Is 2023 the year for fixed income?

First Sentier Investors

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2022 was a year of extremes for fixed income markets. Before thinking about the year ahead, it's perhaps worth summarising the key themes that drove local and international fixed income markets in the past 12 months.

- **A global surge in inflation** – a combination of aggressive stimulus, both monetary and fiscal, to offset the adverse economic impacts of the Covid pandemic proved (with hindsight) to have been overdone. The re-opening of economies as virus cases subsided saw a surge in pent-up consumer demand, against a background of limited supply owing to supply-chain disruptions and bottlenecks. The result was a sharp increase in consumer prices; exacerbated by the war in the Ukraine and the associated spike in energy prices globally. Inflation rose to levels not seen in decades and wage price inflation picked up in most key regions owing to tight labour markets.

- **A sharp monetary policy response across many jurisdictions** – central banks were largely caught off-guard by the severity of inflationary pressures. Policymakers responded belatedly and aggressively, with dramatic increases in official interest rates.

- **Sharply higher bond yields in response to the two factors above** – the moves in longer-dated bond yields was in line with the most dramatic seen historically (including the famous 1994 bond market sell-off). In turn, total returns from major fixed income indices were among the worst on record. The significant lengthening of duration in major bond indices in the past decade or so since the Global Financial Crisis magnified the impact of adverse market movements.

The other interesting characteristic of 2022 was the relatively strong correlation between returns from fixed income and risk assets.

The outlook for 2023 remains uncertain, but appears somewhat rosier. A couple of key themes have emerged, that might drive sentiment in the year ahead.

Central banks remain focused on bringing inflation under control and back towards target ranges, suggesting we have probably not yet seen the end of the policy tightening cycle. That said, we are likely much closer to the end than the beginning; some moderation in the pace of tightening is anticipated in the months ahead as inflation peaks. Many major central banks have already been guiding their communications in this direction, aware that policy tightening to date will have a lagged effect on economic activity levels and growth.

Ultimately, the extent of further policy tightening will be driven by the persistence of inflation. That path remains challenging to predict at this stage, although it's worth noting that plenty of forecasters are suggesting interest rates could be lowered before the end of 2023 as key markets enter policy-induced recessions. If these forecasts prove accurate, we could see more meaningful reductions in official borrowing costs in 2024.

Against this background, it's possible we might already have seen the cyclical highs in longer-dated bond yields. Further setbacks cannot be ruled out, particularly given elevated market volatility over the past year, but we believe investors focused on interest rate carry will likely re-emerge as the probability of further interest rate hikes reduces. The near-term path remains unclear, but value has undoubtedly returned to the bond market in general. For income seekers, this is clearly a good thing. And for those using bonds for diversification purposes, there is scope for bonds to rally in the event of a negative economic outcome that adversely affects risk assets; there is scope for meaningful capital appreciation from fixed income securities in a 'risk-off' environment, with bonds potentially providing an offset to any weakness in risk assets as they have typically done in the past.

Similarly for credit assets, the widening in spreads over the past 12 months or so has seen value re-emerge. Relative to historical default rates, credit spreads are providing sufficient compensation, and breakeven levels in most market segments are also more compelling. With a higher starting level of benchmark bond rates – and assuming default rates do not increase too significantly in a recessionary environment – the total return profile of credit is currently attractive in our view for investors with a medium-term investment horizon.

Active management back in vogue?

Another key theme to emerge in 2023 could be a resurgence of actively managed fixed income portfolios, versus passively managed strategies that have become so popular over the past two decades. With bond yields falling towards zero over this period, beta provided the lion's share of total return from fixed income portfolios; alpha generated by active managers tended to contribute more modestly.

But with the long-running secular bull market in bonds finally over, going forward the contribution from active management should account for a greater proportion of total return. With yields still low relative to long-term averages, annual total returns are likely to be more muted than in the past (perhaps low to mid-single digits). In this environment, any active returns that can be generated should account for a meaningfully greater share of total returns. Fittingly, with increased policy and inflation uncertainty, longer duration now embedded in most benchmarks, and more volatile and responsive yield curve shapes, there should be no shortage of opportunities to implement active strategies in portfolios. In turn, active management of core fixed income exposures should be a far more compelling alternative than has been the case in the recent past.

In our view, the key is to ensure active management is truly active and aligned with investors' objectives. If fixed income holdings are primarily used as a diversifier against risk assets, for example, structural overweights to higher credit beta and less liquid portfolios should be avoided. Instead, alpha should ideally be well diversified, active in both directions across each key risk parameter, and uncorrelated with the performance of risk assets.