



The Bond Bear Market Appears Over—For Now

An early recession should reduce the chance of aggressive rate hikes.

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The bear market in fixed income appears over—for now at least. The speed of the growth slowdown over the past few months tells me that a recession is going to occur sooner rather than later. If I'm right, inflationary pressures should ease, reducing the likelihood of nasty rate hike surprises in the near to medium term. What happens after that is more difficult to call.

Growth has come down much quicker than is typical prior to a recession. In the past, we've seen recessions preceded by growth slowdowns of up to two years—prior to the global financial crisis, U.S. growth started to slow in the second quarter of 2007, but the recession did not begin until December 2007. This year's fall in growth has been very sharp in comparison, which makes me think a recession will come soon.

A Short but Painful Recession Is Likely

This shouldn't really surprise anybody. In the first half of 2022, the global economy was hit by a combination of rapid monetary tightening, a weakened China due to its zero-COVID policy, the war in Ukraine, an energy shock, and surging inflation. A toxic cocktail of ingredients like this was always going to be hard to swallow.



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The market seems to have accepted that a recession is on its way, but there seems to be a widely held view that it won't arrive until December at the earliest, and possibly not until well into 2023. This is probably partly due to the strong U.S. jobs market and partly down to people just assuming that the descent toward the next recession will follow historical precedent and be relatively leisurely. However, the jobs market is a lagging indicator, not a forward-looking one—it is not a useful harbinger of recession. And the speed at which fundamentals have weakened this year have convinced me that this recession will come much quicker than we'd usually expect.

There also seems to be a consensus that when the recession comes, it will be shallow. I'm not so sure. Although household and corporate balance sheets are in good shape, meaning there are few imbalances in the economy,

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the number of headwinds the global economy still faces looks very ominous to me. There are further rate hikes to come, the war in Ukraine is rumbling on, China's zero-COVID policy is still in place, and the energy crisis has not been resolved. So while I think the next recession may be short-lived, I also think it may cut deeper than expected.

Why I've Adopted My Longest-Ever Duration Position

It's because I expect the recession to come soon that I believe the bond bear market is probably over for the time being. Sharp increases in yields tend to be episodic—they usually occur over a period of three to six months before the market stabilizes again. The market priced in the peak in the Fed funds rate in June, and inflation expectations seem to have peaked for now. The Fed is very unlikely to have to hike more aggressively than is currently priced in—if anything, I suspect it may pause rate increases earlier than expected to determine whether the hikes it has already made have the desired impact.

For these reasons, I currently hold my longest-ever duration position in my portfolios. So far, we've focused primarily on U.S. long duration positions as the U.S. is further in the hiking cycle than Europe and will therefore likely finish sooner. We've also started to move down the curve as the long end has become more anchored following central bank hikes—having started by adding duration at the 10-year level, we're now looking at two-year Treasuries.

It's difficult to say whether the rate hikes already priced in will bring inflation under control or whether another round of tightening will be required. It's always hard to predict how sticky inflation will be—in the early 1980s, it took two rounds of aggressive hiking from the Fed (and a double-dip recession) to bring inflation down to an acceptable level. We don't know what it will take this time, but the prospect of unexpected hikes has receded for now—hence, our long duration position.

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