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A new path for bond investing

Paul Skinner and James Myhill explore the changing nature of fixed income investing

Today, fixed income investors must operate in a very different environment with profound implications for how fixed income and, in particular, credit portfolios are managed.

How has the landscape for fixed income markets changed?

The low-rate, low-yield environment of recent years has given way to a completely new landscape for fixed income. Back in 2020, if you were an investor in government bonds, there was a fairly good chance you'd be receiving a negative yield – essentially paying to buy government debt, while even in better-yielding sectors total returns were challenged. Fast forward to 2023, and bonds benefit from higher rates and, in the case of credit, attractive spread levels.

2022 saw central banks implement an enormous shift in monetary policy to control inflation, and we expect this trend to continue. Looking forward, we think that this new regime of higher inflation, increased volatility and more restrictive monetary policy will remain intact.

This new environment creates real opportunities for long-term fixed income investors particularly in the credit space – provided they can navigate it successfully as, compared to the past decade, this is unfamiliar terrain.

What do fixed income investors need to consider in this new environment?
The new macroeconomic regime we are entering into will come with a new set of characteristics, all of which will affect how we look at bonds. Our macro team expects higher and more volatile inflation, greater interest rate volatility, more restrictive monetary policy, increased dispersion, especially within credit, and further periods of positive correlation between bonds and equities. Those are a lot of opportunities – and risks – to navigate.

How should fixed income investors approach this regime shift?
The rulebook hasn't been torn up, but in this environment, we think the considerations for successful fixed income investing have been somewhat rewritten.

1) Rethink the role of bonds. More volatile inflation will challenge static or passive bond investing. More dynamic and diversified allocations may be appropriate. Considering the full spectrum of fixed income, looking across government, the credit risk spectrum and securitised debt, can give investors a better chance of attaining the important bond attributes of liquidity, yield and uncorrelated returns to equities.

2) Turn volatility into a potential advantage. Given the likelihood of increased volatility and dispersion, we think success will be more aligned with an active approach. Fixed income is more cyclical than is often assumed. Specifically, the removal of central bank support has reconfirmed our view that credit is a cyclical asset class, and that being nimble is key to navigating a quickly changing environment. We expect huge dispersion in how individual credits will navigate the coming cycle.

3) Access multiple perspectives. Success in the new environment will depend on an investor's ability to identify relevant information. Access to multiple perspectives – across a range of regions, specialities and lenses – makes this more likely. Remember that issuers of credit also rely on public or private equity financing – as a manager of both equity and fixed income, we believe an investment manager with access to information from both sides of the capital structure may be able to make more informed investment decisions. We also believe ESG factors can have a significant impact on long-term performance, particularly as dispersion among investment-grade issuers increases.

4) Keep a close eye on liquidity. Recent events in the UK have once again demonstrated the vital importance of ensuring fixed income portfolios have liquidity profiles that are appropriate for a more volatile market.

What should investors look out for over the next 12 months?
The coming year is going to be quite interesting for bond markets. We do not expect a deep recession, but we do not believe that central banks have conquered inflation. This means we probably have a longer but shallower recession to come and that bond yields may remain elevated, perhaps for longer than the market assumes. As a result, credit returns may be healthy as corporates deleverage their balance sheets in a slow, but not catastrophic, economic environment. If rate surprises wrongfoot the market, we expect further volatility – bringing with it opportunities for active managers to outperform.

To find out more, visit: https://www.wellington.com/en-gb/institutional/capabilities/defined-contribution-plans

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