



Duration Hideouts Offer Opportunities as Bond Sell-Off Continues

Five key themes for an uncertain period in fixed income markets.

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KEY INSIGHTS

- The acceleration in global growth is likely to keep pressure on developed market bond yields over the next few months.
- Investors are expected to ignore the widely anticipated rise in headline inflation and instead await signs of real price pressures emerging.
- There is a preference for “duration hideouts” in the current rising rate environment, while select emerging market local currency bonds also look appealing.



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What's next for fixed income markets? A sharp rise in government bond yields since late 2020 has left many investors questioning how much further this trend has to run, if at all. At the same time, inflation fears are growing, and there are concerns about the diversification power of bonds. Given this uncertainty, we have assessed the current state of the global bond market and identified five key themes that we believe investors should be mindful of.



1. The Bond Sell-Off Is Likely to Continue

Bond yields are still too low and will likely continue to rise over the next few months (yields rise when bonds sell-off). There are four themes that currently underpin sentiment in financial markets: ultra-accommodative monetary policy, expansionary fiscal policy, significant pent-up demand for services, and expectations that vaccines will lead to the reopening of economies.

“Bond yields are still too low and will likely continue to rise over the next few months....”

Five Key Themes in Fixed Income Markets

(Fig. 1) Navigating the uncertain environment



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If these themes continue, developed market bond yields are likely to remain under pressure. Monitoring these themes closely will be critical over the coming weeks and months as signs that any of them are reversing could be the catalyst for change.

Looking into more detail at the themes, major central banks have vowed to keep monetary policy broadly accommodative in 2021. But if strong data are sustained and cause real inflationary pressures to build, central banks such as the U.S. Federal Reserve may be forced to change course and signal the start of tightening. Fiscal policy remains supportive for the time being thanks to new stimulus in the U.S., but some governments may look to tighten later in the year after unprecedented spending during the pandemic. We recognize that there is still a lot of uncertainty over the last two themes. For example, it is unknown how effective vaccines will be over a longer time horizon and whether they will be able to fight new variants of the coronavirus disease. There is also uncertainty about potential tax rises in places such as the U.S. and how that might impact the expected rebound in consumption.



2. Investors Need to See Evidence of Real Inflation Pressures

Market participants will probably look past the rise in the headline inflation rate over the next few months as it is widely expected and being driven by commodities and favorable base effects. Any sequential inflation caused by the easing of lockdowns and increased consumption will be harder to predict—investors will want to see evidence that it is actually happening before believing it, given the number of false dawns in the past. If price pressures do finally emerge, they are unlikely to be felt equally across the globe. For example, the U.S. stands out as potentially more exposed due to its procyclical monetary and fiscal policy.

A short duration stance and allocations to positions that aim to mitigate against higher inflation, such as U.S. inflation-linked bonds, should help manage the risks around price pressures. A short U.S. dollar bias could also prove beneficial.



3. Duration Hideouts Offer Opportunities as Rates Rise

From a bond perspective, we favor “duration hideouts”—markets that are potentially less correlated and sensitive to a sell-off in core rates—in the current market environment. Chinese local currency government bonds, in particular, stand out on this front. In contrast to the rest of the world, China is expected to slow this year as policymakers focus on deleveraging and rebalancing the economy. This could drive the central bank to shift toward easing monetary policy later this year while most other major central banks potentially start moving toward tightening and removing some accommodation. We believe that the policy divergences from major markets make China a good duration hideout.

There are also some good opportunities in select emerging market local currency government bonds. In some countries, we believe there are too many interest rate hikes priced in, which we believe makes the steepness of curves attractive.



4. Bonds Can Still Deliver Diversification Benefits

There have been doubts for some time about whether bonds can still deliver diversification benefits with bond yields so low. We believe that time horizon is an important consideration here. In the short term, there is a question mark over the diversification benefits, but we would not bet against investors continuing to use bonds as a diversification tool over the medium term. Let's not forget that bond yields are higher and curves steeper than where they were at the start of 2021, so the backdrop has improved.

“...a risk that investors are not always aware of is the duration risk hidden in credit markets today....

Furthermore, if we were to face another extreme event that puts major selling pressure on risk assets such as equity and credit, we believe fixed income will deliver diversification benefits—the caveat being that this can only work if the cause of the sell-off is not related to bond yields.

Using the full toolkit that is available to help balance and mitigate risks in portfolios is therefore important, which has very much been our approach.



5. Managing Duration Is Becoming More Important

Fixed income can be used either for income-seeking or for diversification purposes. What's important is that investors know and understand the role they want their fixed income allocation to play. For example, investors seeking income may decide to allocate to credit sectors such as investment grade and high yield—however, although these may carry less risk than equity markets, they are still positively correlated and will likely suffer when there's a sell-off in risk assets. Investors also need to be mindful that credit sectors are typically less liquid than government bond markets.

Lastly, a risk that investors are not always aware of is the duration risk hidden in credit markets today—credit contains a duration component that exposes it to changes in the underlying risk-free rate. Over the past decade, duration has become a key driver of credit returns, highlighting the importance of active duration management for credit investors. The strong influence of duration has not been a problem while yields were trending lower, but the environment is changing. Going forward, there's likely to be more interest rate volatility, so managing duration is not only going to matter in government bonds, but also in credit portfolios.

Brighter Days Are Likely Ahead for Government Bonds

The next few months could be tough to navigate, but once we are through that period, the conditions are likely to be a lot brighter for investing in government bond markets. Any further sell-offs in the long end of curves should help valuations to improve, and at some point, these bonds will become attractive again because of their absolute level of yield and curve shape. Let's not forget that there's potential to earn greater income when curves are steeper. Identifying that key inflection point will likely be critical for future returns.

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