NDL

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Making money in bonds

Global Matters Weekly

17 January 2022

– **Richard Stutley, CFA**

Last year, US Treasuries suffered one of their worst years this century[i]. Treasury Inflation-Protected Securities (TIPS), on the other hand, returned +6%, making 2021 a pretty good year for these bonds versus their long-term average[ii]. So how did investors like us make money in TIPS; was it purely down to QE-fuelled irrational behaviour; and what do we expect from here?

TIPS respond to real interest rates (the rate you receive after inflation) in the same way as regular bonds respond to nominal interest rates. Real yields went down last year meaning bond prices went up. Driving this was an increase in inflation expectations with no corresponding rise in interest rate expectations (something we don't see very often): while investors came to realise that inflation in the US was running faster and for longer than they had predicted, they nonetheless staunchly held onto the view that it would come down without the Fed having to do much at all.

10-year TIPS started 2021 yielding -1.0% and by August were yielding -1.2%. Is there any justification for paying away 1.2% a year in real terms? If you're not compensated for lending your money you should…: 1. Spend it. Ah but wait; you've got a retirement to fund so you have to save some of your money. 2. Hold it in cash. In that case you'd stand to make -2.4% per annum in real terms, assuming inflation expectations were roughly accurate in August last year.

The theoretical lower bound to nominal interest rates (not real) is probably somewhere around -1 to -2%: beyond this level, I'd imagine it becomes cheaper for people to hold their money in a vault. From that, deduct inflation. So real interest rates on 10-year TIPS approaching -4.5% last year would have been within the bounds of what's theoretically possible – you don't need 'QE-fuelled irrational behaviour' to achieve that, despite what you may think.

Why don't we always and everywhere have negative real interest rates of -4.5%? It would seem a much cheaper way for governments to fund themselves. The answer is the same when we ask the question why we don't we have interest rates of +20%: because it would collapse the economy. In the case of negative interest rates, if the difference between the riskless rate and the growth rate is large enough, everyone will rush to invest their savings (plus any borrowings) into new ventures, and we'll quickly run out of spare capacity and the economy will stall. While people ascribe a lot of power to central banks, growth rates and risk appetite ultimately determine interest rates: central banks' only job is to try and gauge what these variables are and to set policy accordingly.

Last year, US Treasuries suffered one of their worst years this century

At the start of 2021, the market and the Fed's narrative was that inflation would come down of its own accord. Come the start of 2022, the view has shifted and the consensus now is that it will take a few hikes to get us there. We think the hiking cycle discounted by markets may still be too benign to bring inflation down. Hence we're expecting further tightening and remain underweight duration. As we head into the second half of the year, the picture is likely to become more balanced if we're right and there has been a further leg-up in the path of interest rates. In the long run, interest rates are determined by growth and risk appetite, as stated above. Unless you think Covid has increased one or both of these variables, then it is not clear why the economy will ultimately settle at materially higher interest rates than prevailed pre crisis. In the short run, interest rates may need to overshoot this long run neutral level to arrest the current surge in inflation. As we head into H2, we may find we're looking for interest rates to roll over again if consumers are under too much pressure from the combination of higher interest rates and higher prices, which would therefore require a pivot in our duration positioning.

[i] *J.P. Morgan GBI US Unhedged USD; source Bloomberg Finance L.P.*
[ii] *Bloomberg US Govt Inflation-Linked All Maturities. Data on Bloomberg Finance L.P. goes back to 1997.*

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The **Marketplace**

- Global equities fell -0.1% last week
- US inflation hit 7% in December as prices climbed at rates unseen for decades
- Brent crude returned 5.3% over the week to $86.1 a barrel
- Gold returned 1.2% to $1817.9 per ounce

Market **Focus**

US

- US equities fell -0.3% last week
- Headline inflation hit its highest level since 1982 at 7.0% year-on-year. The month-on-month reading came in at 0.5% in December vs 0.4% expected, marking a deceleration from the prior monthly gains in October and November
- The core CPI reading was slightly stronger than anticipated with the monthly print at 0.6% vs 0.5% expected, sending the annual core CPI reading up to 5.5%, its highest level since 1991
- PPI came in at 0.2% in December vs expectations of 0.4%, the slowest increase since November 2020, leaving the year-on-year measure at 9.7%
- Initial unemployment claims totalled 230k in the week ending 8th January, up 23k from the prior period
- Retail sales declined -1.9% month-on-month in December, well below consensus expectations.

Europe

- European equities returned -1.4% last week
- The Euro Area unemployment rate in November fell to its lowest level since March 2020, at 7.2% in line with expectations
- The Italian unemployment rate for November fell to 9.2% vs expectations of 9.3%
- Industrial production in the Euro Area grew by 2.3% in November, beating expectations of 0.3%
- German GDP grew 2.7% over 2021, despite shrinking in Q4, driven by strong government spending, net exports and investment.

UK

- UK equities rose 1.0% last week
- GDP grew by 0.9% in November, while overall GDP grew by 1.1% in the three months to November
- There were further signs last week that the Omicron wave in the UK was easing.

Asia/Rest of The World

- The benchmark Global Emerging Markets index returned 2.6% last week
- Japanese equities fell -0.9% over the week
- Chinese equities returned 2.9% last week
- Chinese exports went up 20.9% year-on-year in December vs expectations of a 20.0% increase, whereas imports in December rose 19.5% year-on-year vs expectations of 28.5%
- China locked down its central Henan province as the city registered the most Covid cases nationwide
- Japan's Prime Minister Fumio Kishida announced an extension on its strict border restrictions up until late February to prevent the spread of the Omicron variant
- Producer prices in China advanced less than expected 10.3% year-on-year while consumer prices increased +1.5% year-on-year, down from 2.3% in November
- The Bank of Korea lifted borrowing costs by 0.25% to 1.25% amidst increasing inflationary pressures, taking the benchmark rate back to pre-pandemic levels.

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Asset Class/Region	Currency	Currency returns			
		Week ending 14 Jan. 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	-0.3%	-2.4%	-2.1%	24.1%
United Kingdom	GBP	1.0%	2.4%	2.7%	16.4%
Continental Europe	EUR	-1.4%	-2.2%	-2.1%	18.9%
Japan	JPY	-0.9%	-0.7%	-0.7%	7.8%
Asia Pacific (ex Japan)	USD	2.1%	2.0%	1.4%	-7.1%
Australia	AUD	-0.8%	-1.6%	-0.7%	14.2%
Global	USD	-0.1%	-1.9%	-1.8%	17.5%
Emerging markets equities					
Emerging Europe	USD	-2.2%	-2.1%	-2.0%	4.9%
Emerging Asia	USD	2.4%	2.7%	1.8%	-9.5%
Emerging Latin America	USD	5.0%	3.8%	3.8%	-8.3%
BRICs	USD	2.6%	3.3%	1.8%	-14.4%
China	USD	2.9%	3.2%	1.2%	-25.1%
MENA countries	USD	4.4%	5.5%	5.5%	32.0%
South Africa	USD	4.7%	6.8%	6.9%	8.9%
India	USD	2.7%	6.6%	5.8%	24.7%
Global emerging markets	USD	2.6%	2.9%	2.1%	-6.3%
Bonds					
US Treasuries	USD	-0.1%	-1.5%	-1.6%	-2.8%
US Treasuries (inflation protected)	USD	-0.3%	-2.7%	-2.7%	3.8%
US Corporate (investment grade)	USD	-0.4%	-2.2%	-2.4%	-2.1%
US High Yield	USD	0.1%	-0.9%	-0.9%	4.0%
UK Gilts	GBP	0.5%	-1.5%	-1.7%	-5.6%
UK Corporate (investment grade)	GBP	0.3%	-0.8%	-0.9%	-3.4%
Euro Government Bonds	EUR	0.2%	-0.5%	-0.5%	-3.8%
Euro Corporate (investment grade)	EUR	-0.2%	-0.6%	-0.6%	-1.7%
Euro High Yield	EUR	-0.1%	0.0%	0.0%	3.0%
Japanese Government	JPY	-0.1%	-0.5%	-0.5%	-0.6%
Australian Government	AUD	0.0%	-1.1%	-0.9%	-3.6%
Global Government Bonds	USD	0.6%	-0.5%	-0.7%	-6.1%
Global Bonds	USD	0.3%	-0.7%	-0.9%	-5.5%
Global Convertible Bonds	USD	-0.1%	-1.4%	-1.4%	-6.5%
Emerging Market Bonds	USD	-1.2%	-3.5%	-3.7%	-6.1%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 14 Jan. 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	-0.8%	-3.8%	-4.0%	37.8%
Australian Property Securities	AUD	-3.9%	-7.5%	-6.0%	18.8%
Asia Property Securities	USD	0.2%	0.7%	0.8%	-3.1%
Global Property Securities	USD	-0.4%	-2.4%	-2.6%	20.5%
Currencies					
Euro	USD	0.4%	0.8%	0.1%	-6.3%
UK Pound Sterling	USD	0.6%	1.3%	0.9%	-0.2%
Japanese Yen	USD	1.3%	0.9%	0.8%	-9.2%
Australian Dollar	USD	0.3%	-0.7%	-1.0%	-7.6%
South African Rand	USD	1.0%	3.4%	3.3%	-2.5%
Swiss Franc	USD	0.5%	0.0%	-0.3%	-3.0%
Chinese Yuan	USD	0.4%	0.3%	0.1%	1.9%
Commodities & Alternatives					
Commodities	USD	2.8%	4.1%	4.9%	40.5%
Agricultural Commodities	USD	-0.6%	0.0%	0.5%	29.3%
Oil	USD	5.3%	8.5%	10.6%	52.5%
Gold	USD	1.2%	0.2%	-0.6%	-2.0%
Hedge funds	USD	-0.1%	-0.7%	-0.7%	2.1%

Source: Bloomberg. Past performance is not indicative of future returns

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