more attractive entry point for investors.

EM Debt Attractive for Those With the Risk Tolerance

We may well be at an inflection point in emerging market debt. Having faced the combined headwinds of an ever-strengthening dollar, a major sell-off in advanced economy bonds and a string of high profile defaults last year, much of the worst of the news and deterioration in fundamentals may be behind us.

Further substantial falls in inflation should provide cover for the Fed to cut rates in the second half of this year which in turn can alleviate and reverse the pressures arising from a strong dollar, especially for hard currency EM debt. Fundamentals here are also moving in the right direction: sovereign debt has either been restructured or is already priced for it, so after two record years of EM restructurings the hard currency segment is better positioned and tail risks have been reduced.

Add to this the positive implications of a China re-opening for key trading partners across Asia and a constructive case for hard currency debt emerges. The market has moved quickly to price-in this improved position with benchmark yields falling from over 10% in late October to approx. 8% at time of writing. After such a sharp rally, a short-term setback would not be surprising but the case for medium or long-term investors seems solid.

The prospects for local currency emerging market debt are also attractive. A potential peak in the US dollar and the re-opening of China are favourable catalysts for this segment too. An added dynamic in the local currency arena comes from domestic monetary policy.

A number of emerging market central banks started on the rate hiking cycle well ahead of their advanced counterparts and as a result some (Brazil and Mexico for example) have pushed real policy rates well into positive territory.

Elevated real rates will choke back inflation and should provide investors with substantial potential for yield curve steepening as rate cuts are priced-in. Not all nations are at this point yet and some — notably Central and Eastern European countries — may take a bit longer for the disinflation trend to follow through.

In tandem with their hard currency counterparts, local currency sovereigns have also performed well since October with yields falling almost 100 basis points to ca. 6½%. Historically yields above 7% have presented attractive entry levels, so as with hard currency, a modest setback may offer an opportunity for a tactical or indeed strategic move.

The other point to watch in local currency EM debt is the fair value of the currency exposures. Currency movements (often a stress release valve) explain much of the short-term volatility and can — when picked up below fair value — add a welcome tailwind to the whole proposition. We estimate the basket of currencies[2] to be about 11% undervalued versus the US dollar and almost 4% undervalued against the euro. A modest setback in yields combined with those attractive currency valuations may provide an interesting entry point.

Figure 5
Emerging Market Debt Yields

Source: State Street Global Advisors. As of 31 January 2023.

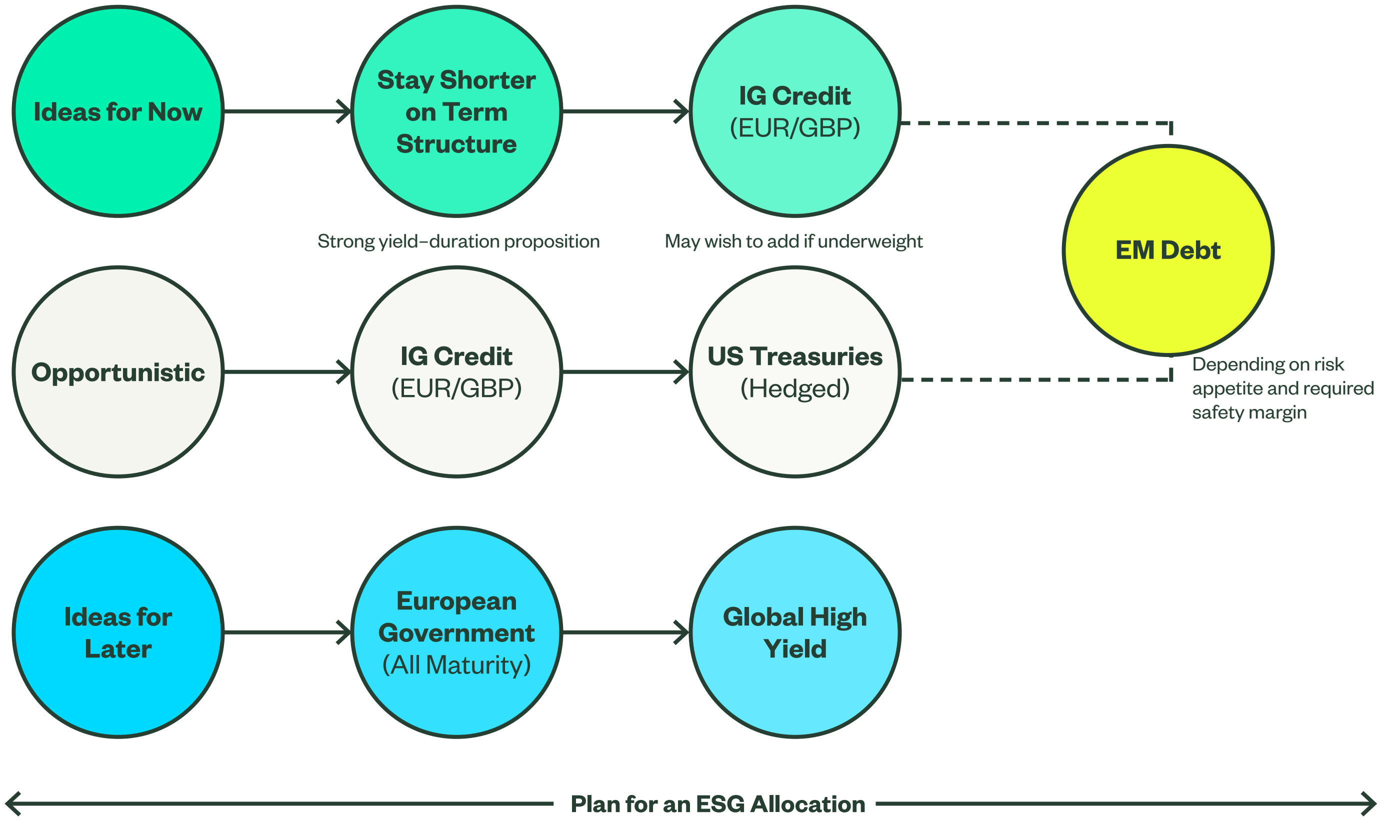
The 2023 Game Plan

As cuts in policy rates come more clearly into view we expect yield curves to ultimately steepen in the coming quarters. The US Treasury market is more advanced on this journey whereas European sovereign markets may take longer given inflation dynamics. In the meantime, investors in European fixed income can take advantage of much improved short-end yields and look at US Treasuries as the currency hedging regime turns more favourable.

Corporate debt has a role to play this year but investment grade is preferable. That said, the sizeable spread compression of Q4 has reversed some of the safety margin — investors may see more attractive entry points in the coming months.

Emerging market debt may be at a turning point. Sentiment has certainly improved with emerging markets attracting near record inflows in late January. Yields have fallen quickly recently and a pullback might offer an attractive entry point as fundamentals turn and the rate cycle provides added support.

We see 2023 as the year where central banks try to balance credible inflation management with the avoidance of needless economic pain — by no means an easy task! Expect choppy conditions but also attractive opportunities for tactical and perhaps strategic re-positioning.



Endnotes

1 Bank of England/Ipsos Inflation Attitudes Survey, November 2022: Asked about expectations of inflation in the longer term, say in five years' time, respondents gave a median answer of 3.3%, up from 3.1% in August 2022.

2 As measured by the J.P. Morgan GBI-EM Global Diversified Composite benchmark index at end December 2022.

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* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as of December 31, 2022 and includes approximately $58.60 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. Please note all AUM is unaudited.

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