HSBC Global Research

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The Major bond letter

#26. Bring it on

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Fixed Income - Rates

Global

With 2022 likely to be the worst year in nearly half a century for the bond markets, bond investors want to bring on 2023. Clients ask, "When will it be time to buy bonds?" Often the question is framed around potential catalysts in the data, but at its core what is being asked is quite simple: tell us when, not why.

We obviously don't have a crystal ball. But we do have a framework that helps us understand the longer-run drivers of the bond market. Markets move first, reasons follow. Bonds normally move in advance of the economic data and policy decisions, especially around turning points. This means the causality is not from the economic data and central banks; it is reversed: markets, central banks, then data.

We think four aspects of valuations are worthy of more attention to help us answer the question about timing that investors are asking.

First, the forwards – the market's estimate of where rates and yields will be in the future – are likely to pre-empt a change in policy direction. True, in 2022 the market was consistently caught off guard by inflation surprises. Inflation prints were often on the upside of consensus until the October CPI release last week, when there was a significant downside surprise. Markets are discounting mechanisms. Rapidly pricing in all available information is what they are supposed to do. In more normal times, we would expect markets to pre-empt central banks.

Forwards are telling us a lot is in the price. For example, the upper bound of the Fed funds rate is now at 4.0%, but the forwards recently went as high as 5.0% for the March 2023 projection. Inflation-linked Treasuries had put the 12-month real yield at around 2.0% for the 1-3 year tenors only three weeks ago. As a gauge of how restrictive policy has become, this is almost double the level reached in the 2018-19 cycle. It is also significantly above the Fed's own measure of the longer-run equilibrium of 50bp, given a return to 2.0% inflation, the central bank's target level.

Sticky inflation – the type that does not fall back to central bank targets – presents the main risk to lower bond yields. There were policy mistakes in the 1970s, and Fed officials are referencing this period as a reason to maintain their hawkish bias. But we should consider the extent of rate hikes to date, how many are yet to come, the sharp tightening of financial conditions, and the growing likelihood of recession. Considering all these factors gives policy a decent chance of working by bringing inflation lower.

A second timing consideration is the appeal of cash versus bonds. Rising rates make it intuitively appealing to park cash in short-dated deposits or money market funds. Investing today for six months at 4-5%, for example, is all very well if it is possible to invest at the same or higher rate in May 2023. But what about the opportunity cost? If at any stage the investor thinks the rate cycle will turn, it would be better to hold longer-maturity bonds. If everyone tries to make the switch simultaneously, yields are likely to fall quickly. Practically speaking, it may not be so easy to switch into bonds without some expense; this is especially the case with deposits.

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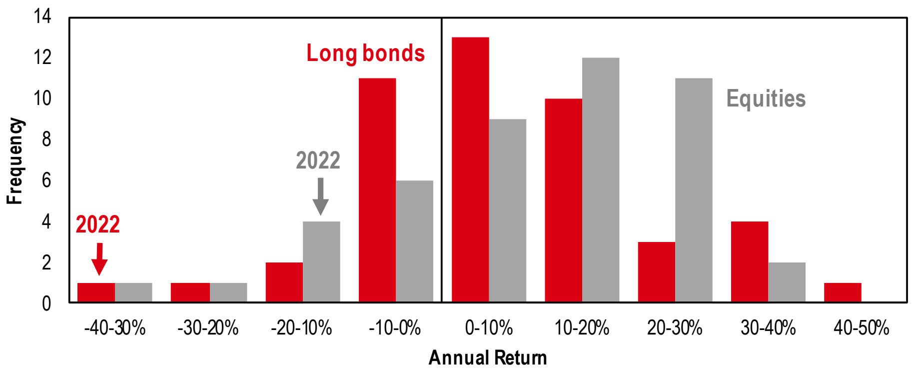
A third clue as to when to buy bonds is related to the fact that bond markets are global. Events in the UK recently had an impact on global bonds whilst central banks in Canada and Australia, along with many emerging market economies, are likely to be ahead of the Fed in this cycle.

Anyway, we think US yields are relatively high compared with the equivalents in Europe and China. Given that the US appears to be ahead in the tightening cycle compared with these two regions, we think the most likely way for the already wide spreads to revert to historical levels is through US yields falling, rather than those in the other regions rising. Related to this, with real yields recently approaching 2.0%, they are close to trend GDP, and offer significantly less risk.

As a fourth criterion, related to the point about forwards and the real yield, we should compare bonds with equities. We can see what a bad year it has been for both bonds and equities in the chart. Total returns on US Treasuries, the bond market that matters most in global fixed income, are in fact the worst on record; the aggregate Treasury index is down 13% and long bonds 33%.

Figure 1. Worst year for bonds on record



Note: Indices used are Bloomberg US Treasury 20+ Year Total Return Index and S&P 500 for 1977-2021 and 2022 YTD
Source: Bloomberg, HSBC

Our histogram (Figure 1) uses data for the last 45 years and compares long bonds with equities. We chose long bonds because their high duration makes them more directly comparable with the equity asset class. The y-axis represents the frequency of observations whilst the x-axis shows buckets of total returns. So, year-to-date, the 2022 returns for long bonds are in the -40% to -30% bucket, and the number of observations is one. Equities are to the right, with four observations.

We know that there is more than one way to present this data. A series of accumulated returns, using logarithms to capture exponential growth over time, show bonds beating equities for most of the last 20 years. Until this year, that is.

Whilst investors are mindful that the past can be a poor guide to the future, we can at least look ahead to next year reasonably confident in the knowledge that there are aspects of valuations in place that may make it less likely that this year's terrible performance will be repeated in 2023.

As we head into the new year, we think these four aspects of valuations will be key in the decision about when it will be the right time to buy bonds.

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