The Bond Market Has Woken Up From a Deep Slumber

Heightened volatility reflects a changed reality.

November 2021

KEY INSIGHTS

- Bond market volatility has surged recently as central banks try to strike a balance between easing fears over inflation and continuing to encourage growth.
- Inflation is rising as the release of post-lockdown pent-up demand meets supply constraints and rising energy prices.
- The likelihood of continued inflation-related market volatility strengthens the case for an active approach to bond investing.

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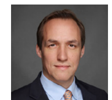
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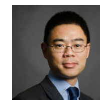
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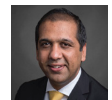
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Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

Bond market volatility has surged recently as central banks try to strike a balance between easing fears over inflation and continuing to encourage growth. This follows a long period in which bond volatility was artificially suppressed by the huge injections of central bank liquidity that followed the global financial crisis. In our latest policy meetings, the investment team discussed the reasons behind the latest volatility and its implications for bond investors.

How Long Is "Transitory"?

Inflation is causing alarm across the world as the release of pent-up demand following the easing of COVID lockdowns is being met with supply constraints and rising energy prices. Markets have reacted to this by speculating on how quickly central banks are likely to taper asset purchases and raise interest rates—hence the volatility in fixed income markets, particularly at the front end of the curve.

So far, the leading central banks have responded by insisting that they will "look through" the surge in inflation because it is likely to be transitory in nature.

This claim is becoming harder to sustain, however—and central banks are feeling the pressure. "The reality is that central banks in smaller countries, whose credibility is more fragile than the Fed or the European Central Bank, are already buckling," said Quentin Fitzsimmons, a portfolio manager and member of the fixed income investment team. "The Brazilian and Russian central banks, for example, have both raised rates quickly. But the more mainstream, orthodox central banks are slowly getting dragged in, too. We saw this in early November, when the Reserve Bank of Australia announced it is going to abandon its yield curve control policy."

It's hard not to feel some sympathy for central banks—the dilemma they face is a tricky one. If they're too slow to react

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>
> — **Quentin Fitzsimmons**
> *Portfolio Manager*

to the threat of inflation, it could spiral out of control; if they act too quickly, they risk spooking the markets and strangling the recovery. "They have to tread so carefully," said Mr. Fitzsimmons. "However cautiously it's communicated, if a bank says, 'We might have to raise rates next year,' the markets will immediately adjust their expectations and that will cause volatility."

Indeed, this exact scenario occurred recently when the Bank of Canada (BoC) issued a statement in which it said that it will consider raising rates "in the middle quarters of next year" in response to rising inflation. While a vague commitment to thinking about raising rates in the middle of 2022 might sound like a dovish stance to many investors, the markets reacted as if the BoC had adopted a hawkish stance—the Canadian dollar soared and bonds were hit hard.

Investors Seek Strategies to Manage Volatility

As long as uncertainty remains over the path of inflation and the responses of central banks, volatility in fixed income markets is likely to persist. Worried bond investors are now scrambling to buy inflation-linked securities as a form of insurance against continued rising prices—only to find that there is not enough of it to go around. "Countries that issue inflation-linked debt face a contingent liability problem in that if inflation continues to rise, the cost of servicing that debt will rise too," Mr. Fitzsimmons said. "That's why some countries, notably the UK, seem reluctant to issue more inflation bonds, even though there is clearly a market for them."

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Another way to mitigate risk would be to reduce interest rate exposure by lowering the amount of duration in the portfolio—or even running a negative duration strategy. Alternatively, investors may consider structural curve positioning strategies, which seek to benefit from changes in the shape of the yield curve, not just overall level of duration.

Attempting the latter may be complicated at present because there is disagreement over whether the yield curve should be flatter or steeper. "Yields steepen if a recovery is expected, but also if inflation is anticipated because people want to be compensated for inflation risk," said Mr. Fitzsimmons. "Recently, though, the curve has been flattening. This is a common phenomenon at the beginning of a hiking cycle as the front end of the curve shifts up and the back end remains anchored or shifts down because of concerns over future growth. A flattening curve implies the markets believe that the mainstream central banks will hike soon."

The likelihood of continued volatility strengthens the case for adopting an active approach to bond investing—particularly given the Bloomberg Global Aggregate Total Return Index was down by more than 4.5% year-to-date on November 29. "There's such a variety of potential outcomes depending on the speed, timing, and levels of central bank hikes," said Mr. Fitzsimmons. "There's also an asset class choice—how much inflation protection you want and how much it will cost you—as well as your yield curve positioning. It's very much an environment for active management."

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