What happened to the ‘safe haven’?

Sandra Haurant looks at the latest developments in the bond market and what this means for pension fund portfolios

Summary

- Bonds have traditionally been a low volatility element of a portfolio – the 40 per cent in the classic 60/40 balanced portfolio that acts as a foil to the more volatile equities.
- After more than a decade of stability (and low yields) bond markets have become far less predictable, with yields rising and prices falling.
- For pensions using bonds for liability matching, this is less concerning but those looking for returns could have greater worries.
- The past few years have exacerbated a cyclical issue, as central banks and other big bond buyers stop and turn to selling off instead.
- Bigger picture economic pressure could push default rates up …
- … although recession risks are already priced in.
- Bonds will remain a mainstay for pensions, but selectivity and synthetic products may play an increasingly important role.

“Bonds have traditionally been used to not only provide a current income, but also as a kind of defensive ballast to the portfolio where, in periods of volatility, if you had equity selling off or risk assets selling off, typically government bonds would rally,” says Ninety One head of alternative credit, Jeff Boswell. “So you had an offset in the form of an instrument that not only was providing you with a nice kind of anchor, a steady income base, but then some defensive characteristics as well.”

Aon investment partner, Calum Mackenzie, agrees: “Typically, you’d expect that when equities fall, bonds go up. That’s effectively the basis of the balanced portfolio, the 60/40 traditional portfolio that’s been the bedrock of the investment theory for decades.”

Then things began to change. “With the kind of secular compression seen in government bond yields, where they went to next to nothing, two things happened,” Boswell says. “One was that, in terms of those outcomes that it was providing, it stopped producing much income. Then secondly, as government bond yields collapsed, it left underlying investors more vulnerable to some sort of rates reset, which is exactly what we’re going through now.” And in recent months, we have seen headlines screaming the likes of ‘bond market nightmare’ and ‘crash’ and collapse’. So what happened to the so-called safe haven?

A long time coming

According to Cheyne Capital portfolio director and head of credit research, Duncan Sankey, a shift in the bond markets is no surprise: “We had 10-plus years of extraordinary and monetary accommodation quantitative easing. It has kept bond yields very, very low – arguably artificially. Consequently, we’ve seen interest rates at very unusually low levels,” he says. “So what we’re seeing now is degree of normalisation, and it’s been so long since we’ve seen normal rates that this is coming as a bit of a shock, particularly since in some jurisdictions this means a shift from a negative rate position. When you start seeing rates increase, that is absolutely value disruptive. The value of your bond holdings is going to go down.”

Cardano client portfolio manager, Nigel Sillis, adds: “We’ve been accustomed during the past 10 or 15 years to seeing government bond yields that are below the level of inflation, and it seems clear now that the world central banks are determined to use monetary policy much more aggressively, to stave off the risks of inflation escalating further.”

Yields, says Mackenzie, have been driven lower and lower as central banks, pension funds, banks, insurance companies, all piled into the bond market, in something of a buying frenzy. This, combined with low inflation, pushed bond yields to “incredibly low levels where people were willing to lend for 10 years for half a per cent”, he says.

But, although a long time in the making, the shift has been massively exacerbated by more recent events – in particular, he says the global phenomena of: “The double whammy of the re-emergence of inflation and the ending of quantitative easing.” Central banks, rather than buying all the bonds that were being issued, are now allowing their bonds to be sold into the market – which means, in essence, that the biggest buyer

of bonds has now left the room. "Simple supply and demand would say that should reduce the price," Mackenzie says. "As a result, the bond market is almost behaving like a rubber band – it's been stretched and stretched and stretched. And now suddenly it has snapped back."

No panic for pensions?

"One of the interesting factors for pension schemes investing in bonds is that they're using the bonds not specifically to generate return, or not with absolute return focus, but to match their liabilities," says Mackenzie. A retail investor or an endowment fund might look at a year-on-year fall of 33 per cent in index-linked gilts as a disaster, he says, but: "A pension fund might be thinking, OK, my bond portfolio has fallen by a third, but actually my liabilities have fallen by the same or more. So actually, in that context, they're doing their job as liability-matching assets."

For those funds using bonds for diversification purposes in a returns-seeking portfolio, though, it's a different story. "One of the big challenges we've had is that the traditional correlation between equities and bonds has increased," says Mackenzie. That correlation means bonds can't do their job as a diversifying stabiliser.

Floating free

According to Cambridge Associates head of European pension practice, Alex Koriath, very few areas of the bond markets that have escaped the recent tumult. "We have seen increases in volatility and falls in market values across bond markets with no shielded safe havens," says Koriath. One possible exception is the floating rates sphere – which encompasses loans or private credit strategies. "These have not repriced along government bond nominal yield curves, but have nevertheless suffered from spread widening and volatility," adds Koriath.

"The floating rate loan market, where the rates reset to reflect underlying interest rates, have been a bit more protected," agrees Mackenzie. "That's because it's the market with the lowest duration, so is the least sensitive to changes in interest rates." Floating rate loans are likely to have durations of between one and five years, while terms for traditional bonds can be as long as a decade.

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Default rate risk

When, as with bonds, you effectively lend money as an investment, you want to know you'll be paid back, and default concerns become all the more pressing when talk of recession is in the air. "The natural question is, 'what if we go into a recession, are our default rates likely to spike? Are we getting compensated for that?'" says Boswell. "Our answer is that, if we look at balance sheets and leverage levels and debt serviceability, and maturity walls, you know, corporates, and certainly investment grade corporates, are in very robust health."

Still, the effects of inflation on the economic environment are an important issue, says Sillis. "Every day we are reading about the cost-of-living crisis actually being extended into the so-called 'cost-of-doing-business crisis', which could start to affect creditworthiness of businesses and corporations, especially in Europe," he says. "We're not seeing those kinds of stresses appear in corporate bond markets yet – but I emphasise the word 'yet' because that would be a risk, if the challenging economic environment that we're presently in extends over multiple quarters into next year."

"To take it right back to the cost-of-living crisis, that ultimately has to play through to the economy, and to the investment market," says Mackenzie. "And to take it to its extreme, if a pension fund owns a property which is let out to a coffee shop, and people start feeling they can't afford coffee anymore, and the tenant of that coffee shop starts to struggle, you could lose your tenant and lose your rental income."

Indeed, Sankey says: "I think default rates *[in high yield]* clearly accelerate from here." But, crucially, he argues, recession and resultant default risks have been priced in for investment grade credit. "Credit spreads offer compensation for a cumulative default rate in investment grade (IG) credit, the top end of the credit market, of about 8.7 per cent cumulatively over the next five years," he says. "If I look at any five year period from 1970 to the current day, the average five year cumulative default rate is about 0.8 per cent. The worst was 2.3 – 2.4 per cent. So you're being compensated for a default rate over 10 times the average and over three times the worst that we've seen for any five year period of the past 50 years. So they're pricing in a huge amount of recession risk right now."

Sticking with bonds

For Boswell, bonds remain of important to pensions but, he says: "It's about being very wary about that range of possible outcomes. It is still very much about credit selection and being very careful in terms of what you do buy, because we could see credit spreads widen from those average levels to something more like recessionary levels." In spite of what feels like uncharacteristic volatility in the bond market, pension funds won't be turning their backs on this mainstay asset any time soon, Sankey says: "Bonds will remain key investment vehicles for pension funds."

Written by Sandra Haurant, a freelance journalist