Bonds in 2022: A Tale of Two Halves?

As we have been reporting in our Quarterly Reviews, 2022 has thrown the levels of protection and diversification offered by the traditional 60:40 portfolio into the spotlight. In what might ordinarily be viewed as the safe haven asset of choice in the face of adversity, bonds all but sold off in lockstep with equities during the first six months of the year. One consideration, which arguably is not talked about much, is that, like equities, bonds had themselves enjoyed exceptionally strong long-term performance up until the end of 2021, having effectively enjoyed a 39-year bull run. A culmination of several narratives are to blame for their H1 downfall – the US Federal Reserve's (Fed) intervention to quell the rising cost of living sat chiefly among them. As markets grappled for stability in the wake of the pandemic, global supply simply could not keep pace with demand, which was somewhat fuelled by excess household cash from previously supportive fiscal policy in the US. The untimely and tragic circumstances of the subsequent global commodity price shock propelled inflation to eye-watering levels.

As investors held their breath for the Fed to react, anticipation of a series of interest rate hikes weighed heavily on fixed income markets globally. The inverse relationship of rising rates with bond prices led some investors to opt for the relative security and diversification offered by alternatives, such as the strengthening US dollar, or real assets such as infrastructure investments. In fact, the aggregate losses in the global bond sector represent the worst H1 returns in more than a century. Given the trajectory of the yield curve and lack of clarity long term, bonds with longer duration (and thus sensitivity to changes in interest rates) typically fared worse than their shorter duration counterparts. The most notable detractor of the major bond markets was UK Gilts, which shared a similar volatility profile to global equities during the period, shedding more than £150 billion in value. The performance of US government and US corporate bond markets offered some solace to sterling investors, buoyed by the strength of the dollar and arguably adjusting quicker to the new higher interest rate environment.

As portfolio managers licked their wounds following a bruising H1, indications that inflation had already, or was about to peak in the US, partly thanks to a more aggressive policy from the Fed, offered glimmers of hope. The ability to distinguish between rate hikes being implemented and those that are simply anticipated in the future are two very different things, and, from the conversations we have had with the managers of our underlying funds, it is clear that, whether investing in

bonds or equities, this is a time to be hyper-selective when picking investments. June and July also saw a shift in mind-set, from inflationary to a recessionary one, along with the associated risk-off environment that comes with it. With building societies and banks not necessarily passing rate increases onto savers, the traditional diversification and protection benefits of bonds have come into focus once again. Whilst it may be a little premature to be factoring in future rate reductions with a high degree of conviction, yields have started to return to levels that look more appealing compared to cash.

Inflection points are perhaps an overused saying in our industry, however investors could be forgiven for feeling that bonds may have been oversold in H1, particularly given the exaggerated hypothetical level of defaults being implied by the sharp retrenchment earlier in the year. Conversely, markets now appear to be digesting the prospect of inflation being brought under some semblance of control in the near future. Investors are currently faced with a paradox of elevated household savings, buoyant demand and relatively strong corporate earnings and labour markets, amid a cost of living crisis and a recent raft of downward revisions of global GDP growth. Last week's statement from the Bank of England suggested inflation is yet to peak in the UK and predicted that we will officially enter a recession in the final quarter of the year. It certainly made for grim reading, however in an elongated economic cycle, many analysts feel it is what is needed for markets to 'push the reset button' and ultimately for conditions to improve.

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