Is it a good time to invest in bonds?

2022 was a year where a perfect storm hit fixed income markets. This storm has been brewing for a long time as bond yields have been falling for several decades to record lows. In Europe, bonds were even issued at negative yields. Moreover, the duration of fixed income benchmarks had increased over time, increasing the sensitivity to interest rates. As a consequence, the rapid and aggressive interest rate rises caused havoc in bond markets. In the US alone, the FED announced three 75bps hikes in a period of only 4 months in order to curb inflation pressures. 2022 will be remembered by many as an annus horribilis. As we embark on a new year, we explore whether bonds are an interesting investment in the year ahead. To answer this question, we look at the future path of interest rates, the current bond valuations and the credit outlook.

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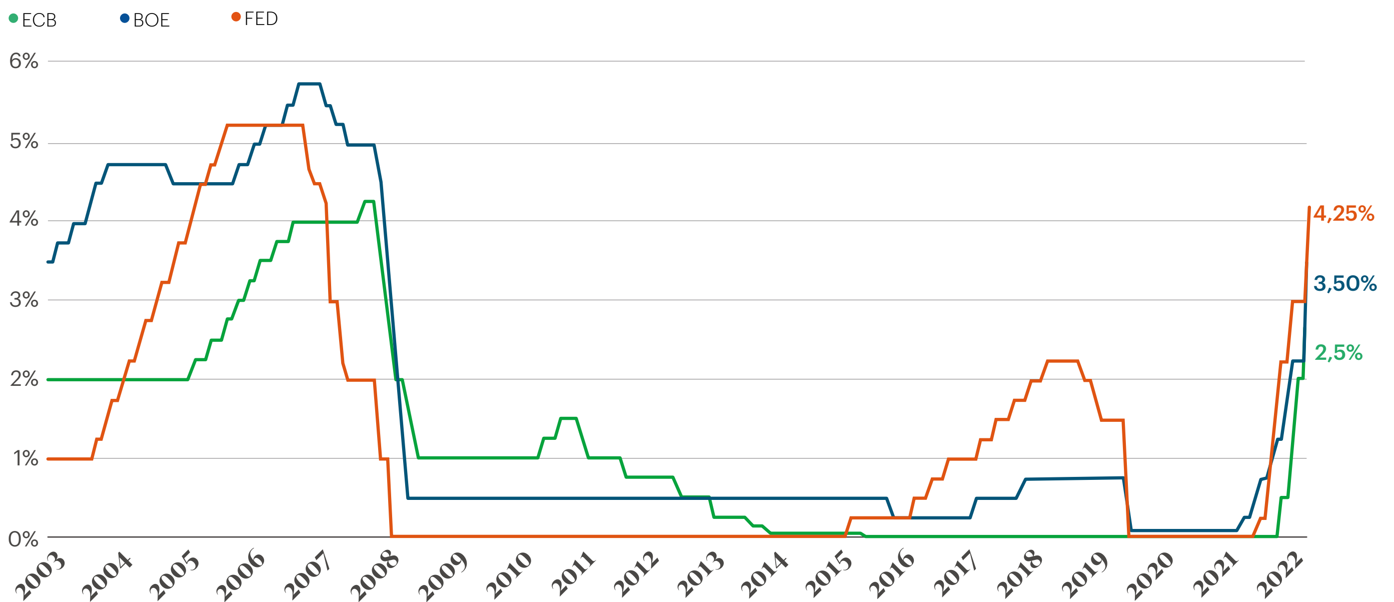
Inflation tends to start with goods inflation which could then be followed by more sticky service inflation. For inflation to cool down, we need to see these sticky components such as wages come down.

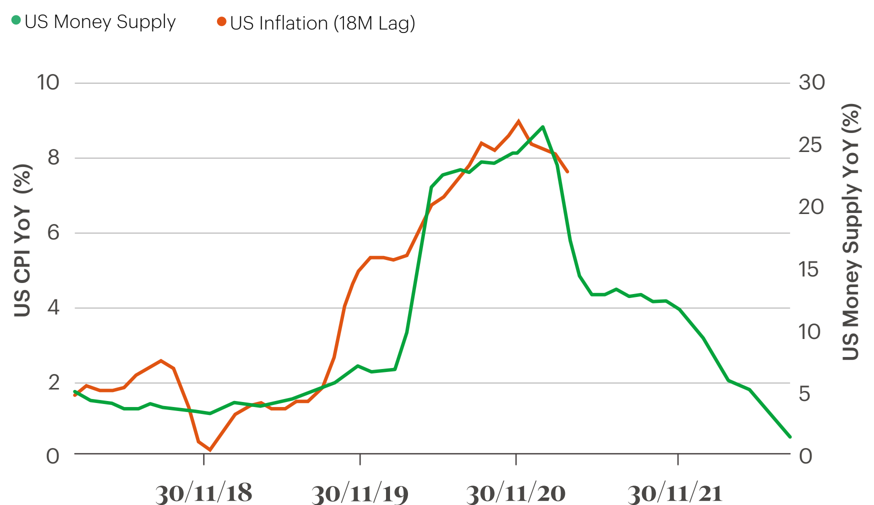
Graph 1: Central Banks have increased interest rates at a much faster pace compared to history.
Source: Bloomberg. Data as of 26/12/2022.



Will interest rates rise much further?

Bond prices are largely impacted by interest rates. When interest rates rise, bond prices go down and vice versa. When inflation rises, central banks raise interest rates to slow down consumer spending and encourage saving. Less borrowings and more savings reduce the money supply which cools down the economy. Many factors impact inflation. One of them is money supply which is illustrated in Graph 2. In 2020, vast amounts of stimulus were announced to support the economy in the aftermath of the pandemic. The money supply grew from below 5% to over 25% year over year. However, since the end of 2021, the money supply growth has returned to normal levels. This should support the desired inflation rate of 2% over the longer run.

Graph 2: Money supply is slowing down, inflation should follow.
Source: Bloomberg. Data as of 26/12/2022. CPI: Consumer Price Inflation.



Inflation tends to start with goods inflation which could then be followed by more sticky service inflation. For inflation to cool down, we need to see these sticky components such as wages come down. Currently, the flexible parts of inflation have come down after a dramatic rise. However, the sticky parts of inflation continue to rise gradually. As a result, inflation could remain elevated for a longer period of time (Graph 3).

Inflation is likely to come down slowly but it can take several years to reach the Central Bank's target of 2%. As a consequence, we expect rates to continue to rise in 2023 albeit at a slower pace than in 2022. When inflation falls below the central bank rate, we can almost certainly expect a rate cut. However, let us bear in mind that markets tend to run ahead of expectations, hence lower rates in less than a years' time could be positive for bonds today.

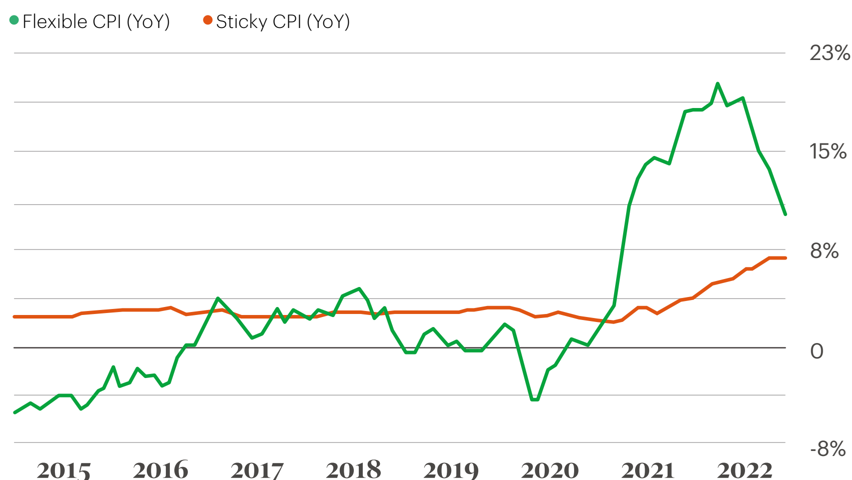
Are bonds cheap or expensive?

Bond prices depend on a number of criteria such as duration, credit rating and currency. As bonds are issued around par, the best way to measure whether bonds are expensive or not is by looking at their yields and spreads instead of their price. Today, yields on both EUR- and USD-denominated investment grade debt are above 4%. High quality USD bonds haven't been as attractive since 2008 based on their yield to maturity. Also, yields on EUR-bonds are at their 10-year high. Not only are the yields higher because of the higher underlying interest rates, but equally thanks to their higher spreads (Graph 4).

As we take a closer look at the US bond market, we notice a modest rise in both investment grade and high yield spreads. The spread on US investment grade debt is 130bps, whereas the spread on US High yield debt stands at 448bps. This shows that investors are receiving a higher premium for investing in credit compared to last year. However, spreads remain relatively low compared to history. Should the corporate outlook worsen, then spreads will continue to move higher. Higher spreads mean lower bond prices. Good quality companies with investment grade ratings should see lower spread rises in this situation than the riskier high yield bonds (Graph 5).

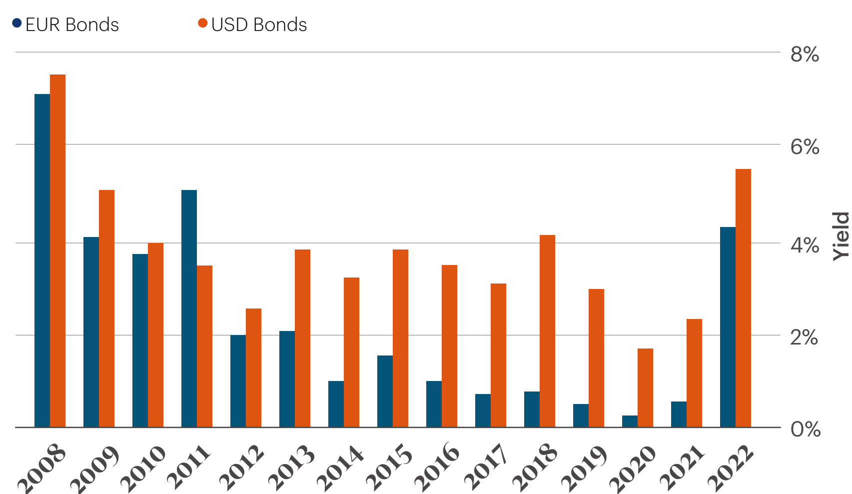
Graph 3: Flexible inflation is falling but sticky inflation is still rising

Source: Atlanta FED. Data as of 26/12/2022.Inflation.



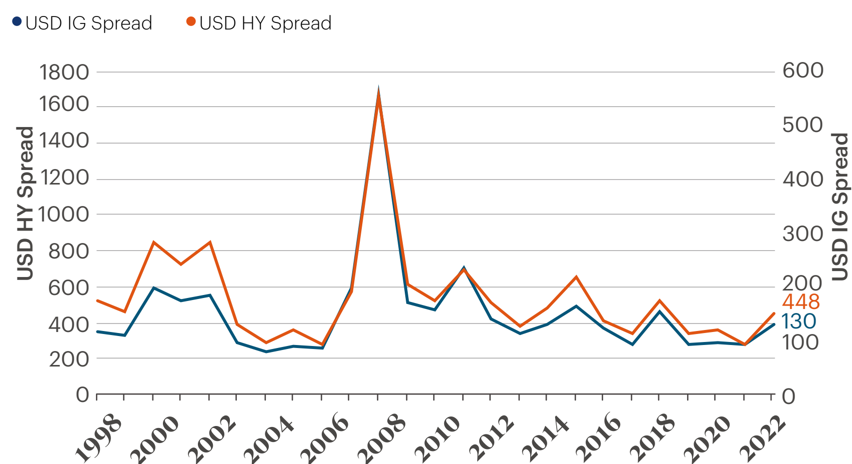
Graph 4: Yields on EUR and USD-denominated investment grade bonds have risen to attractive levels.

Source: Bloomberg. Data as of 26/12/22. Yield is Yield to Worst for US Aggregate Credit Index and Euro Aggregate Corporate Index.



Graph 5: Bond spreads have only risen modestly

Source: Bloomberg, data as of 26/12/22. Spread is option-adjusted spread.
IG: Investment Grade. HY: High Yield.



Federal Reserve Bank

Is there a risk of downgrades?

The higher than usual probability of a recession in the next two years damps the outlook for corporate revenue growth. The combination of higher interest rates, higher wages and lower demand might impact the ability of a company to repay its debt. As a consequence, credit ratings could be revised lower. This is of particular importance for bonds that are on the border of investment grade and whereby one downgrade might lead to a high yield/junk rating. Many investors have specific rules related to bond ratings and a high yield rating might force them to sell their holding, leading to a sharp decline in the price of the bond. Hence, we prefer high quality debt (BBB or higher) which could withstand a recession.

Conclusion

Central banks have aggressively lifted interest rates to keep inflation under control. As inflation is expected to come down gradually, the probability that most of the rate hikes are behind us is high. As markets are pricing in lower rates in the future, bonds with longer duration look interesting. Yields are attractive from a historical perspective but spreads could widen further if the economic climate worsens. As a result, we prefer higher quality, longer duration bonds which are less impacted by spread increases. •

Are you interested in starting a bond portfolio? Do not hesitate to contact us on info@sdm.lu for more information.

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Yield to maturity (YTM) is the total return anticipated on a bond if the bond is held until it matures. Yield to maturity is considered a long-term bond yield but is expressed as an annual rate. In other words, it is the internal rate of return (IRR) of an investment in a bond if the investor holds the bond until maturity, with all payments made as scheduled and reinvested at the same rate.

Yield to Worst (YTW) is used to evaluate the worst-case scenario for yield at the earliest allowable retirement date. YTW helps investors manage risks and ensure that specific income requirements will still be met even in the worst scenarios.

Option-adjusted spread (OAS) measures the difference in yield between a bond with an embedded option, such as callable bonds, with the yield on government bonds.

Duration: Modified duration measures the change in the value of a bond in response to a change in 100-basis-point (1%) change in interest rates.

The three main credit rating agencies who provide bond ratings are S&P, Moody's and Fitch. Bonds can be rated by 1, 2 or all these rating agencies. Not all bonds are rated.

	S&P / FITCH	MOODY'S	
Higher quality and lower default risk	AAA	Aaa	Investment grade
	AA$^+$ AA AA$^-$	Aa	Investment grade
	A$^+$ A A$^-$	A	Investment grade
	BBB$^+$ BBB BBB$^-$	Baa	Investment grade
	BB$^+$ BB BB$^-$	Ba	High yield / Junk
	B$^+$ B B$^-$	B	High yield / Junk
	CCC$^+$ CCC CCC$^-$	Caa	High yield / Junk
	CC	Ca	High yield / Junk
	C	C	High yield / Junk
Lower quality and higher default risk	D	/	

Source: Bloomberg, Investopedia

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