![HSBC Global Research]

20 May 2024

The Major bond letter

#49. No regrets

Fixed Income
Rates

Global

Shortly after publishing *Triple top*, 29 April 2024, we were told that we just had to extend the x-axis a bit to see that there were in fact four tops. This led to the feeling of regret that we had not stated up front that the chartist view of where yields might go next is only one angle. Each peak or trough in yields has its own context, something that the two dimensions of a chart can't show.

Hindsight is all very well, but you kind of have to be there at the time. We can look back at the charts and see when we should have bought and sold. For those who miss out on the high yields, there might be a certain amount of regret when they see that yields are falling (prices rising). Just as those who bought when yields were low (prices high) feel some pain as yields rise and the market moves away from them.

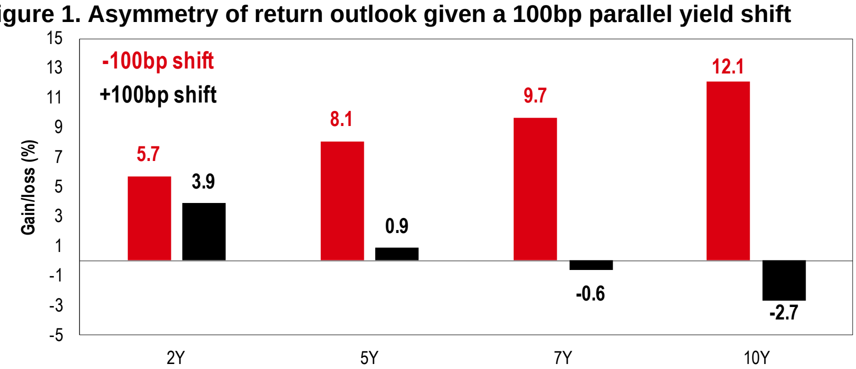
The more fundamental points that we have been making are that yields seem to be peaking, and that recent increases are better explained by the real yield than sticky inflation (see *Fixed Income Asset Allocation: Altitude acclimatisation*, 9 May 2024).

Analysing plausible scenarios gives us structure as we seek ways to justify our actions. Bond investors consider the outlook for inflation and growth, believing it might infer some meaning for interest rates, along with valuations across the different asset classes: bonds versus equities, for example. Surely fear of missing out (FOMO) cannot apply to something as sophisticated as bonds?

The way to avoid regret bias is to establish some rules and build a framework to justify our decisions; philosophy and process. Thinking through scenarios and projecting what might happen is a start.

Our chart captures projected returns under certain assumptions. Given where yields are today, investors can look forward to a coupon of 4% or so on government bonds, and even more for bonds with a credit spread, and this compares with less than 1% four years ago. The asymmetry comes from the fact that the coupon is paid whatever (assuming no default) and this is added to capital gains or losses from the movement in price. For a 100bp shift in yield, the gains from lower yields far outstrip the losses from an equivalent move higher. Bond investors will recognise this as convexity, the non-linear relationship of bond prices to changes in interest rates.

Figure 1. Asymmetry of return outlook given a 100bp parallel yield shift



Note: Key assumptions: parallel curve shift and 12-month holding period. Uses the prevailing yield for that tenor as the reinvestment rate. Total return measures price appreciation, accrual and coupon payment.
Source: HSBC, Bloomberg

Steven Major, CFA
Global Head of Fixed Income Research
HSBC Bank Middle East Ltd, DIFC

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As with the chart in the last bond letter, the one in this edition does not tell you that yields have peaked. It just shows a high ratio of positive returns in a falling yield scenario compared with one where they are rising. If we were looking for something more fundamental, it would be that the Federal Reserve indicated the next move in policy rates will be unchanged or down (see *The Major bond letter: #42. Going binary*, 11 December 2023). Indeed, the FOMC expressed this stance in recent "dot plots", and, just to make sure the message is clear, Fed Chair, Jerome Powell, responded to questions at the last FOMC meeting by saying "*I think it's unlikely that the next policy rate move will be a hike"* (1 May).

Let's examine the four assumptions that underpin the chart to better understand what it's telling us: 1) yield shifts of 100bp, 2) a 12-month horizon, 3) the curve move is parallel, and 4) cash flows are reinvested at the yield to maturity for each tenor.

First, the average trading ranges for the two- and 10-year segments of the US Treasury curve have been 175bp and 157bp over the past five years. We cannot possibly know whether the next 100bp yield shift is up or down, but we do know it's not an unreasonable magnitude to take for a scenario, given the precedent of recent years.

Second, the assumption that investors will hold the same position for 12 months is not binding. It applies better to asset classes and securities with low liquidity. For US Treasuries, the available pool of marketable securities is USD27trn, so in this regard, there is no lack of liquidity. Compared with 3-4 years ago, the good news for investors today is that the reward for a given risk has swung in favour of the more liquid bonds.

Third, the yield curve remained resolutely inverted these past two years, defying expectations of normalisation. When rate cuts start, it is possible that the front-end of the curve will lead the curve into a steepening trend, which means the left side of our chart might underestimate returns. It is contingent on the speed and scale of the rate cuts compared to what has already been priced into the forwards.

Fourth, the assumption that cash flows can be reinvested at the prevailing rate when the bond was purchased will be most unlikely to hold if yields have just moved up or down by 100bp. This brings in the angle of opportunity cost (see *The Major bond letter: #44*, 5 February 2024. Opportunity knocks, 5 February 2024). Faced with the decision of rolling maturing deposits and bills, say for another six or 12 months, investors will wonder whether it's the right time to grab some bonds, locking in today's coupons for many years into the future. The decision will depend on the policy rate call. Those expecting rates to stay where they are for another year or so don't need to rush to buy.

The regret bias[1] is at work when one makes that impulsive purchase, perhaps motivated by the limited time special offer. But regret bias doesn't have to be a negative emotion. It might even provide the motivation to do the right thing, such as investing in further education or saving for retirement. The feeling of regret may exist because the decision today is going to have some bearing on how one will feel in the future. We probably spend more time worrying about the bad decisions we make than we do making good ones. We hope not to later regret the choice of chart in this bond letter. Like all the others, it doesn't tell you what to do. It's just a part of the process that will hopefully result in making the right decision.

[1] Brewer, N. T., DeFrank, J. T., & Gilkey, M. B. *Anticipated regret and health behavior: A meta-analysis* (2016)

Previous editions of 'The Major bond letter'

Disclosure appendix

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