The Outlook for Bonds

14 April 2022

Bond holders have endured a challenging start to the year as fears of inflation and rising interest rates have pushed bond prices lower. However, there are signs that we may be at a turning point, and we believe high quality bonds continue to deserve their place in diversified portfolios.

A challenging start to the year

Bond holders have endured a challenging start to the year. While events in Ukraine and concerns over the economic outlook might ordinarily be expected to boost the appeal of 'safe haven' assets, including high quality bonds issued by the likes of the US and UK governments, the threat of inflation has outweighed such considerations. As a result, holders of treasuries (bonds issued by the US government) and gilts (bonds issued by the UK government) have suffered losses over the year to date.

All about inflation

Bonds offer a compelling investment proposition, particularly for more cautious investors. In the absence of default (where the bond issuer is unable either the pay the regular income or repay the bond at maturity), bonds present investors with a stable income stream and a predictable return of capital invested at maturity.

Inflation, however, can undermine this equation. If prices are rising, the *real* value of both the annual income and the repayment of capital at maturity are falling: that stable income stream and predictable return will buy you less stuff. Investors therefore place a lower value on bonds when they fear inflationary pressures are mounting.

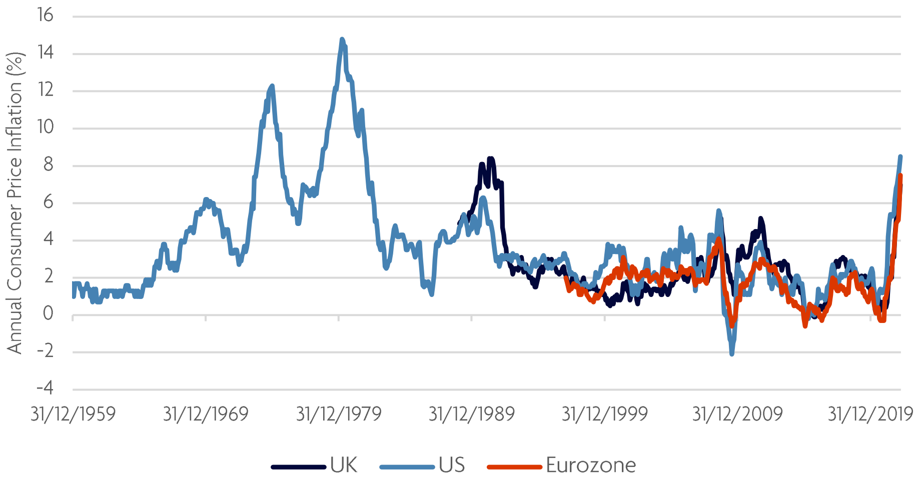
This is exactly what has happened over recent months. The pandemic triggered a huge shift in global consumption patterns. Unable to spend on services such as holidays, meals out or trips to the cinema, people around the world sought instead to spend on goods, renovating their houses, upgrading their home IT systems and baking untold quantities of banana bread. Suppliers were unable to cope with this sudden surge in demand, creating shortages and supply chain bottlenecks that drove prices higher. Though many countries are now 'learning to live with Covid', the consequences of suppliers' struggles have continued to reverberate through the global economy.

Two key events this year have exacerbated concerns about global supply. Firstly, Russia's invasion of Ukraine, together with the economic sanctions with which the US, Europe and the UK have responded, have impacted the supply of key commodities including oil, natural gas, wheat and fertilisers, prompting sharp increases in energy and food prices. Secondly, serious outbreaks of the omicron variant have led the Chinese authorities to impose strict lockdowns in many districts, including Shanghai, home to the world's largest port. This has reignited fears over bottlenecks in global supply chains.

Inflation in many parts of the world is now at levels not seen for decades. In the UK, prices (as measured by the headline consumer price index) have risen 7.0% over the past year, while in the US the increase has been 8.5%. Even in Europe, where policymakers have, for the past decade or more, typically been more concerned with *falling* prices, the rate of annual inflation has reached 7.5%.

Omnis INVESTMENTS

Consumer price inflation has reached multi-decade highs



Source: Bloomberg

Enter the Central Banks

For economists, a little inflation is a good thing. Gently rising prices encourage consumers to spend, greasing the wheels of the economy and stimulating a degree of growth. However, if prices start to rise too quickly, it becomes difficult to make sensible long-term economic decisions and savings have their value eroded. For this reason, many countries task independent central banks to maintain a degree of price stability. The Bank of England, for example, is mandated to deliver inflation at a steady 2% each year. Clearly, the current levels of inflation are significantly wide of this mark.

In response, central banks in the UK, US and Europe – among others – have kick-started efforts to rein in inflation. Their primary weapon in this battle is interest rate policy. Central banks can seek to ease inflationary pressures by raising interest rates. However, this comes at the cost of deliberately slowing economic growth. Higher interest rates encourage consumers to save rather than spend, and raises the hurdle that new projects must clear to be deemed economically worthwhile.

This last point applies equally to financial assets. If the central bank is offering to pay a higher rate of interest, investors should also increase the return they demand from their assets. Given that bonds deliver a pre-determined outcome (a fixed annual income plus the return of capital when the bond matures), the only way to increase the rate of return is to pay less for the bond at the outset. So, as central banks raise interest rates, bond prices tend to fall.

The Bank of England has already raised interest rates from 0.10% at the end of last year to 0.75% currently. Further increases are anticipated, with expectations that interest rates will top 2% by the end of this year. Meanwhile, in the US, having begun to lift interest rates in March from near zero, the Federal Reserve is expected to have interest rates close to 2.5% by December.

What does the future hold for bond holders?

With inflation at multi-decade highs and central banks increasingly determined to combat rising prices, bond holders may be forgiven for feeling despondent. However, we see reasons for optimism.

Firstly, though events in Ukraine and China have prolonged the problem, we believe there are signs that supply chain issues are gradually easing. For example, the cost of renting a shipping container to transport goods from China to the west coast of American has fallen by a fifth since late February. Meanwhile, surveys of manufacturers in the US point to normalising supplier delivery times.

In addition, as an increasing number of economies – with China the notable exception – emerge from covid-induced restrictions, consumers are redirecting their spending back away from goods and towards services. Though the price of airplane tickets has been rising, inflation in the service sector is much more subdued than that for goods. Recent data from the US emphasised this shift, with a sharp decline in the price of used cars contributing to a softening of inflationary pressures.

Though central banks will undoubtedly raise interest rates from here, we believe moderating inflationary pressures will allow them to back away from the aggressive pace of increases currently expected by investors. Bond prices should therefore receive support as the market moves to reflect a shallower path of interest rate hikes. At the same time, evidence of the slowdown in economic growth should bolster demand for high quality bonds, such as those issued by the US and UK governments. While it has certainly been a rough few months for holders of these assets, we believe that the worst is behind us, and that the outlook is much fairer.