Insights
Fixed Income

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Build A Better Bond Portfolio

Where to Look, What to Do in 2022 — Revisited

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- We foresee a moderate slowdown in growth with inflation starting to abate later this year but note substantial downside risks around both.
- This could have big consequences for central banks (policy error) and many capital markets (increased volatility and risk premia).
- For now we stick to our view that the market has, broadly speaking, priced in too many rate hikes over the coming quarters.
- Re-pricing of the inflation risk premium is critical across many bond segments.
- The broad move higher in yields may begin to offer investors an opportunity to consider a phased entry or an expanded allocation to some spread assets.

Updating

While a number of aspects of our outlook for bond markets remain unchanged since we published our Building a Better Bond Portfolio earlier this year the investment landscape has clearly changed dramatically in recent weeks. This companion note is intended to highlight a few key changes in our outlook in light of Russia's invasion of Ukraine and evolving central bank positions. Our outlook here is more opaque than normal due to the consequences of the tragic events unfolding in Ukraine.

Inflation

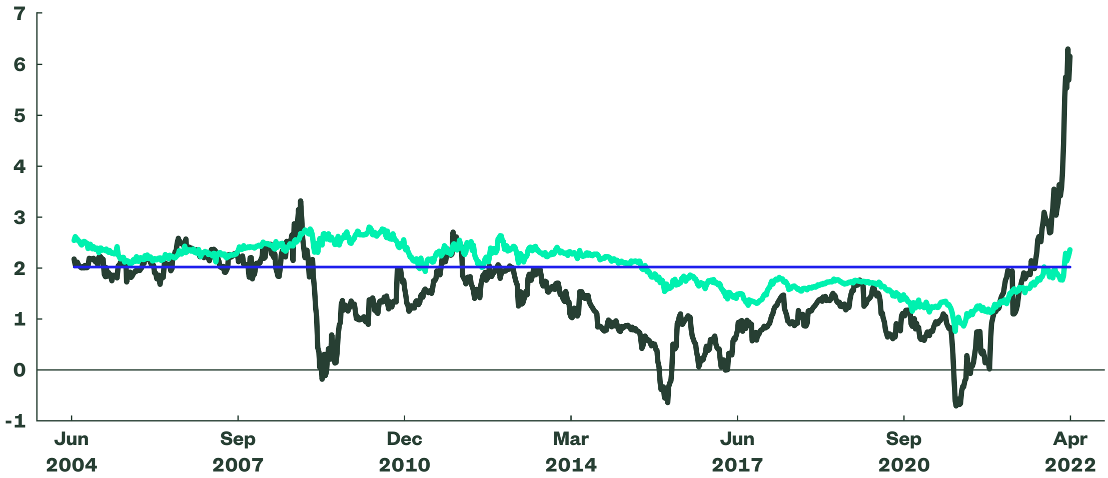
The market's assessment of forward inflation (5-yr 5-yr inflation swap) spiked upwards on the news of Russia's invasion of Ukraine in response to the implications for energy and food prices in particular. And while this was a substantial move in inflation expectations for the Euro area — up 0.6% to 2.4% p.a. at time of writing — this measure of future inflation is still below the levels reached in 2008 and 2009.

However, a critical point is that between now and the start of that 5-year window a lot can happen. Protracted or escalating conflict in Ukraine could have substantial repercussions for inflation and demand in the near term. Inflation markets are attempting to price this — one-year Euro inflation is currently priced well above 6% having traded at 4% days before the invasion. The inflation risk premium — the added compensation demanded by investors for uncertain inflation outcomes — has come back with a vengeance.

The key question of whether and how much this can become entrenched in consumers' inflation expectations and wage increases is still wide open. This could have big consequences for central banks (policy error) and many capital markets (increased volatility and risk premia). For now we stick to our view that the market has, broadly speaking, priced in too many rate hikes over the coming quarters.

Figure 1
Euro Area Inflation Expectations

Euro 1-year Inflation Swap
EUR 5-yr 5-yr Forward Inflation
ECB Target



Source: Bloomberg Finance, L.P., as of 8 April 2022. Inflation expectations are derived from EUR inflation swaps.

Sovereign Yields

The pronounced hawkish tilt in the Fed's forward guidance and its March economic projections has accelerated the flattening of the yield curve in the US (and elsewhere) in surprisingly short order. So much so in fact that the classic so-called *recession predicting* US 2s–10s curve is topic du jour as it closes in on a foreboding zero line. But the more conspicuous change has been a meaningful and concerted lurch upwards in yields further out the curve and across several markets. We had anticipated a flatter curve in the Eurozone later this year but the significant jump in 10-year Eurozone yields — dragged higher by US yields and a reinforced inflationary impulse — means the Eurozone curve has in fact steepened moderately in the last few months.

As noted in our main publication the factors that determine long-term potential growth are waning in several advanced economies and, in turn, point to more moderate yields on sovereign debt. This should limit the extent of the rise in yields but this dynamic is long term in nature and therefore much less relevant than a re-pricing of the inflation risk premium. In light of that potential re-pricing investors may wish to re-examine their duration position, tactically and perhaps strategically. In the near term bond investing might have an element of white-knuckle ride rather than staid old coupon clipping.

Corporate Bonds, EM Debt and China

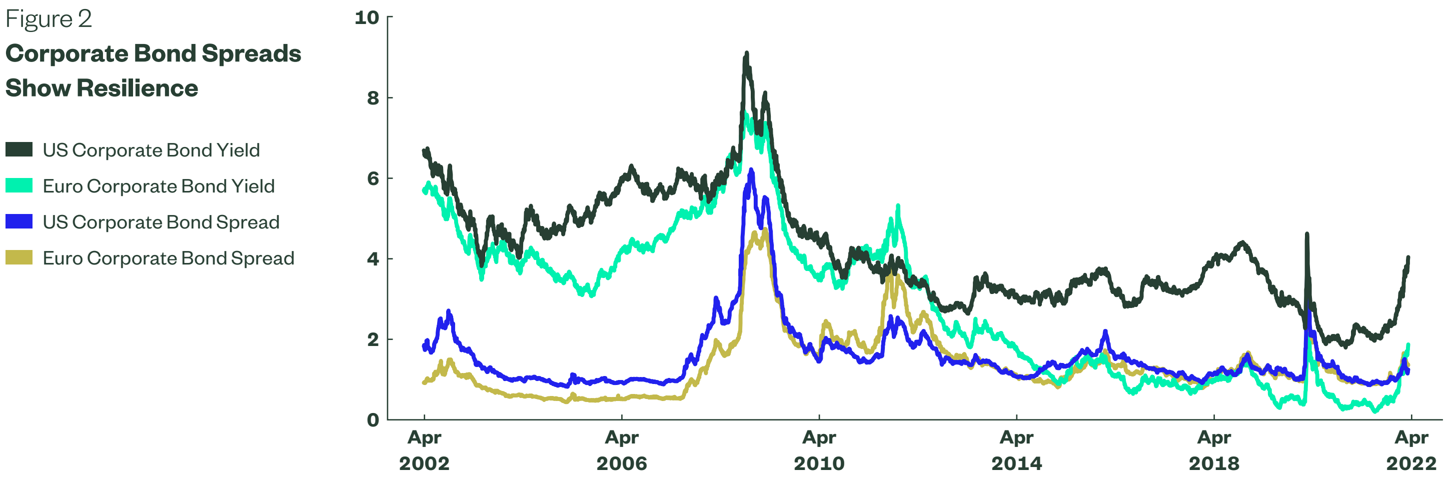
Credit and emerging markets responded in a typical risk-off mode on the news of hostilities in Ukraine. Its impact is both interesting and salutary.

It's interesting in the sense that even though investment grade credit has suffered a significant setback from the spike higher in underlying sovereign yields investors appear to have confidence in the fundamentals that underpin broad IG markets insofar as spreads have retreated from the early March blowout. A favourable sign for now but investors do need to pay close attention to the economic landscape. While relatively tight spreads and yields were acceptable in an improving and re-opening economic backdrop the disruptions to growth from Russia's war means the risk and reward position is more finely balanced at a time when central banks are considering running off their bond holdings and a potential price-wage spiral could have significant implications for corporate profit margins. A similar observation applies, in general, to high yield debt in relation to spread and absolute yield. However the higher absolute yield level has softened the blow of the recent setback in price for high yield bonds. Again, relatively well-behaved spreads reflect a positive assessment of credit fundamentals and earnings prospects — one to watch in an economic environment complicated by conflict.

It's salutary in that it highlights the true nature and impact of idiosyncratic risks in an asset class such as local currency EM debt: the broad index characteristics such as average credit rating, average debt metrics, yield etc. tell us little about those individual issuers in the index. The ejection of Russia's rouble denominated debt from the benchmark is a shock for us all but it also means we embark on EM debt investing with a better appreciation of these issuer-specific risks. China, typically one of the index heavyweights, deserves a mention as a solid diversifier for investors but also a candidate that can involve headline and idiosyncratic risk — especially given its significant debt build-up and geopolitical priorities.

Ironic or otherwise investors now bring a greater degree of circumspection to their investment decision to the point that the more generous yield of almost 6.5% today is the yield demanded by a better informed investment community. Challenges undoubtedly lie ahead for emerging markets and conflict in Ukraine will impact individual countries in distinctly different ways but they are, generally speaking, also further along the rate normalisation cycle than their advanced counterparts.

Figure 2
Corporate Bond Spreads Show Resilience



Source: Bloomberg Finance, L.P., as of 11 April 2022. Bloomberg Euro-Agg Corporate Bond Index and Bloomberg U.S. Agg Corporate Bond Index (investment grade corporate bonds). Yields are yield to worst while spreads are option adjusted spreads or OAS.

Conclusion

This is a particularly uncertain time for investors. Much depends on the path and duration of the war in Ukraine, its impact on growth, inflation, supply chains and how central banks respond. We foresee a moderate slowdown in growth this year and see inflation starting to abate later this year but note substantial downside risks around both. Investors may wish to sense check their duration exposure in light of those risks.

However, the broad move higher in yields may offer investors an opportunity to consider a phased entry or an expanded allocation to some of the spread assets we mention here. Not without their risk but also offering higher yields for those investors with the risk appetite and the resources to understand the nature of these segments at this point in the rate cycle.

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of December 31, 2021 and includes approximately $61.43 billion 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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