Bond market outlook – a different starting point in 2023

M&G Investments

M&G Public Fixed Income

January 2023

- Bond markets experienced one of their sharpest sell-offs on record in 2022, as persistently high inflation and a series of interest rate hikes pushed government bond yields to their highest levels in over a decade.
- Following these unprecedented moves, we believe bond investors go into 2023 on a much better starting point and that current yields look compelling as inflation starts to ease.
- We see especially good value in investment grade credit, which we believe offers natural diversification qualities and a source of resilience during uncertain market conditions.

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A different starting point for bonds

Bond markets experienced one of their sharpest sell-offs on record in 2022, as concerns over persistently high inflation led to an aggressive tightening in monetary policy, with the world's central banks pushing through a series of rate hikes. Inflation was further stoked following Russia's invasion of Ukraine, which led to a spike in energy and food prices, while putting further pressure on many emerging market economies.

There were few places to hide in fixed income, as government bond yields climbed to their highest levels in over a decade. Credit valuations also came under severe pressure as markets started to factor in the impact of slowing economic growth and higher borrowing costs on corporate earnings. Investment grade corporate bonds were therefore hit by a combination of wider credit spreads and a higher 'risk-free' rate, as yields reached their highest levels in over a decade (Figure 1).

However, given the scale of these moves we believe bond investors go into 2023 on a much better starting point. While mindful of the challenges facing the global economy, we believe corporate fundamentals remain sound and that current yields look compelling on a medium-term view. Through a combination of slowing growth, lower goods prices and favourable base effects, we would also expect inflation to ease throughout 2023. After a brutal year for fixed income, we think this will allow central banks to slow their pace of rate hikes, which could provide a very welcome tailwind for bond markets.

Figure 1. Bond yields over time – five-year USD investment grade yield to maturity

Source: Bloomberg, 28 November 2022

Past performance is not a guide to future performance.

Time to look at credit again

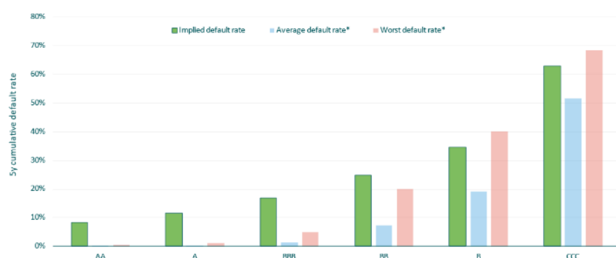
We believe there is now attractive value to be found in credit, with investors being well paid to take risk. While further volatility is likely in the short term, from a long-term perspective we think credit provides compelling risk/return dynamics. Defaults are expected to stay low due to strong company fundamentals and robust balance sheets, while many businesses have taken the opportunity to refinance their debt for several years at cheap levels.

We believe that markets are pricing in much of the bad economic news, with credit spreads reflecting an implied default rate well in excess, not only of average default rates, but also of the worst default rates (Figure 2). For instance, corporate bonds rated BBB are indicating a five-year cumulative default rate of 16.9%, which compares with an average default rate of 1.5% and a worst default rate of 5.1% (as at 31 October 2022).

We believe current valuations reflect an excessively gloomy outlook for default rates, and we have been taking the opportunity to add credit risk across many of our portfolios. However, given the uncertain economic environment, it is important to remain selective, and we generally favour higher-quality, more defensive names in sectors which would be expected to hold up better if we do see a more recessionary scenario. In contrast, we remain much more cautious on more speculative areas, such as high yield bonds rated CCC, where we think defaults could rise quite significantly.

Another notable trend is the significant spread dispersion we are seeing across corporate bond markets – this is where bonds with the same credit rating trade at a different credit spread over government bond markets. We think spread dispersion could increase further as we move towards a Fed pivot, and this could provide a rich source of opportunities for active managers who are able to identify mispriced securities through in-depth credit analysis.

Figure 2. Market implied default rates vs historic default rates



Source: Bloomberg, Deutsche Bank, ICE indices, S&P, 31 October 2022.

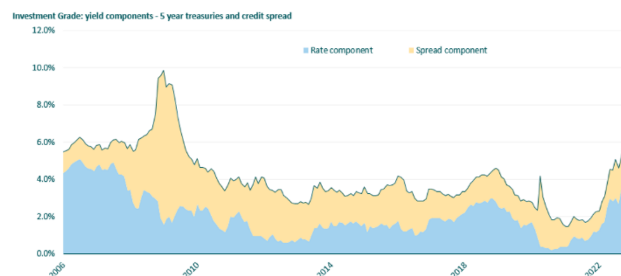
Investment grade – natural diversification qualities

By providing exposure to both interest rates and credit, we believe corporate bonds offer natural diversification qualities and can be a source of resilience during uncertain market conditions. While 2022 was an exception, credit spreads and interest rates typically move in opposite directions to one another, and we believe this inverse correlation can provide a valuable cushion against adverse market movements.

For instance, while credit spreads may be expected to widen during a recessionary period as corporate fundamentals deteriorate, this could potentially be offset by a fall in government bond yields as markets anticipate a cut in interest rates to boost growth. We believe these separate interest rate and spread components can provide a more diversified source of returns throughout the economic cycle (Figure 3).

Furthermore, in contrast to the post-pandemic period in 2020 – when credit spreads spiked, while government bond yields collapsed – investment grade bonds today provide a balanced mixture of credit and interest rate exposure, which we believe should provide a good deal of resilience as we move into a period of slowing global growth.

Figure 3. Investment Grade: yield components - 5 year treasuries and credit spread



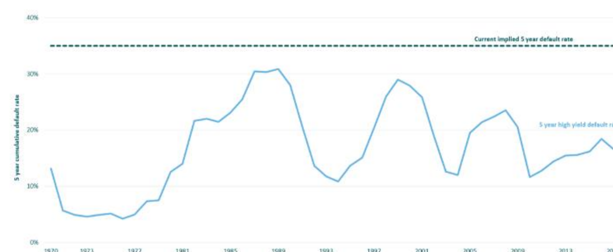
Source: Bloomberg, 22 December 2022

High yield – attractive income helps cushion downside risks

At the end of November, global high yield spreads were at the 508 basis point level, which we believe prices in a lot of the bad economic news and provides a fairly attractive entry point for the asset class. Whilst a global recession may prove unavoidable, we believe it will be less severe than what high yield spreads are indicating.

Current spread levels translate to an implied five-year default rate of around 30%, which is much higher than our expectation, and would be as extreme as the worst-ever default experience (Figure 4). We believe that corporate fundamentals are in generally good shape and expect company revenues to prove fairly resilient overall. Leverage across the asset class remains relatively modest, with many companies having taken the opportunity to reduce their debt or extend its maturity following the pandemic, which should significantly reduce re-financing risk.

Figure 4. Five-year cumulative high yield default rates



Source: Deutsche Bank, Moody's Research, 30 September 2022 (latest data available). Calculated using the CDX HY index with 30% recovery rate assumption

Past performance is not a guide to future performance

From a sector perspective, banks are currently one of our favoured areas, as we believe the sector offers resilient fundamentals and compelling valuations. We believe that

banks today are in a much better shape than in 2008, being strongly capitalised and well placed to withstand a recessionary environment. Banks also generally benefit from higher interest rates, since they are able to capture a wider spread between their lending and deposit rates. Despite these positive factors, banks currently trade at a significant discount to other sectors having sold off sharply in 2022.

Selective opportunities in EM

Another area where we see attractive medium-term value is in emerging markets, although a highly selective approach is needed when investing in this area. Emerging market bonds have seen significant drawdowns this year, with yields now at very elevated levels. The relentless rise in the US dollar against other currencies has clearly been a major headwind for the asset class, although we think the bulk of this rally is likely to be behind us, and expect a further softening from here as a result of the worsening US trade deficit.

Some of the larger emerging countries, in particular, have better fundamentals now than in 2013, with current accounts surpluses, smaller budget deficits, higher foreign exchange reserves and cheaper currencies. Moreover, unlike in previous hiking cycles, many emerging market central banks have pre-empted the Fed and have moved to hike rates aggressively since 2021, helping to boost the potential for very attractive yields which have been available to investors.

While the different players in the asset class tend to get lumped together, there is a great deal of dispersion between emerging market issuers, both in terms of valuations and growth trajectories of individual countries. For instance, many Latin American countries have remained relatively well insulated from the effects of the war in Ukraine, with several having benefited from elevated commodity prices.

One area where we are examining risk/reward opportunities closely is among sovereign bonds from Central Asia and the Caucasus. This region was the one bright spot in an otherwise gloomy GDP global growth outlook released by the IMF in October. In stark contrast to the majority of other regions, 2022 growth forecasts here were revised significantly upwards. For some countries in the region, the fresh forecasts exceed even those made by the IMF a year ago when the global economy was in a much better shape.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the portfolio. High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

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