ISG Insight
Bond market riot: Rates are rising, but is it sustainable?

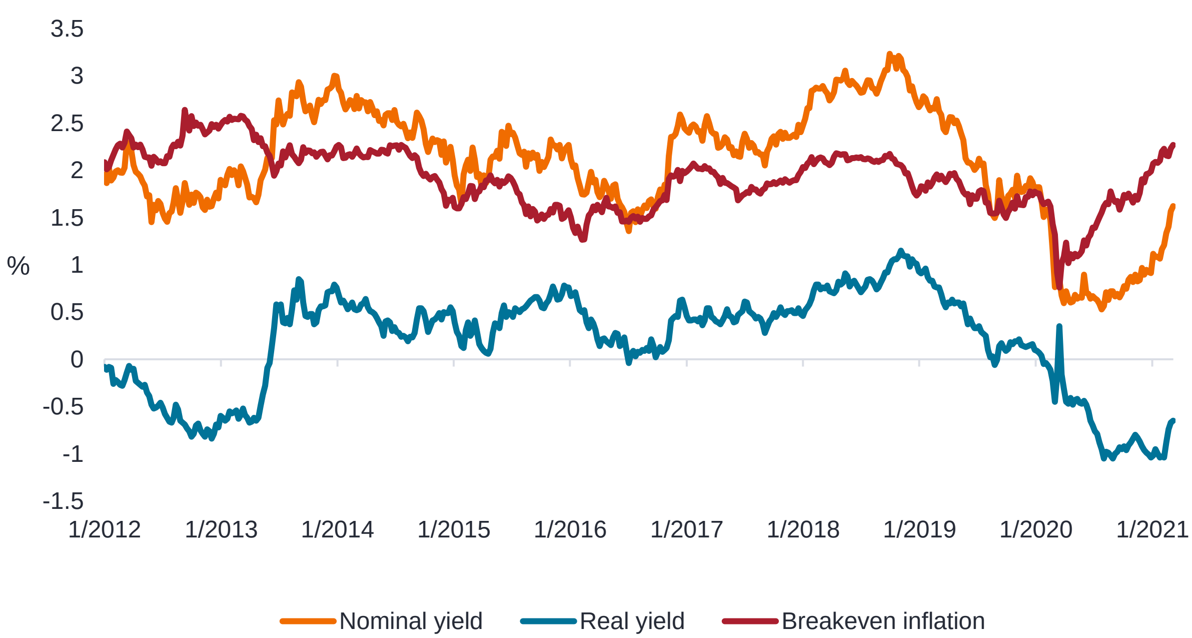
March 2021

The Investment Strategy Group (ISG) brings together investment professionals from across the global fixed income platform and other Janus Henderson teams, providing a forum for research and debate on the key areas of fixed income asset allocation and macro economic outlook, including rates and currency. It is designed to bring together our best ideas globally, aiding portfolio manager decision making around both portfolio positioning and risk allocation. The ISG Insight seeks to provide a summary of recent debate within the group.

The new year has awoken the bond market from its slumber. What began as a gradual climb in nominal yields from the summer accelerated in February with the yield on the US 10-year Treasury note briefly topping 1.6%, and significant moves higher globally including in Australia and the UK. Moves of this speed are rare, so we dedicated an ISG meeting to ask why global yield curves have steepened so quickly, when does a "good" rise in yields turn into a "bad" one and what the implications are for fixed income asset allocation.

Taking a step back, the reflation trade has reversed some of the overvaluation in high-quality bond sectors. US 10-year yields have risen by more than 100 basis points (bps) from the lows reached in 2020, but when looking at the absolute level of yields, as shown in Figure 1, a few things are clear: First, the move is retracing an even faster decline in yields from just about a year ago when markets (rightly) feared a global economic collapse induced by the exogenous shock of COVID-19. Second, while the initial move upward was led by higher breakeven inflation reaching 2.25%, in recent weeks this has stalled and been followed by higher real yields, which have moved off the lows.

Figure 1: US 10-year Treasury, real yield and breakeven inflation



Source: Bloomberg, 6 January 2012 to 12 March 2021, as of 15 March 2021.

Despite the sharp rise in yields, and the corresponding rise in interest rate volatility, credit markets were not spooked. Corporate credit indices, by and large, saw spreads tighten in February, though they began to move wider in March. This is notable for credit markets as they tend to be more sensitive to spikes in volatility. They also tend to correlate more highly with equity markets, and global equity markets were on the surface unnerved by this (with the S&P 500® Index still close to all-time highs). However, this does mask the severe rotation within equities, with cyclicals and value equities rallying and growth and more defensives underperforming sharply.

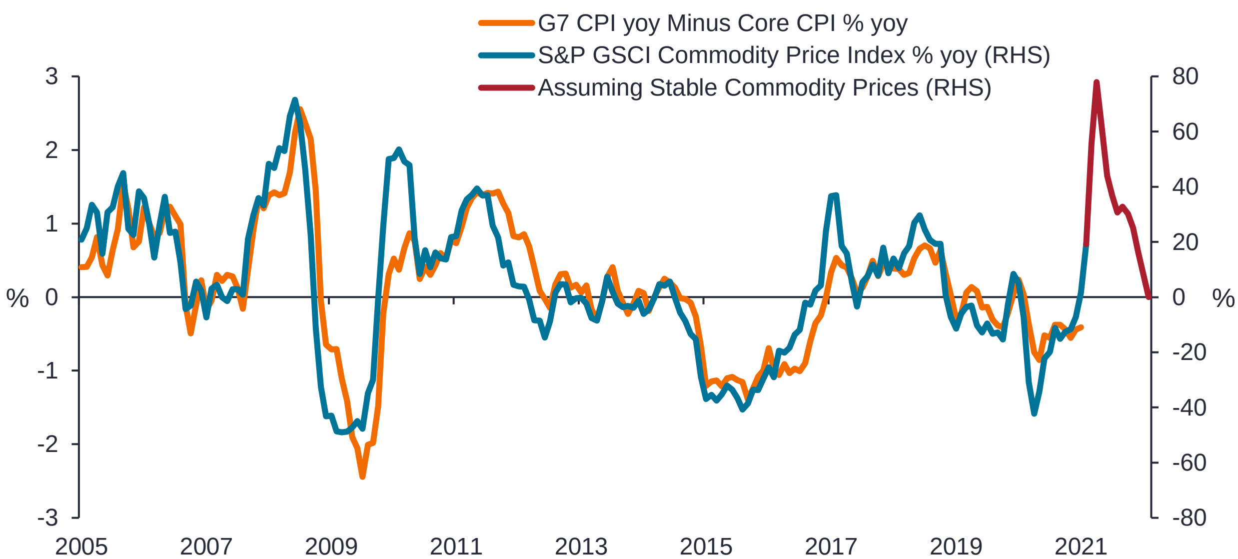
A healthy correction?

The lows that 10-year US bonds reached in the summer of last year were the result of fears that a synchronised global economic shutdown could cause historic economic damage. And, with no historical precedent, investors could only speculate how long it might last. Caution was king. By the time the efficacy of the early vaccines was announced in the first week of November, 10-year bond yields had already climbed from the summer lows to around 0.80% as investors began to consider the possibility of Democratic control of both the executive and legislative branches of government leading to additional spending. But it was the vaccine news that sparked the markets, and 10-year yields almost immediately surged to near 1%. Investors could now debate the when, not the if, of economic recovery and by February, the reflation narrative was consensus. Federal Reserve (Fed) Chair Jerome Powell described the move towards higher yields as a statement of confidence in the economy. It also is a mechanical result of flexible average inflation targeting (FAIT). The 2-year rate has barely moved, reflecting the Fed's commitment to keep rates on hold for the foreseeable future, and inflation breakevens have surpassed 2% since the lows nearly a year ago. However, central banks do not want a disorderly repricing in real rates, which would temper economic growth, and so it is difficult to envision the current pace continuing.

We don't think a structural regime shift to higher inflation is happening (yet)

Central banks are being challenged, and we likely will get an inflation upswing in coming quarters – the key for markets is whether this is temporary or becomes more persistent. While year-on-year inflation is expected to rise quickly as a result of the low base set in 2020 due to the pandemic, it is more difficult to make an argument that there is a regime change such that trend inflation is likely to be structurally higher for the foreseeable future. Despite (perhaps excessive) fiscal and monetary stimulus, unemployment is very high, and the output gap is wide. While we agree with consensus forecasts that the US economy will recover in the next year, it will take time to sufficiently reduce both variables to the point where they become a cause for inflationary concern.

Figure 2: Inflation and commodity prices



Source: Bloomberg, Janus Henderson Investors, 1 January 2005 to 1 January 2022, as of 15 March 2021.

In the short term, inflation is going up. But we think it peaks in the US this spring. As can be seen in Figure 2, the base effect from 2020 lows should both push inflation sharply higher, then nearly as rapidly fade. A similar story is likely, in our view, regarding consumption. Pent up demand for goods and services could well result in a year-on-year surge, but inflation is a rate of change index, and spending more than last year is unlikely to continue for years.

Finally, Figure 3 shows a range of regional Fed inflation measures. The data shows that many underlying inflation measures are trending weaker. This could change, but today it reinforces the idea that the Fed has no reason to respond and that it would need to move above 2% and stay there to meet their criteria to begin hiking rates under their new average inflation targeting regime.

Figure 3: Fed inflation measures

Source: Bloomberg, 31 December 2007 to 31 January 2021, as of 15 March 2021.

- **While inflation will rise on base effects and higher commodities, we are still missing some key ingredients – credit creation and wage inflation – for a longer-term inflationary trend.**

Another possibility: The market is too optimistic about the economy

Economists have over-predicted inflation for more than a decade, but the new US fiscal policy regime may spark fears of a modern monetary theory (MMT) style game-changer. This is the first time fiscal and monetary policy are working in tandem – does that change the secular stagnation narrative? Risk of a ‘surprise’ is probably greater in the US due to larger fiscal spend, huge Treasury supply and a higher potential growth rate compared to other developed economies. We fully expect a short-term sugar rush, as there will be some revenge spending by consumers (think holidays and haircuts), but this will be time limited.

More generally, the fiscal multiplier will probably be low because most of the excess savings has been accumulated by the top 20% of income earners, with a lower marginal propensity to consume and greater desire to invest savings. While markets are obsessed with the reflation narrative, we debated the idea that the global economy will face even stronger headwinds in the years ahead as a result of debt burdens and other secular factors. The world’s developed economies will exit this recession with substantially higher debt levels than even 12 months ago. Debt financed spending, rather than investment (aside from the Biden infrastructure plans), does not typically increase the productive capacity of an economy over the long term. In already highly indebted economies, the (low) marginal productivity of this debt has acted like a gravitational pull to the downside on government bond yields. According to HSBC estimates, global debt growth has grown 3.4x faster than global GDP over the last 20 years.

Finally, consensus forecasts show the US as the only developed economy likely to see complete economic recovery from the COVID-19 crisis by the end of 2021. Much of Europe and Japan are not expected to see a full recovery before even the end of 2022. Past periods of dramatic reflation driven by China's rise are unlikely to be repeated due to the growing maturity of the Chinese economy. Additionally, with the China credit impulse rolling over, this may suggest a slowdown into 2022, where all of this will be combined with the negative base effect of a fiscal cliff as stimulus rolls off.

When do rising rates start to become a problem in the eyes of the central banks? What could spark disorder in credit and equity markets?

Central banks have, so far, tolerated the rise in long-term bond yields, seeing the move as a sign of improving economic sentiment. At the same time, markets are having to price some *genuine uncertainty* in balancing the unknowns regarding the scarring of the pandemic, which we believe are likely underestimated, against the unprecedented fiscal spending boost and elevated bond supply (particularly in the US), requiring a greater risk premium.

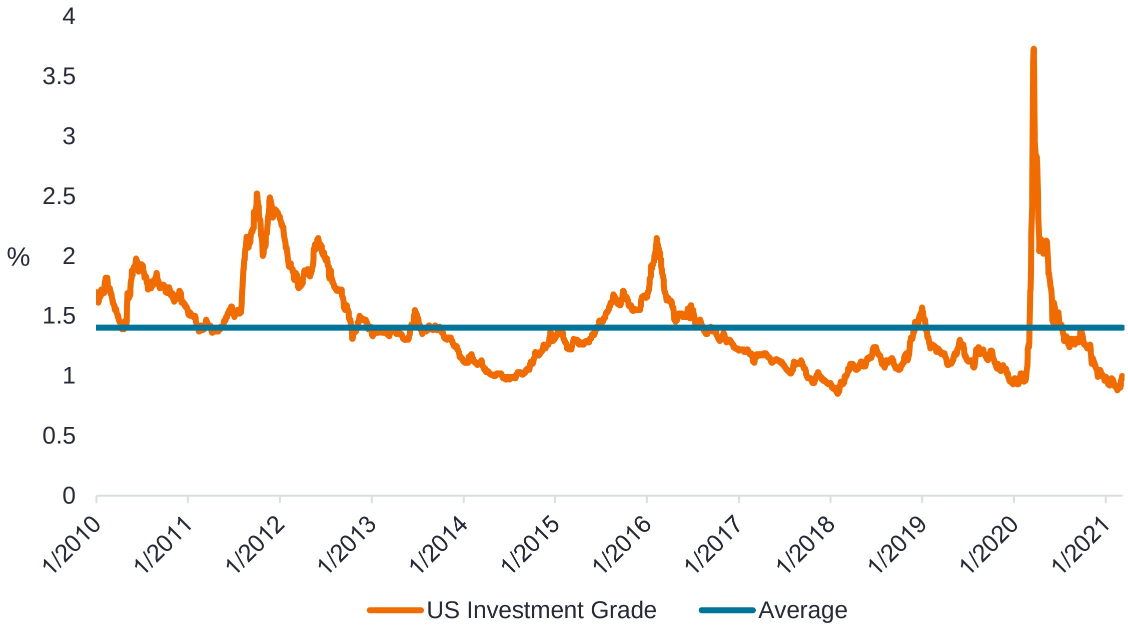
But when does a rise in bond yields go from good news to bad? We believe this has to do with both the pace and the cause – to put it simply, central banks would be concerned if they saw more disorderly and correlated markets (like March 2020), or a persistent tightening in financial conditions due to higher real rates. For now, while real yields remain negative, the Fed is likely to remain sanguine, but it will not want to see a repeat of the taper tantrum of 2013. Higher real rates not only increase costs of debt finance but also have knock-on effects on credit spreads and equity market valuations, which tighten financial conditions. A rise in real yields may end up being self-limiting, if it feeds through to a significant correction in risk assets.

What does this mean for asset allocation?

In our view, the fundamental environment remains positive for credit markets. The outlook for an economic recovery has improved steadily since the vaccine announcements in early November. And, many companies are in the early stages of balance-sheet repair, looking to use the coming quarters of the recovery to improve their credit quality, de-lever their balance sheets, and – in some cases – aim for credit-rating upgrades. The expected backdrop of global earnings growing by nearly 50% cumulatively over this year and next[1], boosted by a powerful combination of monetary and fiscal policies, sets an unusually supportive scene for risk assets. Against this positive fundamental backdrop looms expensive valuations. Current prices, and spreads, already have priced in the improving economic environment. Particularly in investment grade, breakevens are amongst the lowest in a decade reflecting the combination of lower rates and tight spreads. The risk to watch is the degree to which negative returns year-to-date feed into investor outflows. The first week of March saw the largest week of outflows in corporate debt and emerging markets for 12 months.

- **Fundamentals and the point of the cycle still suggest a credit overweight is prudent, but current valuations make us uneasy.**

Figure 4: US investment-grade credit spreads back near cycle tights



Source: Bloomberg, 4 January 2010 to 11 March 2021, as of 15 March 2021.
Note: Depicts Bloomberg Barclays US Aggregate Corporate option-adjusted spread (OAS).

Vaccines seem to offer a clear path out of the pandemic and should boost the most troubled sectors of the economy, offering some opportunities within the credit markets to position for further compression between COVID losers versus winners and lower credit quality versus higher-rated debt. As an example, the high-yield market offers lower interest rate duration than investment-grade corporates, while its higher yields offer greater cushion against losses driven by rising interest rates. The securitised markets also offer a potential haven insofar as it can offer very short-durations in the asset-backed securities (ABS) market, floating-rate securities such as collateralised loans obligations (CLOs), and a range of credit ratings to potentially boost income, all with traditionally low interest rate sensitivity.

Given the recent sell-off in core rates, securitised credit is the asset class that has moved closer to value territory within fixed income. Additionally, longer maturity bonds in some markets (ex Germany and Japan) are now back to levels that at least offer better prospects as a risk-off hedge. With longer maturities leading the sell-off, term rates have normalised closer to their long-run expected level (e.g., US five-year rate five years forward swap rate is close to 2.5%). Unless a regime shift is underway, and central banks move to hike rates well ahead of current guidance, it is hard to justify that the pace of the rise in government bond yields that we have seen in the last month can be sustained.

What to watch:

- **An abrupt or pronounced repricing of real rates remains a key concern for risk assets but not our central case – higher real yields, a stronger dollar and increased volatility would be the toxic combination for credit markets.**
- **Floating rate and/or short duration assets may provide some shelter in the case of accelerating outflows.**
- **Higher yielding government bond markets are regaining their poise but will likely continue to be volatile in the near term as markets grapple with reflation and the central bank response.**

[1] Source: Refinitiv Datastream, MSCI AC World earnings growth forecasts by year, as of 11 February 2021.

The above are the teams' views and should not be construed as advice and may not reflect the other opinions in the organisation.

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