HSBC Global Research

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The Major bond letter

#2. How to spice it up in a dull market

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Global

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Fixed income investors must be wondering, once again, how they can generate decent single-digit returns when there is next to no yield available. But developed bond markets need not be as dull as they first appear. Things can be spiced up: the key is to know when to focus on duration, credit and FX.

As is so often the case in financial markets, patience is crucial in taking advantage of the opportunities. But it means setting up in advance with strong convictions, preserving some dry powder, and being prepared to think outside of the normal silos.

Mr Market, with his perfect hindsight, knew exactly what to do at the start of this year. He could see the clear opportunities for global fixed income investors, mainly presented around the events of March. A rally in developed market rates was led by US Treasuries, which had a lot of catching up to do. Eventually a weaker dollar came through, contributing to significant FX gains for unhedged dollar-based investors in Europe and China. Re-entering credit markets after the significant spread widening in March 2020 was a gift to those that had patiently waited for such an opportunity. Mr Market would have done very well indeed.

This list is by no means exclusive but it serves to illustrate the importance of agility and dry powder when the time comes to invest.

All the aggregate indices, in dollar terms, have managed to eke out a positive return so far this year (see Table 1). Europe, China and the US have returned between six and ten percent for USD-based investors, which will go down as another good year if this is maintained through the remaining weeks of 2020. Even those sectors that faced the greatest challenges – such as local and hard currency EM debt – have managed to generate a positive return.

So a USD-based investor tracking the indices would have made good money in 2020. But those skilful enough to make the right calls – on duration, FX and credit – could in theory have made much more.

Table 1 shows five years of annual total return data split into its main constituents: 1) duration, that part of total return due to the movement in government rates; 2) FX, the movement in the local currency versus the dollar; and 3) excess returns, the remainder generated from spread products, above and beyond interest rates. Five years of data represent a full rate cycle in the US.

As the table makes clear, most total return in USD-based fixed income index portfolios has been coming from duration (rates) and currency (FX), with the call on credit (spreads) potentially adding some more.

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During these last five years the bond market has seen no shortage of calls for the multi-decade bond rally to start reversing. The table shows how wrong these calls have been. At the end of 2019, with the Fed in easing mode and much of the European and Japanese bond markets offering negative yields, the consensus call was for higher yields. The logic presumably went like this: bond yields are already low, there is little space for them to fall, so they will surely to go up.

Granted, some parts of Asia are enjoying a decent economic recovery but this has to be put in the context of what went before. In the US and Europe, the structural headwinds have only got stronger, particularly from the mounting debt pile, and central banks have anyway pre-committed not to hike. Not that they would need to, given such low inflation levels. The vaccine news is unambiguously positive for humanity but does not in itself need to mean a reappraisal of the lower-for-longer rates backdrop.

The point is that the 'cyclical mindset' that seeks to map every move in the bond market to the economic data and newsflow has been frustrated over the last two decades by the bond market's refusal to comply. Structural drivers are more important and central bank forward guidance looks through the near-term fluctuations. Bond investors long ago learnt that it is not quite so simple as 'what goes up, must come down' and vice versa.

In reality the more hyper-active types of investors, hedge funds for example, have not all done so well. Total return is not the same as yield to maturity and we should be careful to distinguish between a trade and an investment, with the latter having a time horizon measured in months and years.

To conclude, if bonds once again resist the consensus forecast of higher yields, the core markets of Europe and the US are likely to move within a narrow range, following the precedent of Japan.

So having the conviction to switch from one sector or region to another will be the key to replicating the positive total returns of recent years. And focussing on duration, credit and FX.
So let's throw down the gauntlet and spice it up a bit by making sure we can answer the following:

- How dependent are credit recommendations on the rate call?
- Are we sure that a rate call could not be better expressed in FX (and vice versa)?
- If we have high conviction that a currency will be stable, are there good carry trades in either rates or credit?

Table 1. USD-based return attribution through the last five years

	Return Attribution	2016	2017	2018	2019	2020ytd
US	Duration	1.21%	2.31%	0.61%	7.24%	7.63%
	FX	-	-	-	-	-
	Excess	1.62%	1.23%	-0.84%	1.83%	-1.02%
	USD Total Return	**2.83%**	**3.54%**	**-0.23%**	**9.07%**	**6.61%**
China	Duration	1.92%	-1.56%	8.59%	4.27%	1.34%
	FX	-6.62%	6.73%	-5.32%	-1.55%	6.11%
	Excess	-0.38%	1.07%	0.54%	0.60%	0.70%
	USD Total Return	**-5.19%**	**6.20%**	**3.33%**	**3.24%**	**8.26%**
Eurozone	Duration	3.23%	0.17%	0.96%	6.78%	4.66%
	FX	-3.80%	14.15%	-4.67%	-2.14%	5.83%
	Excess	0.09%	0.51%	-0.57%	-0.79%	-0.98%
	USD Total Return	**-0.60%**	**14.93%**	**-4.30%**	**3.73%**	**9.73%**
Germany	Duration	3.97%	-1.36%	2.35%	3.02%	2.85%
	FX	-3.80%	14.15%	-4.67%	-2.14%	5.83%
	Excess	-0.55%	-0.20%	-0.84%	1.51%	-0.57%
	USD Total Return	**-0.51%**	**12.36%**	**-3.24%**	**2.29%**	**8.24%**
Japan	Duration	3.21%	0.17%	0.95%	1.72%	-0.87%
	FX	3.03%	3.83%	2.20%	1.28%	4.12%
	Excess	-0.17%	0.00%	-0.03%	-0.08%	0.03%
	USD Total Return	**6.16%**	**4.01%**	**3.15%**	**2.95%**	**3.25%**
UK	Duration	11.09%	1.95%	0.65%	6.51%	6.56%
	FX	-16.71%	9.51%	-6.02%	3.26%	0.66%
	Excess	2.41%	0.24%	-0.09%	0.35%	-0.10%
	USD Total Return	**-5.47%**	**11.91%**	**-5.50%**	**10.34%**	**7.15%**
Australia	Duration	2.11%	3.66%	4.92%	8.87%	4.35%
	FX	-1.08%	8.34%	-9.76%	-0.75%	4.66%
	Excess	1.02%	-1.14%	0.91%	-0.64%	0.10%
	USD Total Return	**2.01%**	**11.06%**	**-4.49%**	**7.41%**	**9.31%**
EM external debt	Duration	7.96%	11.27%	-4.80%	12.07%	3.81%
	FX	-	-	-	-	-
	Excess	1.04%	-1.66%	1.71%	0.13%	0.78%
	USD Total Return	**9.00%**	**9.61%**	**-3.09%**	**12.20%**	**4.59%**
EM local Currency debt	Duration	3.58%	4.20%	1.11%	9.21%	4.38%
	FX	3.37%	10.74%	-6.02%	3.01%	-3.14%
	Excess	-	-	-	-	-
	USD Total Return	**7.08%**	**15.39%**	**-4.98%**	**12.49%**	**1.10%**

Source: HSBC, Bloomberg

Note: For each country/region we are splitting the USD-based total return on the Bloomberg Barclays Aggregate for that region. The Duration return attribution is split from the aggregate by calculating the sovereign benchmark return. By subtracting this duration return from the return of the aggregate index (both in local currency) we are left with excess return. Hence excess return is such that it is the return associated with any move in bonds in the aggregate index, above and beyond the return that can be attributed to moves in sovereigns – i.e. that due to spread movements. For the FX return we take the move in the spot market. All returns are calculated over calendar year windows, from the close on the last trading day of one year, to the last trading day of the next. For the FX return in EM LCD we used the difference in a USD hedged return vs the unhedged return as a proxy that reflects the currency impact at the index level.

Disclosure appendix

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Source: HSBC

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Source: HSBC

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