Outlook
Fixed Income

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Building a Better Bond Portfolio
Where to Look, What to Do in 2022

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- Expect flatter yield curves in 2022, although this will take time to materialise in some European markets where the short end remains anchored for now.
- The search for yield remains as pressing as ever. While there are risks, there are also rewarding opportunities and complementary exposures in emerging market and high yield debt.
- Inflation may stay elevated for a bit longer than originally assumed and bond market volatility is here to stay for now.

Flatter Yield Curves, with Nuances

We expect to see flatter yield curves across many developed sovereign markets over the coming year. It will vary, however, as a number of central banks advance into a rising rate cycle sooner and faster than others — the Federal Reserve, the Bank of England and the Bank of Canada likely forming the vanguard. Others such as the European Central Bank and Swiss National Bank are likely to move later and perhaps more slowly.

As forward guidance evolves and policy rates move higher, short-dated government bonds will bear the brunt of the impact. Further out the term structure — where inflation and inflation expectations matter much more — yields should witness much less upward pressure.

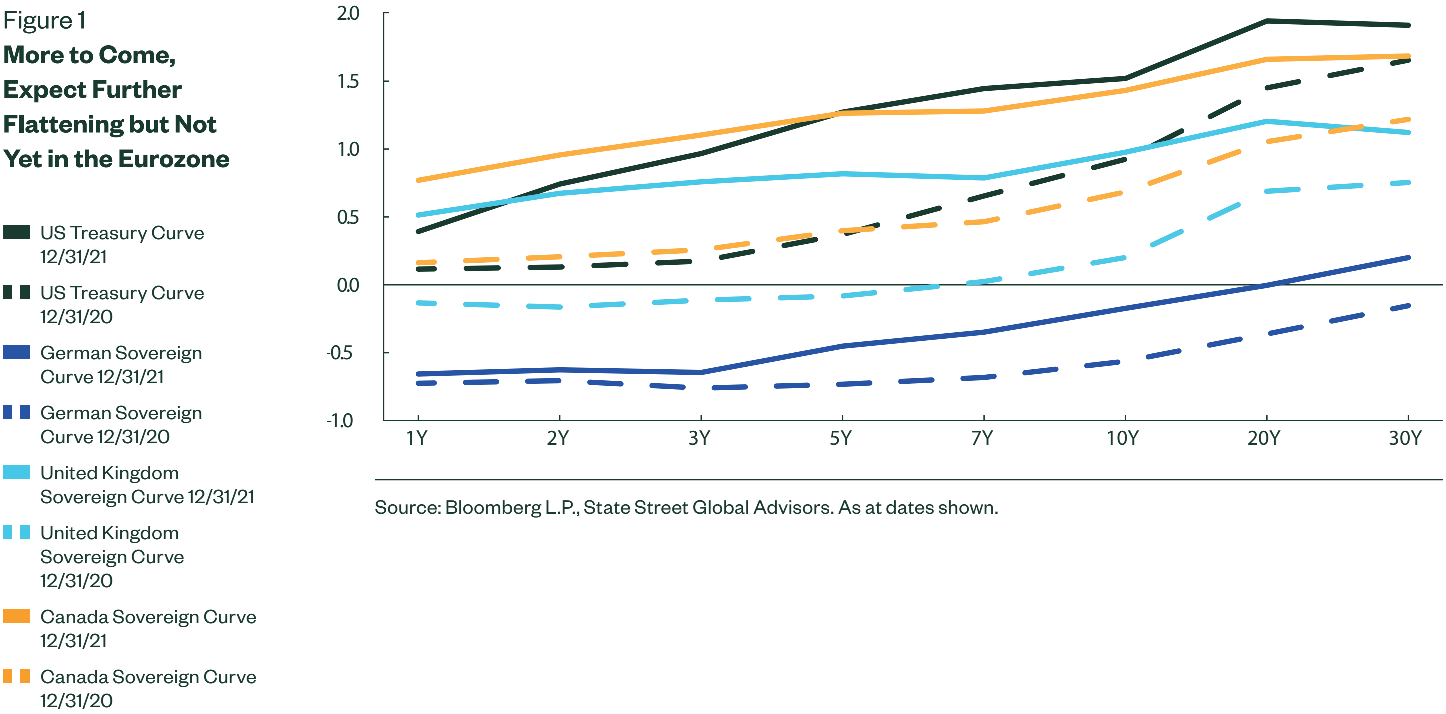
This is for two reasons: firstly, the factors that determine long-term potential growth (labour force growth and productivity growth) are waning in several advanced economies and, in turn, point to more moderate yields on sovereign debt and secondly, the same rate hikes that will lift shorter-dated bond yields should help to contain inflation expectations and dampen the rise in long-term yields.

As those stars align we generally expect to see flatter yield curves across advanced economies. We expect that dynamic to take longer to play out in the eurozone as policy rates remain anchored lower for some time yet.

The Effects of Flatter Yield Curves

A flattening of the yield curve has already been underway over the past year in some markets as tapering of bond purchases and a policy rate lift-off has been priced into the short and intermediate part of the yield curve, while the longer end has remained relatively stable after the first quarter's sell-off. While that rise in yield has delivered modest capital losses for investors it has also reset some yields to more attractive levels.

Figure 1
More to Come, Expect Further Flattening but Not Yet in the Eurozone



Source: Bloomberg L.P., State Street Global Advisors. As at dates shown.

For example, UK sovereign investors can now achieve a yield of over 1.0% in their domestic market while their US, Canadian and Australian counterparts can capture yields of around 1.5% — more than double the level available a year ago. All very welcome and further flattening of yield curves will bring more relief though it may still not be enough, given how modest the absolute numbers are.

The evolving market cycle may mean bond investors demand more than safe-haven status from their holdings — yield and diversification are still key in meeting obligations and cashflows. This is painfully true across much of Europe.

Eurozone, and especially Bund, investors have seen little improvement in available yield and, as noted, a remedy in terms of a flatter curve may be some time off still. The issue is compounded by a steadily rising term to maturity and duration in many markets as governments have taken advantage of ultra-cheap borrowing cost for longer terms. Investors are still at the receiving end of a very poor deal — wafer-thin yields for greater sensitivity to curve movements!

The Big Question – Inflation?

Probably the most critical aspect of our outlook for fixed income hinges around the medium- and long-term prospects for inflation. Highly supportive fiscal plans, enormous amounts of pent-up savings and supply bottlenecks have combined to form a powerful inflationary impulse.

The question is whether this gets embedded into inflation expectations and wage-setting processes ie becomes more enduring. Given the inevitable parsing of central bank rhetoric the term "transitory" has been side-lined and we need to judge for ourselves if and when inflation might wash through the system.

We believe it will wane in many economies — though not without some volatility — as we move through the second half of the year. The market also sees the inflation dynamic as one that washes out, albeit not as soon as everyone had expected. The chart below shows market expectations for 5-year inflation five years from now. It therefore looks out beyond the short-term noise that we've seen in recent months and focuses more on the medium term ie the horizon that interests central banks.

These forward expectations have risen significantly since the onset of the pandemic, reflecting the strong rebound in activity. Despite the perfect storm of inflationary factors the market still expects inflation five years out to be more tame than it was in the boom years leading up to the 2008/2009 Global Financial Crisis.

So, with some sensible caveats and a good dollop of pandemic-induced humility around known and unknown unknowns we expect the price rises to wash out in time. A moderating inflation dynamic and credible central bank response help underpin our expectations of flatter yield curves this year.

Figure 2
Inflation Expectations

Source: Bloomberg L.P. Weekly data from 3 Nov 2006 to 14 Jan 2022.

So, Where to Go?

Where does this leave today's bond investors? We see a number of options for those wishing to escape the low yields that are still so much the norm in the traditional bond hunting grounds of domestic sovereigns.

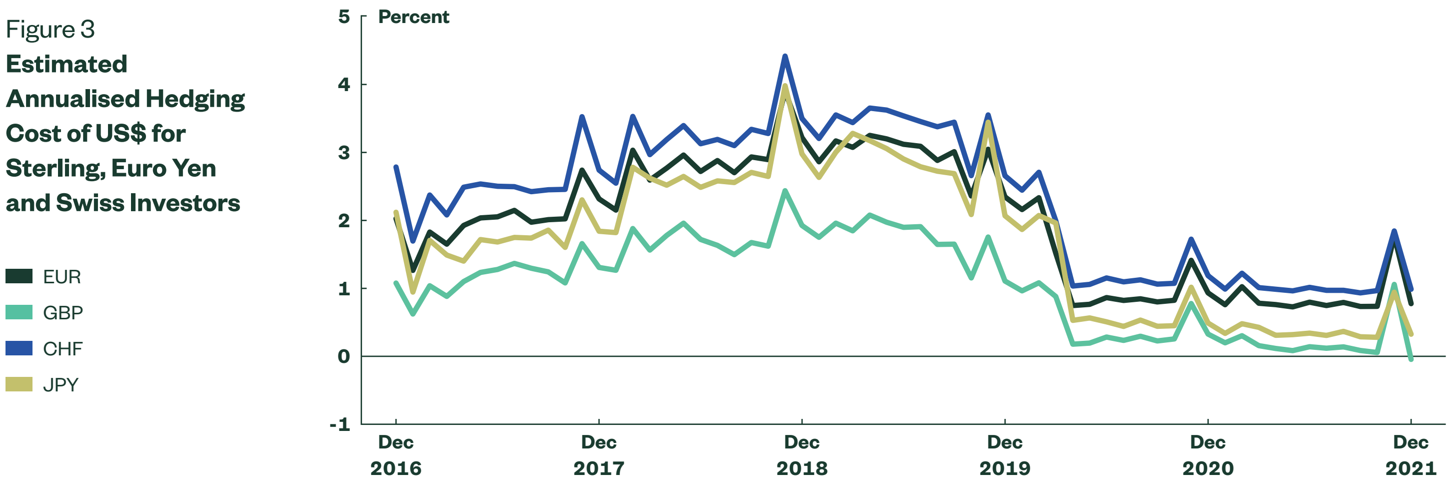
Option 1 US and further afield for Treasury

The first option for European investors is to take advantage of the improving yield on offer in the US and elsewhere by going global with part of their treasury allocation. Of course a global exposure brings currency risk too. For sterling-based investors hedging costs are very modest at present (see chart, hedging USD is the dominant hedging cost in a global treasury exposure).

Euro and Swiss-based investors face a much improved cost profile but need to be mindful of how the coming rate cycle might reverse the favourable trend in hedging costs of recent years and thereby chip away at the additional yield in a global allocation.

For US investors, a global treasury exposure has limited appeal given the significantly lower yields in the eurozone and Japan. However, Australian and Canadian yields are certainly comparable to domestic Treasury yields and a global exposure will provide access to a modest degree of diversification across yield curves and central bank policy developments.

Figure 3
Estimated Annualised Hedging Cost of US$ for Sterling, Euro Yen and Swiss Investors



Source: Bloomberg L.P., State Street Global Advisors calculations. Annualised cost of hedging US dollar exposure using month end spot and forward currency rates from 31 Dec 2016 to 31 Dec 2021.

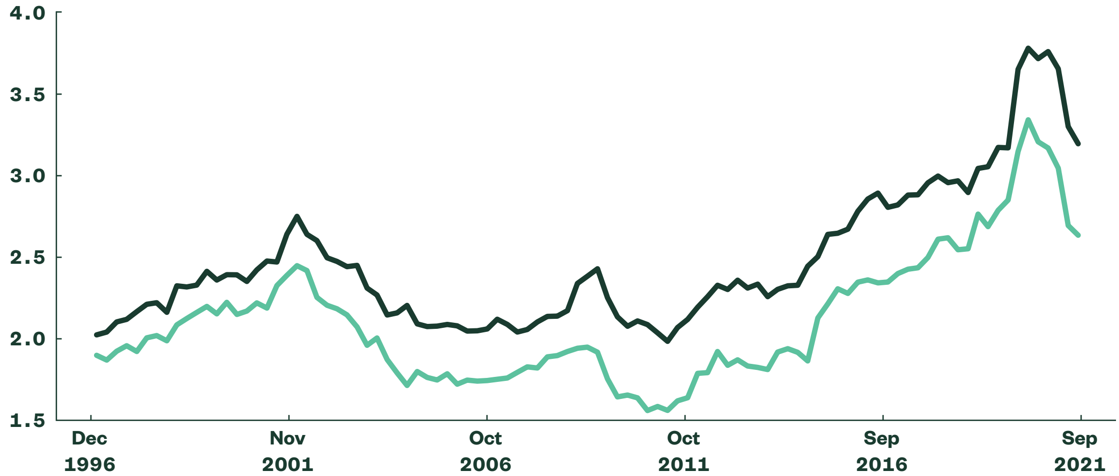
Option 2 Investment Grade Credit

For many, the first step away from sovereign debt is often investment grade (IG) credit. While spreads here have been compressed significantly they still offer an incremental lift in return versus sovereign debt against a backdrop of improving fundamentals.

We are not necessarily looking for further compression — we believe tight spreads can be sustained as long as credit fundamentals continue in the right direction: robust earnings growth is bringing leverage ratios back towards pre-Covid levels (see chart) while a pickup in revenue growth is supporting high profit margins.

Figure 4
Improving Fundamentals Bode Well for US Corporate Bonds

Gross Leverage
Net Leverage



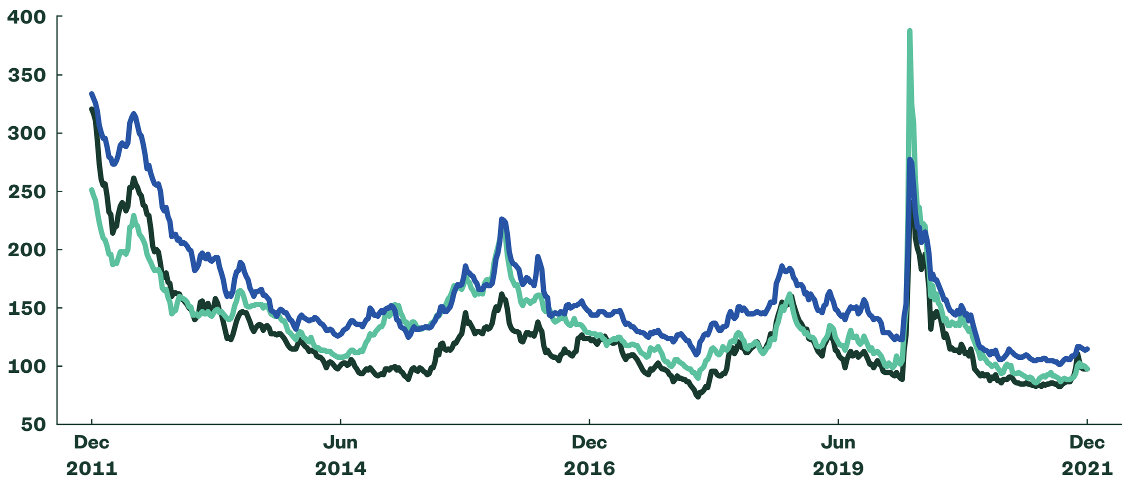
Source: Bank of America, as of 30 Sep 2021. Data represent median values for the broad universe of US investment grade non-financial issuers.

The improvement in fundamentals is an important point as the investment grade realm has seen a gradual deterioration in credit quality over time. Ten years ago BBB-rated issuers typically comprised between 27% and 40% of the index, whereas today they make up approximately 50% of the investment universe.

Most investors in investment grade credit prefer to stick to their domestic currency — which is understandable given the additional risk of foreign currency exposure. This does however reduce the opportunity set and diversification potential and some, sterling investors in particular, may forgo little in capturing the wider set and hedging a US dollar-denominated corporate bond exposure.

Figure 5
Yield Spread on EUR, GBP and USD Investment Grade Corporate Debt

EUR Corporate Bond Spread
USD Corporate Bond Spread
GBP Corporate Bond Spread



Source: Bloomberg L.P. Data from 31 Dec 2011 to 31 Dec 2021.

Option 3 High Yield

While investment grade credit is currently all about an incremental yield benefit, some investors need to raise their fixed income returns more meaningfully. High yield debt can help and is again a beneficiary of the same improving fundamentals noted above — of course much of this has already been priced in and spreads are no longer generous.

Euro high yield currently offers a yield of over 3.0% while its global counterpart offers 5% yield. Ironically, high yield debt is becoming a victim of its own success as rising stars (former high yield issuers upgraded to investment grade and therefore leaving the HY universe) outpace fallen angels. High yield debt will therefore become lower quality and higher yielding, everything else being equal. This needs to be placed in the context of an improving macroeconomic landscape and credit fundamentals.

Option 4 Emerging Market Debt

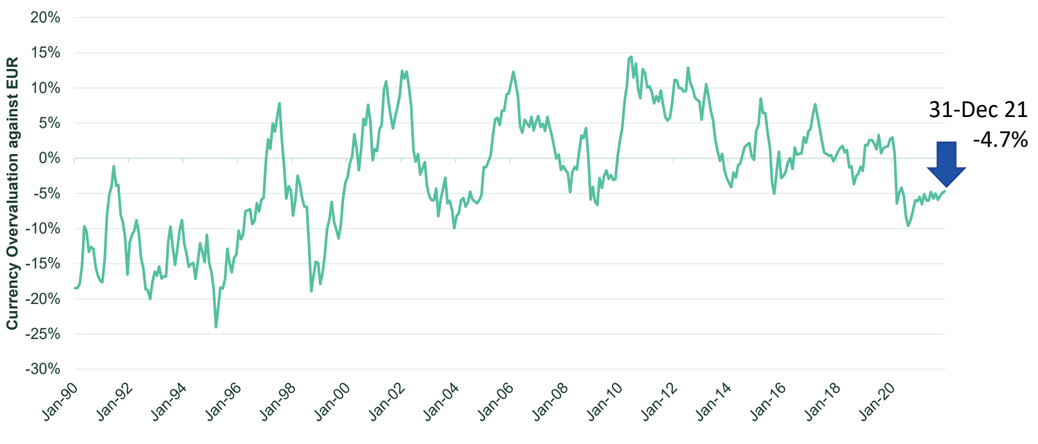
We started this note with a look at developed markets and the anticipated curve flattening as their central banks unwind their extreme policy settings. Many emerging market (EM) central banks have taken several steps already on the rate normalisation pathway and are arguably well ahead of their advanced economy counterparts. Brazil, Mexico and Russia are among some of the bigger issuers of local currency debt that have raised policy rates considerably (more than 7 percentage points in Brazil's case) in 2021 in response to building inflationary pressures. Not for the faint hearted!

Last year was also a good reminder of the headline risk that goes along with the idiosyncrasies of emerging markets. Whether it's the travails of Evergrande or the severe loss of confidence in Turkey's currency — both are salutary reminders of the risks that investors need to appreciate and embrace as they look to add yield. Covid also has the potential to cause greater disruption in some emerging nations so expect more headline risk along the way. But for those who accept these challenges there are rewards and some significant merits in an EM debt exposure.

Credit fundamentals such as gross government debt/GDP are on average in a significantly better starting position versus advanced economies. Growth doesn't face the same demographic headwind noted above for their advanced counterparts.

Local currency EM debt now offers a yield of over 5.75% — a compelling yield for a market dominated (around 80%) by investment grade issues. 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. As can be seen below, the basket of EM currencies is currently below fair value.

Figure 6
EM Local Currency Fair Value for Euro Investors



Source: JP Morgan, Bloomberg L.P., State Street Global Advisors calculations. As at 31 Dec 2021.

Option 5 China

Among emerging markets China deserves special mention for a few reasons. The very nature of its economy, political structures and deep resources means it can set a much more independent monetary and fiscal policy than many other emerging economies. As China's economy slows down and transitions to a broader base those resources and policy levers will be very helpful. Those attributes make it a welcome and complementary addition to an investor's bond portfolio. The greatly improved access and sheer size of China's domestic bond market has prompted the question for many investors of whether or not to have a standalone allocation to Chinese bonds.

In the current yield environment Chinese bonds provide an attractive yield pick-up for European bond investors (with a similar credit rating to the Euro Aggregate exposure) while also offering diversification benefits given their low correlation to other key exposures (see table below).

The question of a hedged or unhedged yuan exposure is important. Euro-based investors who can bear the short-term currency volatility should consider an unhedged exposure to take full advantage of the additional yield and diversification benefits. Those more risk-sensitive euro investors may wish to hedge the yuan exposure and still enjoy the expected diversification benefits albeit with reduced return.

Figure 7
Correlation Matrix of China versus Key Exposures

	China Treasury and Policy Banks	Euro Aggregate	Global Aggregate	US Aggregate	Sterling Aggregate	Japanese Aggregate
China Treasury and Policy Banks	1.00	0.12	0.81	0.88	0.48	0.63
Euro Aggregate	0.12	1.00	0.47	0.30	0.36	0.29
Global Aggregate	0.81	0.47	1.00	0.95	0.62	0.85
US Aggregate	0.88	0.30	0.95	1.00	0.57	0.71
Sterling Aggregate	0.48	0.36	0.62	0.57	1.00	0.35
Japanese Aggregate	0.63	0.29	0.85	0.71	0.35	1.00

Source: Bloomberg L.P., SSGA. As at 30 Jun 2021. Correlations based on monthly returns unhedged in euro from 31 Jul 2004 to 30 Jun 2021.

The 2022 Game Plan

While flatter yield curves will help in the coming year they're unlikely to lift portfolio yields meaningfully — clients still need to look beyond their domestic sovereign markets. Global sovereign and investment grade credit are a good place to add incremental yield depending on currency hedging dynamics.

For a more significant impact high yield and emerging market debt are worthy of attention. We don't necessarily expect spread compression in high yield but improved fundamentals should support ongoing spread capture. Emerging market sovereign debt is arguably further along the cycle offering attractive yields and the potential of a tailwind in currencies trading below their fair value.

A dedicated exposure to China is an obvious one to consider within the EM realm. Not for every fixed income investor but for those with the risk budget and headline tolerance it can offer a favourable risk-reward profile and yield pick-up.

Lastly, given today's prevailing investment ethos and clear regulatory positioning, it's a very short-sighted investor who's not eyeing at least some allocation that captures ESG and climate matters in their bond portfolio.

Further Reading

Chinese Bonds: Enhancing a European Fixed Income Portfolio

China Fixed Income: Weighing Opportunities as Access Improves

The Case for Global High Yield: Why now? Why Indexing?

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