Five factors why 2022 bond rout may reverse

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Quentin Fitzsimmons
Co-portfolio manager of the T. Rowe Price Global Aggregate Bond strategy

Global bond markets have suffered unprecedented losses in 2022, with the Bloomberg Global Aggregate Bond index (unhedged) down almost 15% from its high in January 2021.[1] To put this into context, global fixed income investors have not endured a rout like this since official data began in 1990. It has even surpassed the 10% drawdown witnessed during the global financial crisis.

Bond markets have borne the brunt of central bankers being wrongfooted by spiking inflationary pressures – largely caused by historically-tight labour markets, rising commodity prices due to the war in Ukraine, and Covid lockdowns in China, which have further disrupted global supply chains.

After sharp downside pressure so far this year, fixed income investors are increasingly being asked whether now is the time to take advantage?

Signs of peaking inflationary pressures

There are emerging signs we may have passed the peak of rising inflationary pressures and inflation expectations, as policymakers seek to get ahead of the curve to ensure inflation forecasts do not become self-fulfilling.

While we think prices are likely to remain elevated in the months ahead, US Treasury Secretary Janet Yellen suggested inflation may have peaked in the world's largest economy. With markets aggressively pricing in further Federal Reserve (Fed) monetary tightening, Yellen's statement indicates value could be returning to the global bond market.

Even though calling a peak or trough in any market is a dangerous game, below we highlight five reasons why the recent bond sell-off appears to be losing steam.

1. The aggressive repricing of tightening

Investors are now forecasting nine 25bps rate hikes by the Fed in 2022, which suggests an implied rate of more than 2.75% by year-end – the highest since prior to the 2008 crash. This leaves a high bar for the Fed to meet, and any dovish noise could see yields retract. In addition, while some policymakers late last year insisted the ECB would not raise rates in 2022, there is now talk of a hike as soon as July.

2. Real rates nearing positive territory

This conversation surrounding bond market valuations is also underpinned by the level of real rates. The Fed's aggressive hiking trajectory has momentarily eclipsed inflation expectations and recently powered 10-year real yields into positive territory for the first time since early 2020. This prospect of positive real returns is likely to entice investors back into fixed income. Having endured a sustained period of TINA – 'there is no alternative' – it is understandable if investors are attracted by an asset class providing real returns in this high inflation environment.

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[1] As of 29 April 2021.

3. Portfolio protection increasingly critical

As recessionary concerns continue to rise, this is typically an environment where high quality fixed income assets outperform. Considering the current tumultuous global backdrop, protecting portfolios with high quality assets remains crucial. There is also the threat Europe's energy supply is cut off more drastically than currently expected, which would drive Germany – and Europe – into recession. Should recession risks rise meaningfully, expect downward pressure on yields as investors rush to shield portfolios.

4. Positioning suggests uptick in sentiment

While the bond market rout has been brutal, there are indications investors may be beginning to cover short positions. Investors were net short US treasuries to the tune of 37% in January, the largest net short since late 2017. However, the combination of peaking inflationary pressures and safe-haven demand has resulted in some short covering – with the market's net short at 13% as of 25 April. An escalation in recessionary concerns, or downside inflation surprises, would likely see short covering accelerated further.

5. Institutional demand should prove robust

Having battled with anaemic yields for so long, the sharp jump in rates this year will likely spur strong demand from insurance and pension funds. With a positive funding status, many institutions will now be looking to lock in the recent spike in rates to offset longer-term liabilities. In the UK, demand for index-linked gilts is strong, bolstered by the sharp rise in inflation over the past year. The latest issuance of inflation-linked gilts was significantly over-subscribed, with demand in excess of GBP £20bn for a GBP £1.8bn issuance. In the US, treasury yields fell last week from a three-year high, following strong demand for a 20-year bond sale.

Now duration neutral in Global Aggregate Bond

With an extensive tightening path ahead, there is considerable uncertainty as to how the real economy will cope with significantly higher interest rates. The implied reduction in monetary accommodation could swiftly challenge short bond bets, which is why adding duration seems a wise move at this juncture.

We recently added duration exposure from core markets within the strategy – including US treasuries, UK gilts and German bunds. Our overall duration stance is now neutral versus the benchmark. However, we continue to be underweight eurozone peripherals, with countries like Italy set to see spreads widen as ECB asset purchases are withdrawn. We continue to hold notable off-benchmark exposure in inflation-linked bonds, which have protected the portfolio in the recent elevated inflationary environment. While adding duration seems wise to us considering current conditions, we remain agile in our positioning and are ready to react.

RISKS:

Those risks are materially relevant for the strategy highlighted in this material.

ABS and MBS – Asset-Backed Securities (ABS) and Mortgage-Backed Securities (MBS) may be subject to greater liquidity, credit, default and interest rate risk compared to other bonds. They are often exposed to extension and prepayment risk.

Credit risk – a bond or money market security could lose value if the issuer's financial health deteriorates.

Currency risk – the risk that securities denominated in currencies other than the base currency of the fund may decrease in value due to changes in foreign exchange rates.

Default risk – the issuers of certain bonds could become unable to make payments on their bonds.

Derivatives risk – derivatives may result in losses that are significantly greater than the cost of the derivative.

Emerging markets risk – emerging markets are less established than developed markets and therefore involve higher risks.

Interest rate risk – when interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.

Issuer concentration risk – to the extent that a fund invests a large portion of its assets in securities from a relatively small number of issuers, its performance will be more strongly affected by events affecting those issuers.

Liquidity risk – any security could become hard to value or to sell at a desired time and price.

Prepayment and extension risk – with mortgage- and asset-backed securities, or any other securities whose market prices typically reflect the assumption that the securities will be paid off before maturity, any unexpected behaviour in interest rates could impact fund performance.

Sector concentration risk – the performance of a fund that invests a large portion of its assets in a particular economic sector (or, for bond funds, a particular market segment), will be more strongly affected by events affecting that sector or segment of the fixed income market.

Total Return Swap – Total return swap contracts may expose the fund to additional risks, including market, counterparty and operational risks as well as risks linked to the use of collateral arrangements.

General Portfolio Risks

Counterparty risk – an entity with which the portfolio transacts may not meet its obligations to the portfolio.

ESG and sustainability – May result in a material negative impact on the value of an investment and performance of the portfolio.

Hedging – Hedging measures involve costs and may work imperfectly, may not be feasible at times, or may fail completely.

Geographic and concentration – Geographic concentration risk may result in performance being affected by any social, political, economic, environmental or market conditions affecting those countries or regions in which the portfolio's assets are concentrated.

Investment portfolio – Investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management – Management risk may result in potential conflicts of interest relating to the obligations of the investment manager.

Market – Market risk may subject the portfolio to experience losses caused by unexpected changes in a wide variety of factors.

Operational – Operational risk may cause losses as a result of a result of incidents caused by people, systems, and/or processes

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