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The Major bond letter

#37. The year is still young

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Fixed Income - Rates

Global

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Good things come to those who wait. Back at the beginning of January, expectations were high that this would be “the year of the bond”. Much of this view, that the bond market would recover, enabling yields to fall, was premised on the idea that it surely couldn’t be as bad as last year, when performance was the worst in the last 40 years. US Treasuries returned -12.5% in 2022 (Bloomberg), and it would have been far worse but for the recovery that started in October.

Now, with Treasury yields back at the top of the range, there are calls for still higher yields. Adding to the momentum is a bearish view that bonds have lost their shine, no longer providing the relative safety they are supposed to, arguing that even worse is set to come as yields could burst through the top of the range.

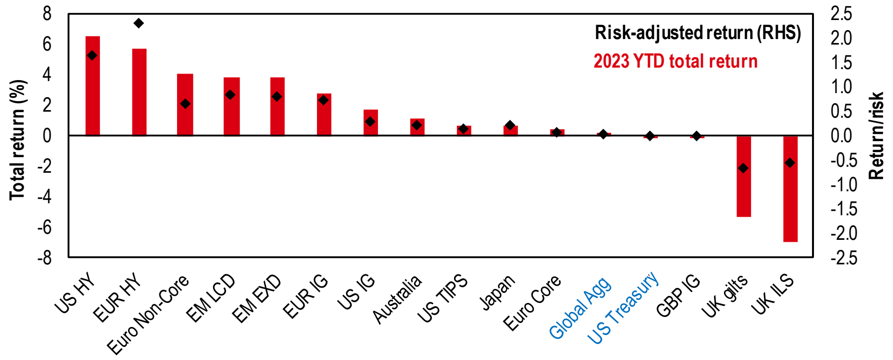
But wait, some sectors of the bond market have done rather well this year. Treasury performance has been flat whilst high-yield credit and emerging-market bonds have generated reasonable returns. Anyway, the year is still young, and there is time for the bond markets to put in a decent overall performance.

We construct a straw man, which lets us lay out the view for still higher Treasury yields and take the opposite side. The bearish view for bonds goes something like this: (1) increased government bond supply faces a lack of buyers, (2) the recent downgrade of the US Sovereign credit rating means Treasuries are no longer “safe”, (3) persistent inflation requires maintenance of higher policy rates, and (4) given all this, it is surely better to just sit in the higher-yielding money markets.

So what might the bearish view for bonds be missing?

First, with rising budget deficits, the supply of bonds increases, and this leads to an intuitive expectation of higher yields. We remain unconvinced by this argument, not least because it assumes demand is unchanged or lower. Supply can be important in a tactical sense – when positioning around an auction, for example – but that is not the same thing.

Bond returns in 2023: Treasuries flat, but good performance elsewhere



Note: EM LCD uses an index that caps China and Korea at 10% of the index. Total return measures price appreciation, coupon accrual and payments. Risk-adjusted return is defined as the YTD total return divided by the scaled standard deviation of the daily return. All return in local currency terms, except for EM LCD, which is in USD.
Source: Bloomberg, HSBC

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What does matter is a central bank's response to projections for the budget deficit, and any impact on the rate projections. If, as recently appears to have been the case, fiscal largesse results in a prolonged boost to consumption, then it will likely result in higher growth and rate projections, putting upward pressure on short yields. So, this is done, it's factored in already. Moreover, consider that, when budget deficits increase this late in the cycle, it might be due partly to lower tax receipts, foreshadowing a recession. That would increase the demand for bonds.

Second, US bonds are less "safe". Our view is that the probability of the US defaulting on its obligations did not materially increase because of the Fitch downgrade (1 August). Indeed, this misses the point that, when Sovereigns issue freely in their own currency, they cannot be compared with a corporate or household borrower. Anyway, by highlighting the wider budget deficit, the rating move may result in a different longer-term response – the increased debt servicing burden is likely to weigh on future growth, as it diverts resources away from investment and consumption. Calls for fiscal tightening could subsequently increase.

In any case, ratings are relative. The USD23trn US Treasury market is a global benchmark against which everything is compared, and the US dollar is the global reserve currency. Suggesting that Treasuries are no longer a "safe" asset is one thing; suggesting a viable alternative is a greater challenge altogether.

Third, inflation will be sticky from here. There are some projections of renewed upward pressure to headline inflation from rising energy and food prices. Developed-market central banks have been keen to stress that the declines in headline inflation so far are the easy part and that it gets hard from here. It could be said that they are well served by such a stance because it suits their current hawkish forward guidance.

But the fact is that US disinflation has been impressively symmetrical to the previous year's increase in inflation. Then there is the growing probability of recession – the New York Fed's forecasting tool put this close to 70% for one year hence – which would likely be consistent with further disinflationary pressure.

Fourth, given all the above, and the uncertain outlook, it surely makes sense just to sit in the money markets. US three-month bills yield 5.23%, which is about 1.0% more than is offered on the 10-year. Investors have seen better performance in their bills over the last two years, so why take the risk of buying bonds?

Opportunity cost is the answer. Investors who are certain that there will be no recession – and nothing over the next 12 months to interrupt the maintenance of a high peak for policy rates – will be fine staying in bills. The alternative view says don't miss the turn. It looks increasingly likely that the peak for the policy rate has been reached in the US, and other central banks are leading with their own easing cycles; Chile, Brazil and Hungary are three examples.

Lastly, much of the bear case for bonds is cyclical and local to the US. It therefore misses the global backdrop, along with longer-run structural drivers (see *The Major bond letter #36. Fly on the wall*, 1 August 2023). The fact that some emerging-market central banks are already easing tells us that inflation is falling fast or that they have cyclical and structural headwinds. The read-across to US policy from this divergence could come from any number of channels, including the stronger dollar, lower global growth, capital flows, and financial stability (see *The Major bond letter #35. Great divergence, revisited*, 23 June 2023)

We are just over 60% through 2023. There is still plenty of time for the patient view on bonds to come through.

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#36. *Fly on the wall*

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