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GLOBAL OUTLOOKS **2023**

# Bullish on bonds in 2023

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## The next 12 months are poised to be a comeback year for fixed income, says Gene Tannuzzo, with a focus on quality and credit selection critical to achieving the desired outcomes

Global bond markets were rattled in 2022 by the aggressive policy pivot of major central banks to address persistent inflation. In the US and abroad returns have been historically and pitifully poor. Throughout the year volatility – primarily emanating from rising interest rates – saw those bonds most sensitive to changes in interest rates, such as government bonds, generate deeply negative returns. But lower quality bonds – those rated below investment grade – also woefully underperformed. This is why fixed income investors could have lost just as much money in treasuries as they did in high yield bonds (Figure 1).

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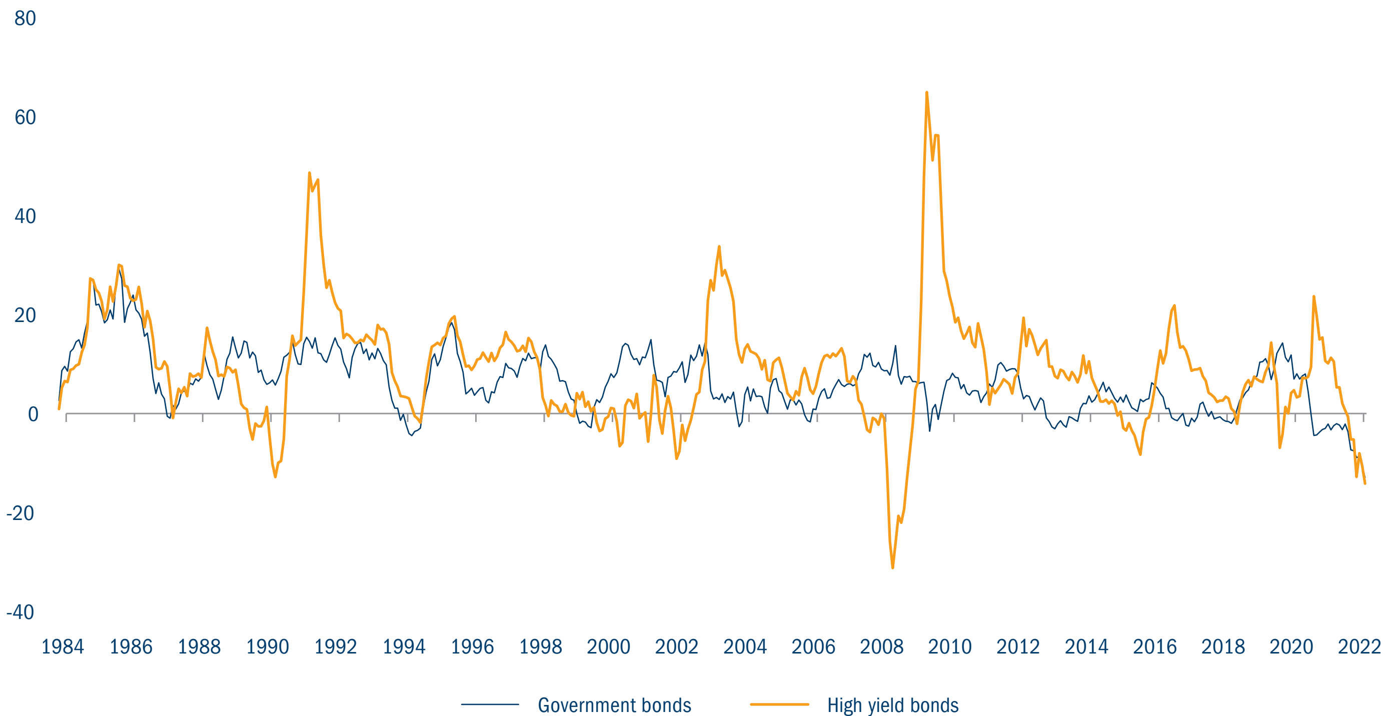
Figure 1: 2022 has been a tough year across fixed income (rolling 12-month total return, %)




Source: Bloomberg LP As at 15 October 2022. Government bonds are represented by the Bloomberg US Treasury Index, which measures US dollar-denominated, fixed rate, nominal debt issues by the US Treasury. High yield bonds are represented by the Bloomberg US Corporate High Yield Index, which measures the US dollar-denominated, high yield, fixed rate corporate bond market

There is nearly universal agreement on what it will take to stop the carnage: clarity on an end to central bank rate rises. US Federal Reserve chair, Jay Powell, has made it clear that the central bank wants to see "compelling evidence of inflation easing" before it shifts policy[1].

But central banks are in a predicament. They know that monetary policy impacts the real economy with a lag. If we assume, for argument's sake, that it takes six months for changes in interest rates to impact growth then, for example, the very first Fed rate hikes from early 2022 are just starting to bite in the US, with more pain to follow. This phenomenon of more pain is often referred to as "tighter financial conditions". Simply stated, central banks are trying to drive economic growth lower and take the pressure off inflation by reducing demand through higher interest rates, which increases the cost of financing for consumers and corporations. Have they been successful? The "good" news is that the US is seeing evidence that its policy is starting to work. The risk is that they go too far with their interest rate hiking regime. Historically, financial conditions any tighter than what we have today have been associated with recessions.

## The Fed has made it clear that the central bank wants to see 'compelling evidence of inflation easing' before it shifts policy

[1]FT.com, Jay Powell faces test of Fed's 'unconditional' resolve to tame inflation, 22 June 2022

## A different driver of fixed income

Rate hikes and tighter financial conditions drove fixed income returns lower in 2022. Heading into 2023 we should see economies slow pretty dramatically. But I don't think we will see a repeat of 2008 or 2020, in which the slowdown was extraordinarily deep in specific areas of the economy. Instead, because financial conditions have tightened so much, I think economic pain will hit the tail of every industry. This means that companies and consumers with too much leverage, and sovereigns that are not well positioned to deal with elevated levels of currency volatility, are going to come under increased pressure.

**Companies with too much leverage, and sovereigns not well positioned to deal with elevated currency volatility, are going to come under increased pressure**

Investors no longer have the benefit of policy-based shock absorbers – like quantitative easing or artificially low rates – to protect their portfolios and will need to find new buffers to cushion the impact of market and economic volatility. This essentially means a higher credit quality: companies with strong fundamentals, a healthy cash flow and lower leverage. It can also involve pivoting away from certain risks, including securities that are overexposed to the low end of consumer credit, to owning asset classes like municipal bonds and agency mortgage-backed securities.

The broad repricing of bonds and the higher starting yields we now have can help insulate investors from further losses. The yield curve is very flat and very high, which means even if investors are not comfortable with longer duration bonds, there are attractive opportunities in short-term corporate bonds which are yielding around 5.5% or 6%[2].

[2]Bloomberg, as at November 2022

For those who are comfortable with longer duration bonds, pay attention to the duration narrative which, in the US I think, will shift from focusing on the aggressive Fed hiking cycle to the impact of the Fed pausing rate increases. We have previously seen negative returns in the bond market followed by high, if not double-digit, returns once policy changes course, but the market response to the end of the hiking cycle generally happens very quickly, and trying to time the bottom can mean an investor misses out.

## Valuations are very attractive, but pay attention to risk

Investment grade bonds, which were down around 20% this year[3], could provide better outcomes in 2023 because they represent companies that don't necessarily need to refinance in what will be a less conducive environment. There has also been enough of a fundamental disconnect between Europe and the US that this is probably the first time in many years that opportunities in Europe appear more attractive relative to the US – particularly in investment grade bonds which have already priced in the geopolitical risk around Russia and Ukraine, and now you have a risk premium to compensate for that. High yield appears fully valued to us but could also stand to benefit if the economy can avoid a recession in the year ahead.

[3]Bloomberg, year to date as at November 2022

## Optimism for 2023

I don't think 2023 will be a repeat of 2022. This is not a time to stay on the sidelines. There are very compelling total return opportunities in high-quality assets. There are risks but investors are being well-compensated, and a focus on quality and credit selection will be critical to setting the stage of successful fixed income investment outcomes.

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