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Can fixed income deliver in an inflationary wave?

Surging inflation and rising bond yields may have delivered some unwelcome drawdowns in 2022, but fixed income still has some key strategic roles to play, says Insight Investment. Here, its fixed income management team surveys the inflationary landscape and wider bond market prospects.

Key points

- Drawdowns in credit markets have been substantial this year.
- Market moves so far in 2022 leave many fixed income instruments with their highest forward-looking yields in recent years.
- The amount of income generated by fixed income instruments (running yield) has also risen sharply this year.
- Credit spreads are close to their widest levels for five years

The weakness and volatility investors have experienced in most mainstream liquid asset classes in 2022 may have left them feeling downbeat, but also confused and concerned about what to do next.

Drawdowns in credit markets particularly have been substantial this year, even in the high-quality investment grade (IG) space.

High yield (HY) sectors have suffered even greater volatility and setbacks. The negative returns generated by widening credit spreads have been exacerbated by rising government bond yields, and as central bank attempts to fight inflation, official interest rate have been increasing too. This uncertainty is reflected in market volatility with global equities and bonds variously experiencing some high levels of volatility.

Historically, yield levels have trended lower over the last 40 years reflecting a wider decline in inflation. Ultra-loose monetary policies and bond buying programs provided more downward pressure on interest rates. In some countries both short-term and long-term rates fell below zero.

The ‘hunt for yield’ forced many investors requiring income streams to move into longer-term bonds and/or weaker credits.

Yet times are changing.

The recent surge in inflation is greater than anything experienced globally since the early 1990s and many market participants are experiencing near double-digit percentage inflation rates for the first time in their working lives. Few expect a rapid reversal to the previous range below two per cent anytime soon.

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A new paradigm?

Many countries also now face the risk of wage inflation - especially those with tight labor markets. If this risk materializes, it could fuel longer-term inflationary impetus and force central banks to raise interest rates even more aggressively.

Against this backdrop, more bonds are providing yields above threshold levels. And while inflation may take a while to be reconquered, this particular cloud may prove to have a silver lining as yields rise to attractive levels in both the investment grade and high yield market.

Without the extensive support central banks provided to the economy and corporate sector through quantitative easing and ultra-loose monetary policy, strong returns from equities also may be harder to achieve, with markets becoming more volatile.

Fixed income instruments may have an advantage going forward in the prevailing environment, as their returns tend to be more predictable and reliable than equities as they are primarily dependent on coupon, rather than price appreciation.

Recent fixed income market weakness does not diminish the important strategic roles the asset class can play in broad and diversified investment plans.

Rising yields

For investors seeking or relying on fixed income assets providing an income stream, higher absolute levels of yields may be welcomed as it becomes possible to gain higher levels of income for every pound, euro or dollar invested.

This means that investors who have an income stream as an objective may be able to enjoy generating a higher income from their investment, achieving a given income with less investment committed, or some combination of both. Yields for most, if not all types of bonds, have risen in the course of 2022, in some cases significantly.

Given credit spreads are close to their widest levels for five years. We believe this could provide an attractive entry point, potentially allowing clients to achieve their target income level with a higher credit quality than would have been possible for some considerable time.

In turn, as opportunities for higher income have arisen, so has the potential for achieving overall returns from the market – beta. Capital gains may be achieved if bond markets recover, and yield levels begin to decline. From a higher base, there is now probably greater potential and scope for yield levels to fall back, generating capital gains as values increase, than there was at the start of the year, or for some time before that.

As absolute yields have risen and spread levels widened, we believe markets generally have become more attractive from a value perspective.

Elsewhere, the increase in the volatility of fixed income markets in recent months has, if anything, increased the opportunities to generate potential alpha. In our opinion, recent volatility and rising inflation may have even enhanced them. Not only have yields increased and credit

spreads widened but the dispersion of spreads within similar categories, such as credit rating bands, or industry sectors, has also increased.

From a liability management perspective, higher yield levels provide a more attractive entry point for cashflow driven investment (CDI) mandates, which helps to increase outcome certainty, as they should be largely indifferent to future yield and credit spread fluctuations.

More broadly, fixed income assets can be a useful diversifier and are often considered helpful in managing risk in a broad investment plan that includes other asset classes, such as equities, if its inclusion can reduce the overall volatility of returns. In turn, combining lowly correlated assets in a broader investment portfolio can help to reduce overall scheme volatility.

Potential strengths

In overview, fixed income is expected to continue providing for the benefits of diversification, risk management and liability hedging strategies in addition to returns and income. Now that yields have risen and credit spreads widened, they may be offering appealing entry points for investors who until recently may have felt constrained in certain areas of the market due to low yields and compressed spreads.

However, we believe it will still be important to ensure that, when identifying the mix of investment strategies for a wider platform, the blend of risk and reward suits the investor, and the prospective time horizon is also likely to have an important part to play in the decision.

Overall, though inflation and monetary tightening has helped drive bond yields higher and spreads wider, we believe the medium-term future is now more promising. Investors may soon be rewarded by a market that could begin emerging like a proverbial phoenix from the flames.

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