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Elston Insights

3rd February 2023

Bonds are getting interesting

- 2022 was a year of dislocation for Bonds
- Rates are peaking and inflation is past-the-peak
- This means Bonds are getting interesting once again

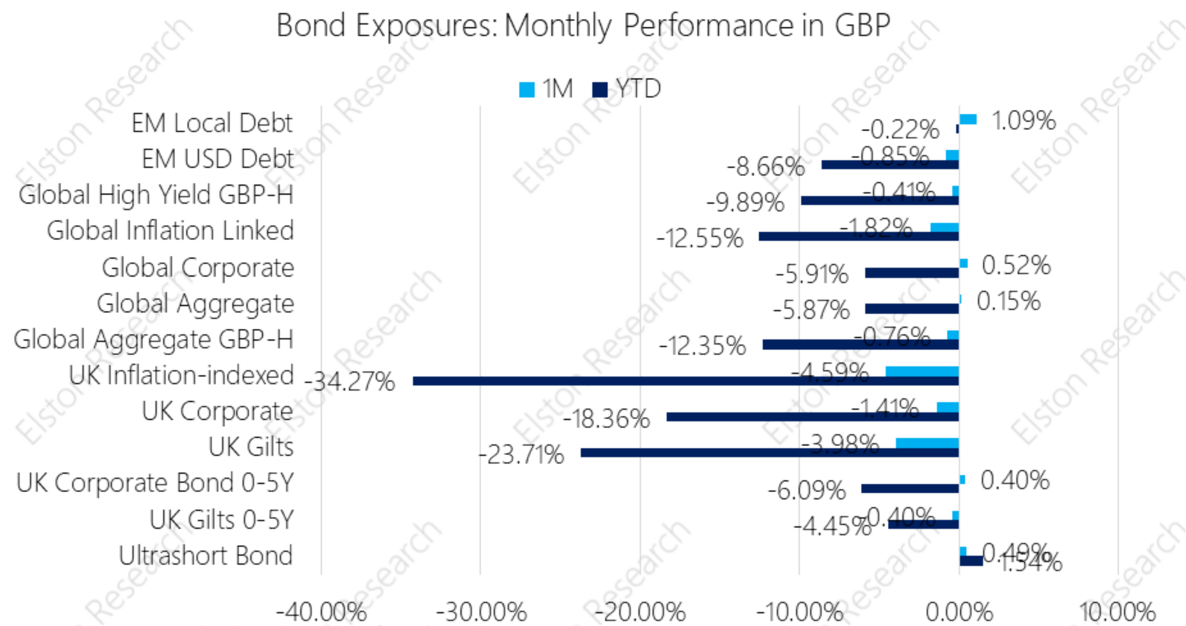
We explore this further in our [CPD webinar: "Investing for Income"](#).

2022 was a year of dislocation for Bonds

2022 was a challenging year for bonds. Far from being a low-risk assets, they became a high-risk asset. Why? A double-whammy of rapid interest rate hikes and soaring inflation. For rate-sensitive assets, rising interest rates reduce capital values. The longer term (duration) the bond, the greater the reduction in capital value.

Similarly, nominal bonds can't keep pace with inflation. If inflation rates rise above a bond's yield, it's real yield becomes negative: it is "guaranteed" to lose money. And in 2022, they did. So across all bond exposures, there was no place to hide.

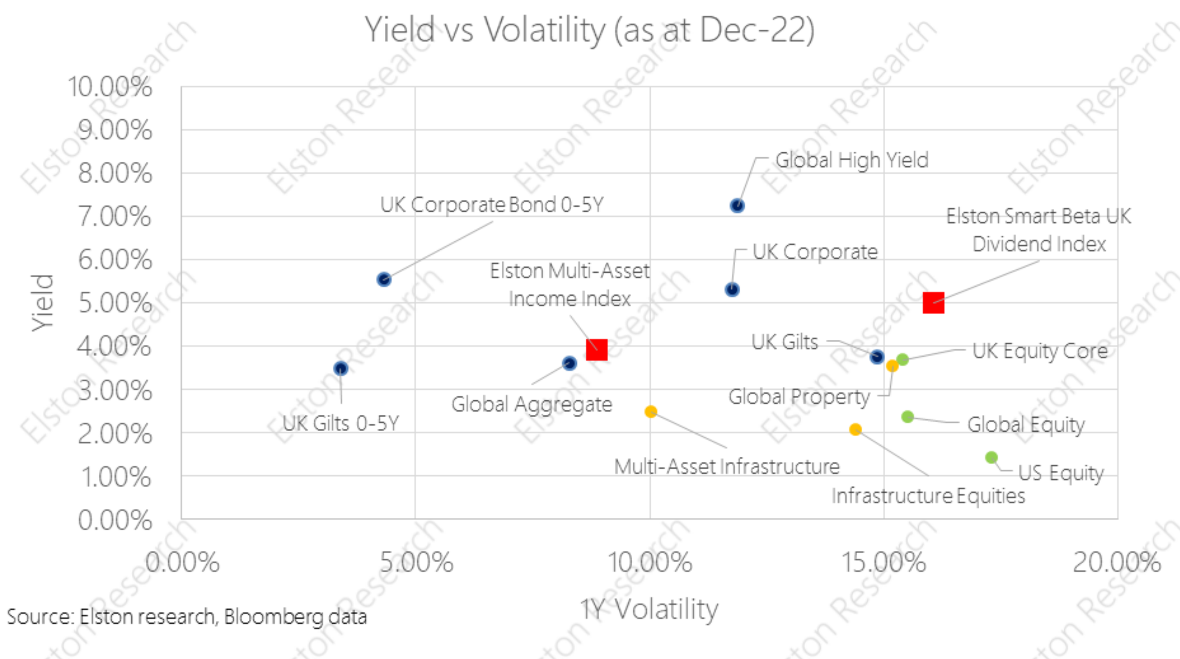
Fig.1. Bond performance in 2022: no place to hide



Source: Elston research, Bloomberg data, for selected representative ETFs, as at report date

Traditional Gilts, declined some -24% in 2022. Furthermore, the gyrations of the yield curve and weakness of the currency following the Truss/Kwarteng budget meant that the 1 year volatility of gilts rose to the same level as equities (see chart).

Fig.2. Multi-asset income yields vs 1Y historic volatility

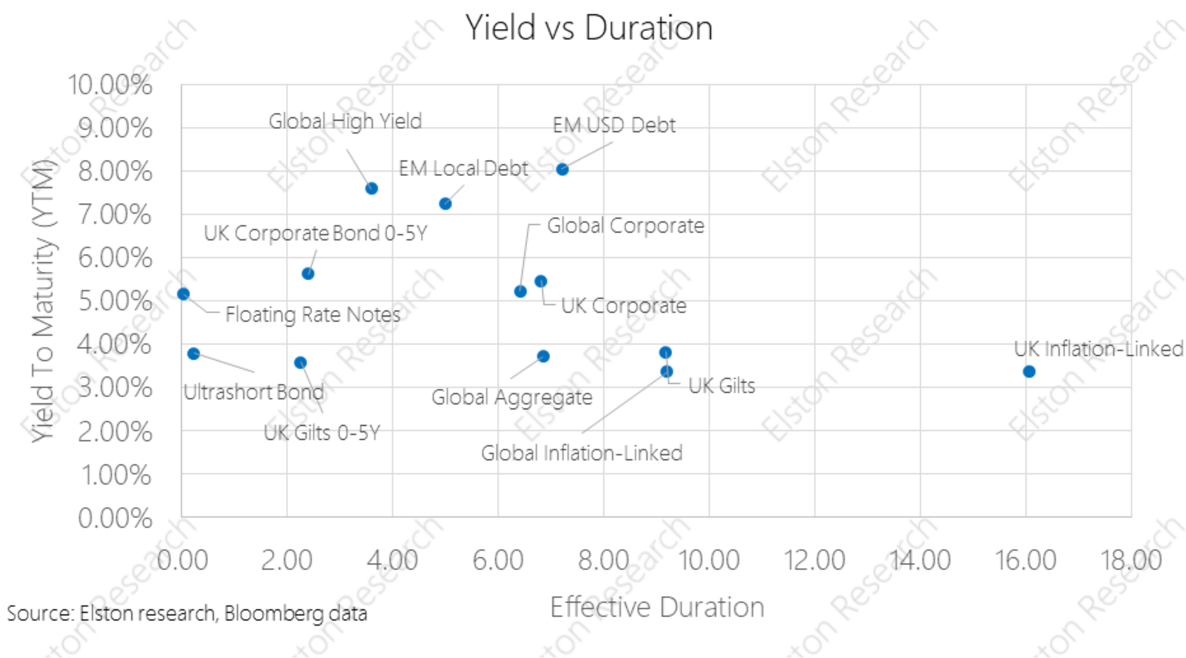


So for traditional multi-asset investors, bonds offered neither real income, nor diversification, nor capital preservation, nor risk mitigation. Hence their failure from a portfolio construction perspective in 2022 as well as drag on performance.

Even more extreme were inflation-linked bonds. These provide long-term (but crucially, not short-term) inflation protection. But owing to their long duration, "linkers" were highly sensitive to rising interest rates, and hence declined a staggering -34% in 2022: the worst performing bond exposure. The interest-rate risk clue was definitely not in the inflation-linked name.

The duration on inflation linked bonds was approx. 21 years as at end 2021. This has shortened to approx. 16 years as at end 2022, but the inflation-linked bond index remains the longest-duration bond exposure for GBP fund investors.

Fig.3. Bond yields vs duration as at Dec-22



Adapting portfolios for inflation

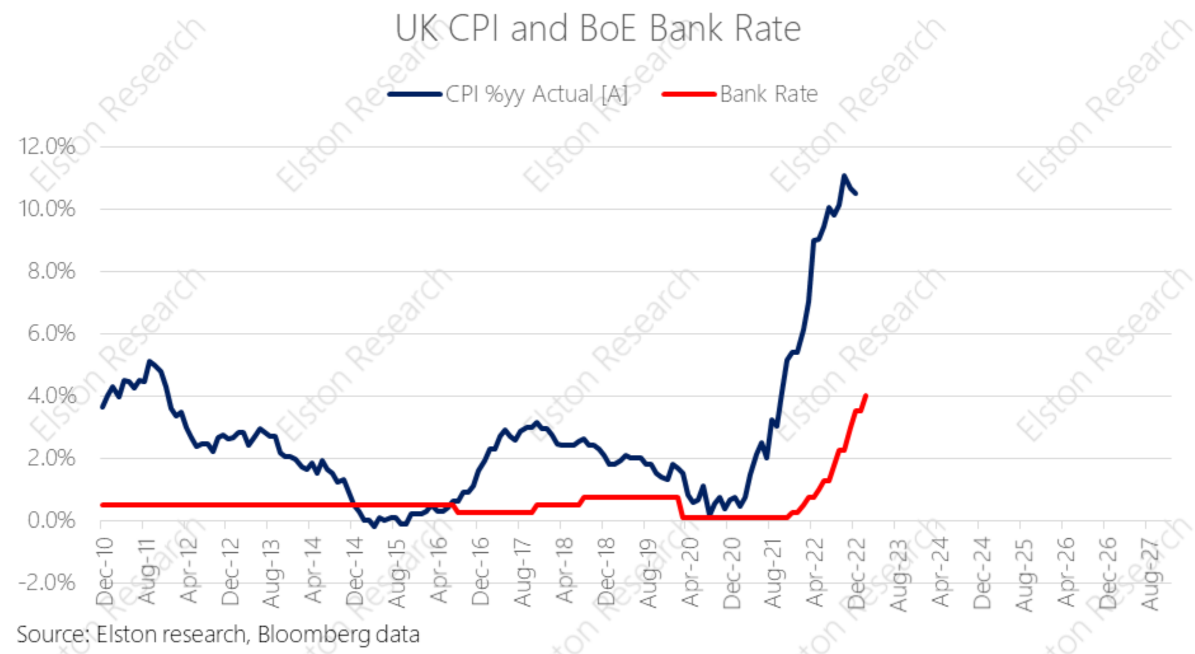
So what were the options to protect capital? We set out our playbook in late 2021/early 2022 on how best to adapt portfolios for inflation: 1) tilt equities towards value/income, 2) dial-down bond duration and 3) reduce overall bond exposure in favour of liquid real assets and absolute return strategies.

These changes helped the adviser firms we work with avoid that particular foreseeable harm arising from rising interest rates and higher inflation. We were just not expecting the reality to be as extreme as it was, owing to the savage Russia/Ukraine war.

Rates are peaking and inflation is past-the-peak

UK inflation has moved past the peak, which is welcome, but could remain stickier, owing to wage-price pressure, supply chain disruption and the remapping of our energy and defence assets in the transition to net zero/increased energy security and a deglobalised world. The Bank of England has been raising rates rapidly as a monetary response to inflation and may be approaching a peak to be held at the current level of 4.0% whilst monitoring the impact on growth and the economy.

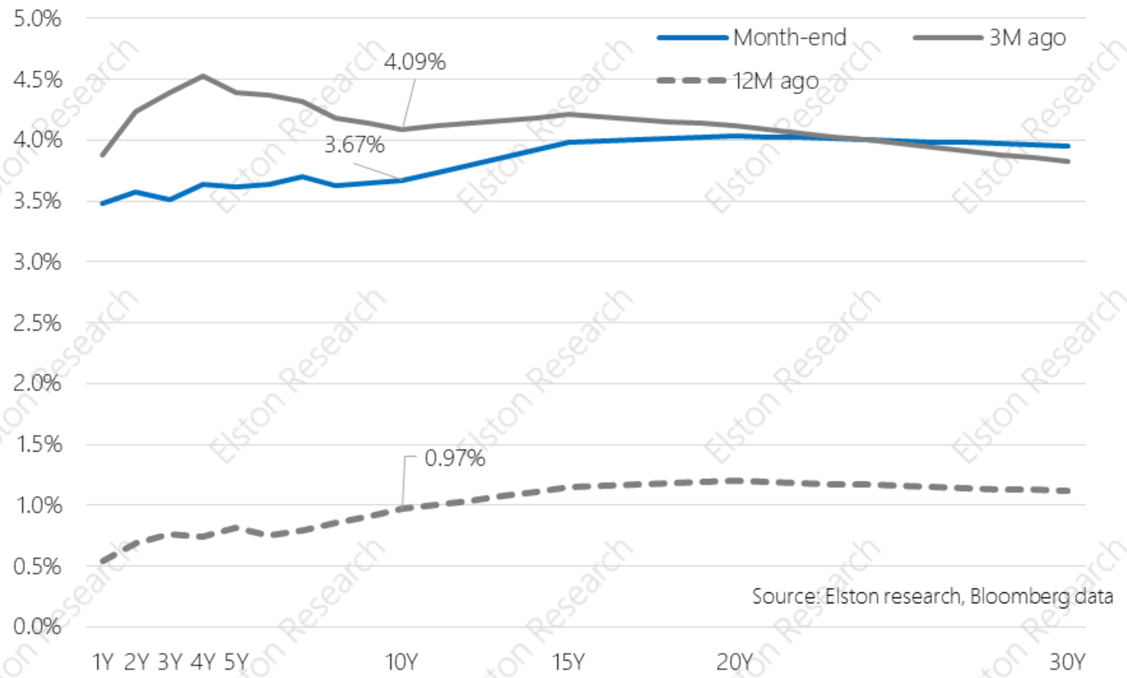
Fig.4. Inflation is past the peak, Bank Rates are near to peak



Yield is back for Bonds

The seismic upward shift in the UK yield curve in the last 12 months is forcing a repricing of assets across the risk spectrum and across time horizons.

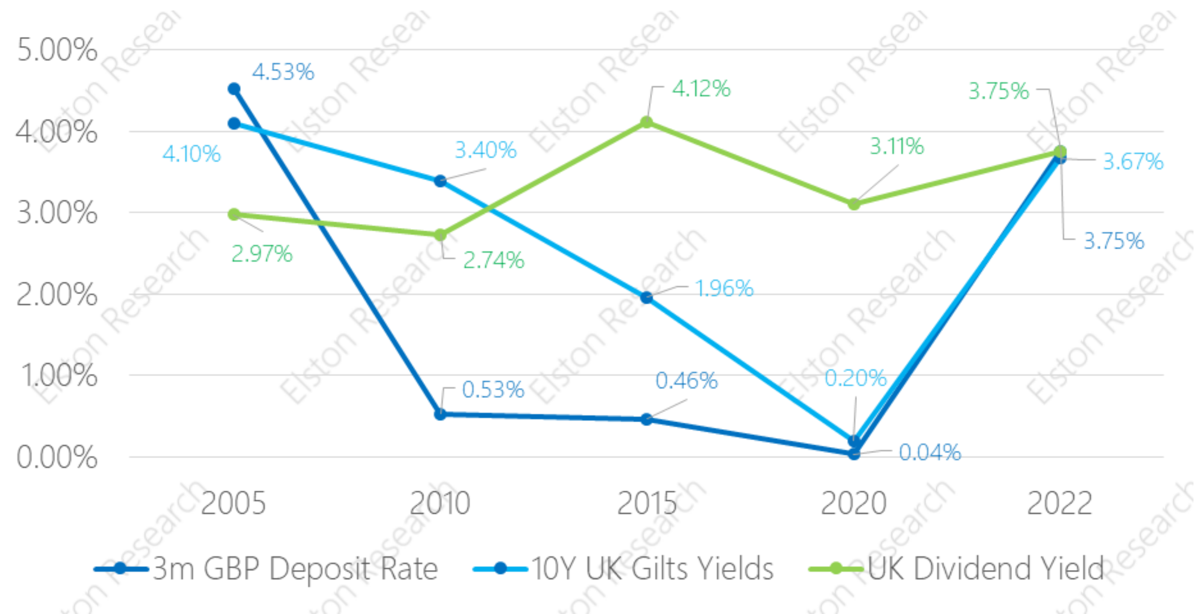
Fig.5. UK yield curve as at Dec-22



As a result, we are seeing three trends emerge.

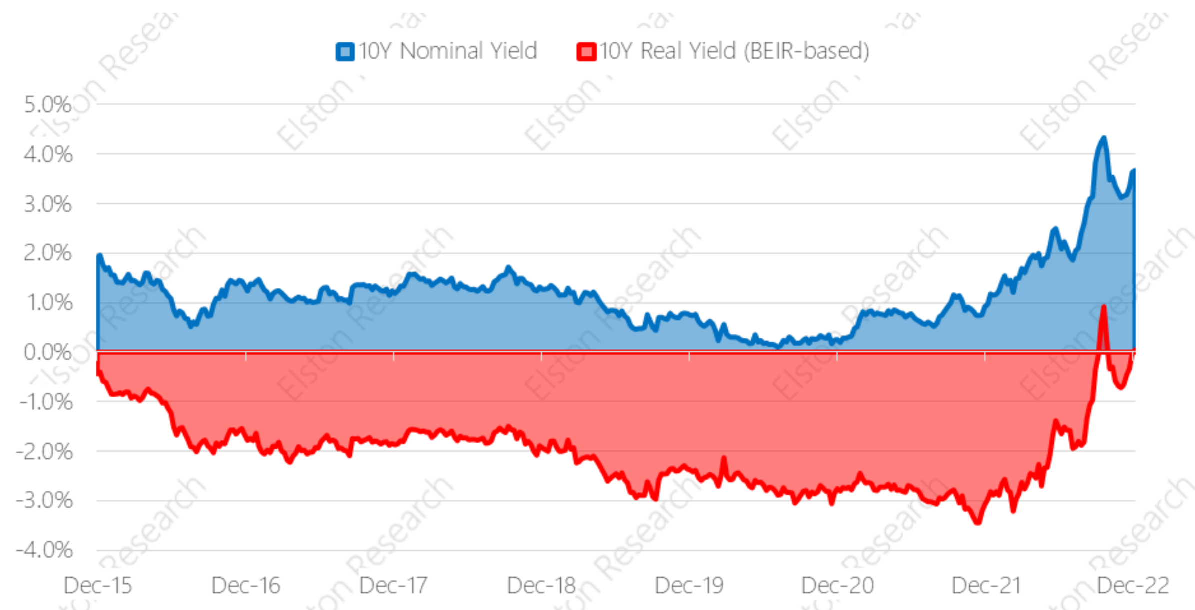
Firstly, after a decade-long drought, yield is back. You no longer need to accept risk to seek yield.

Fig.6. UK reference yields 2005-22



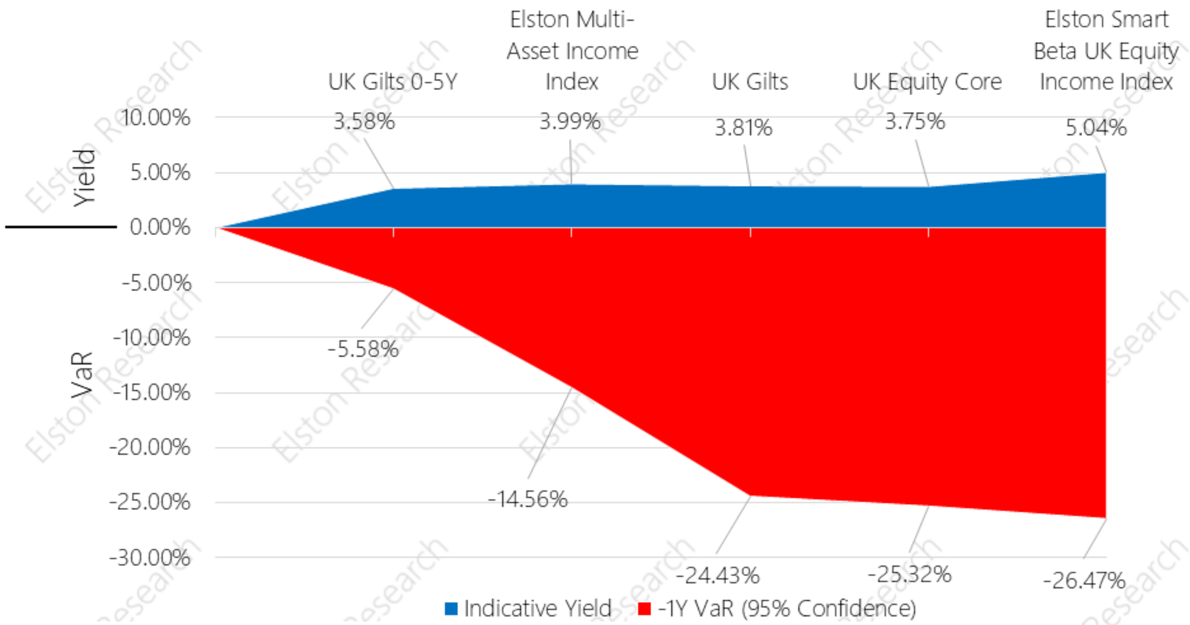
Secondly, real (inflation-adjusted) yields are nearly back. For new allocations, bonds are beginning to look like they can start to hold their value in real terms.

Fig.7. UK nominal vs real 10 year gilts yields, as at Dec-22



Finally, the yield-volatility-inflation trade-off has become a more complex puzzle to solve: a multi-asset income approach for income diversification across equities, alternatives and bonds, can help with yield capture, potential for growth, whilst keeping a check on risk.

Fig.8. UK yield capture vs risk trade-off



Source: Elston research, Bloomberg data

The end of froth?

The return of yield also means that risky, complex or illiquid assets that looked potentially attractive in a zero interest rate world, look at best expensive, at worst unnecessary. That's forcing a harsh repricing of more speculative assets and an end to the "everything bubble". Investment Committees will need to consider carefully whether more complex investments such as private markets are worth the risks. Bets on the direction of cryptocurrency price movements between speculators could generate losses beyond the first trillion dollar wipe-out.

Where next for Bonds?

Given the outlook, where next for Bonds? Well ironically, whilst bonds won't bounce to Dec-21 levels unless interest rates and inflation revert to Dec-21 levels.

Nonetheless, bonds are beginning to look attractive once again.

And as yields recover, bonds' traditional portfolio function – as a diversifier, a preserve of capital and a source of income – comes back into focus. We explore this further in our CPD webinar: "Investing for Income".

Henry Cobbe, CFA

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Our Research & CPD focuses on multi-asset strategies, index funds and ETFs.

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