Rising Yields Present a Familiar Challenge in a New Era

Inflation concerns are highest in decades.

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Kenneth Orchard
Portfolio Manager

Onur Uncu
Fixed Income Quantitative Analyst

Bond investors are facing an old adversary: rising yields. Expectations that central banks will soon begin unwinding debt purchase programs and hiking interest rates have led to sell-offs in government bonds and some corporate bonds. Yields rise when bond prices fall. Rising yields suggest that investors are bracing themselves for higher inflation—and, therefore, rising interest rates.

This poses a challenge for investors in fixed income. As we discussed in an article published in June, duration (the sensitivity of bond prices to changes in interest rates) has been a major driver of credit returns over the past decade. Vast injections of central bank liquidity have driven down bond yields and encouraged corporate issuers and investors to extend out the curve—as of December 2020, bonds of more than 10 years' maturity composed more than 28% of the Bloomberg Global Aggregate Index. The average credit investor now holds significantly more duration than in 2009.

Holding a lot of duration is not a problem when yields are trending lower—in fact, it usually boosts returns. But when interest rates rise, long-duration bonds are vulnerable to sharp price declines. Even the prospect of tighter monetary policy can trigger major sell-offs in bond markets, as happened during the 2013 "taper tantrum." As expectations grow that central banks will soon begin raising rates and reducing liquidity, the likelihood of rising yields is a concern for bond investors.

In our June article, we argued that most credit investors should not seek to systematically reduce the duration of their bond portfolios, but rather try to mitigate the impact of rising yields through portfolio construction and dynamically managing duration risk. We outlined five ways to do this:

1. Structural curve positioning
2. Allocating more broadly across regions and sectors
3. Holding euro-denominated credit
4. Allocating to shorter-maturity bonds
5. Active management of total duration

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We will explore some of these ideas in more depth in a series of blogs over the next few months. To kick off, let's briefly consider inflation protected government bonds, which have strongly outperformed this year. In October, the break-even rate (the difference between the nominal yield on a bond and the real yield of an inflation-linked asset of the same maturity) for five-year Treasury inflation protected securities rose to its highest level since the maturity was introduced in 2004. Break-even inflation rates have surged as U.S. Treasury yields have risen because strong demand for inflation protected assets have kept their yields relatively anchored.

What's particularly interesting is that inflation protected government bonds have even outperformed high yield bonds over the past two years. High yield bonds have rallied this year alongside equities as investors' risk appetite returned on the back of COVID-19 vaccine development and the easing of restrictions. In such circumstances, it would usually be unthinkable for low-risk inflation-linked sovereign bonds to outperform a risky asset like high yield bonds, but that's exactly what's happened in recent months.

What does this tell us? Most likely, that we've entered a very different environment to that of the past few decades. While inflation protected bonds have outperformed high yield at various points over the past 20 years, this is the first time it has outperformed for two consecutive years. This raises the possibility that there has been a sustained shift in the economic environment and market direction, prompting investors to seek inflation protection in their portfolios.

And that's something that we believe is worth paying attention to.

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