Fixed Income Markets in Focus: Weighing Bonds in a Tense Market Environment

Gillian Kemmerer (00:10):

Inflation and rate hikes are top of mind for investors, especially in the United States and Europe. And today, the world is grappling with an escalated conflict in the Middle East. How are investors evaluating bonds as a portfolio diversifier in the context of recent events?

(00:25):

Joining us today to discuss the latest developments in the fixed income markets is Andy Sparks, Managing Director and Head of Portfolio Management Research at MSCI. Andy, it's always great to have you in the studio. And certainly, through last quarter we've continued to see surging interest rates. So are these rates expected to stay higher for longer? And what are some of the risks and opportunities associated with this environment?

Andy Sparks (00:49):

Number one, thank you, Gillian, for offering me this opportunity. It's a pleasure being back on Asset TV. And specific to your question, the market continues to expect that rates will be higher for longer. And a little more specifically, data from the interest rate futures market show that the market believes that the Fed will keep rates pretty high through Q2 of 2024, then will gradually begin easing for the rest of 2024 and continuing into 2025.

Gillian Kemmerer (01:23):

So what are some of the risks and opportunities that you're seeing on this horizon? Is the US debt burden, for example, a potential issue that you're accounting for?

Andy Sparks (01:32):

Yeah. I think a good way to answer those questions is to look at the behavior of real yields. And so real yields at the end of 2021 were negative for all maturities. Now, real yields are positive. In fact, they're above 2% for all maturities. They're at 15-year highs. And that relatively high level is definitely tempting some investors to add exposure to bonds. So I'd say that is the opportunity.

(02:03):

But against the opportunity, you've got to weigh the risks. And you mentioned one, deterioration in the government's fiscal deficit. Treasury supply is going to be large. A very important question is whether there will be sufficient demand for it. So that could be one of the primary reasons why real yields have gone up as much as they have.

(02:28):

But also, in addition to that, we're not out of the woods on inflation yet. So inflation has peaked. It's come down meaningfully, but it's still stubbornly high. And that is a cause for concern. And to the extent that inflation stays unexpectedly high, the Fed will likely continue its aggressive policies to keep rates high, precisely to drive down inflation. But to the extent that they have to maintain a very aggressive monetary policy, it could keep upward pressure on yields.

(03:02):

And so another way to look at this risk versus opportunity is that, number one, in 2022, bonds had terrible performance. But in the government bond sector, and more generally in the investment grade sector, in 2023, performance has also been not as bad as '22. But it's been bad. It's been negative. And so we may say that yields look relatively high, and it is tempting some investors, but they may go higher. And so it's very important when you're looking at the opportunity to also take into account the risks, because they have gone up so much. And I think most investors are tempted, but some have hesitated because they've been burned by it over the past two years.

Gillian Kemmerer (03:55):

It seems that market participants have been weighing the possibility of a recession for months now. Is this still a concern that's top of mind for you?

Andy Sparks (04:04):

Recent data releases show continuing strength in the US economy. So I think that has been reassuring to investors. But at the same time, investors are concerned that we could have a more negative outcome growth wise. And I think particularly is an example, given the recent tensions and the conflict, the outright conflict in the Middle East, that's an example of something that could spill over into other countries and begin to affect economic growth in a broader context.

(04:41):

And so we're not out of the woods yet about a recession or not. But I'd say if you just looked at the consensus over the past six months, it's been increasingly leaning into the direction of a soft landing as opposed to a hard landing.

Gillian Kemmerer (05:00):

You referenced the conflicts between Israel and Gaza. What is the impact that you're seeing on fixed income markets already from the start of this conflict?

Andy Sparks (05:09):

So far, the impact on the broader fixed income market has been very limited, but investors, of course, are following it very closely. And again, the concern is that it could spread to other countries, and it could ultimately result in a spike in the price of oil. And I think a lot of investors who either were alive at that time or have read about it may recall the events of the early 1970s, when we had the OPEC oil embargo in 1973, which was around the time of the Yom Kippur War. And that caused a very significant increase in price level. So inflation went up at the same time that it hit economic growth. So the mid 1970s stagflation was a direct result of that oil spike.

(06:06):

And the economy now is generally much less dependent on oil. So if you look at oil as a fraction of GDP, it plays a smaller role. But nevertheless, a significant spike up in the price of oil would probably hurt economic growth. So markets are watching this very carefully. But so far, the damage has been limited.

Gillian Kemmerer (06:34):

Are there other geopolitical considerations that are top of mind for you right now?

Andy Sparks (06:38):

There's no shortage of geopolitical considerations. And of course, the Ukraine-Russia War continues. And of course, there is tension between the United States and China. It could worsen. And so those events are still out there. And to the extent that they could deteriorate, they could cause crisis to change. And in a crisis, oftentimes that's when US treasuries do well. And so it's not like the entire fixed income market would necessarily go down in price if you did have an escalation of one of these situations. You really have to model each by itself. But there is still that flight to quality in times of economic crisis. Sometimes, US treasuries catch a bid at the same time that equities sell off and corporate bond spreads widen. So you need to deconstruct the fixed income market a little bit to see how different sectors might perform.

Gillian Kemmerer (07:42):

So we've discussed the macroeconomic and the geopolitical environment, which is of course rapidly evolving, as you've discussed. But how are bonds positioned today as a diversifier in multi-asset portfolios and as investors are evaluating this bonds versus equities mix?

Andy Sparks (07:58):

Yeah. Between roughly 2000 to 2020, the empirical observation was that when equities tended to go down in price, bonds tended to go up in price. So they acted as a diversifier. And even though realized returns tended to be much lower in bonds than equities, just having that insurance that, in times of crisis, bonds would tend to do well was reassuring and was definitely used as a reason for having bond exposure in multi-asset portfolios.

(08:37):

And I think one of the best examples of that was the 2008 financial crisis. So at the time, you had equities going down dramatically, but treasuries went up a lot in price. And so that's a good example of diversification in action and how it helped stabilize multi-asset class portfolios.

(08:59):

But so that general negative correlation that we experienced between 2000 and 2020, it's really changed a lot as we moved into this higher inflation environment, roughly speaking, starting around the second half of 2021 and definitely continuing into 2022 and 2023.

[NEW_PARAGRAPH]And so I mentioned earlier about the poor performance, the significantly poor performance of bonds in 2022. That happened at the same time that equities had very bad performance too. So they moved in the same direction. So that diversification was missing. And to a smaller degree, it's still missing in 2023.

(09:44):

And so I think a very important question for asset allocators and risk managers is to assess what do you think that correlation is going to do? Is it going to revert back to where it had pre-COVID or is it going to continue to be positive? And I don't have a magic ball that says it's going to do this or that. But at MSCI, we have done modeling looking at that correlation, and we think it may have something to do with the level of inflation and the confidence that the market has in the Fed.

(10:18):

So one view that we have is that, to the extent that the Fed is able to control inflation and to restore confidence among market participants that the Fed is effective at controlling inflation, it's possible that we might begin to see the positive correlation that we have observed. It's possible it will weaken. Maybe it could go negative. But it may stop going positive as well.

(10:47):

So when looking at the diversification benefits of bonds, it's crucial to look at that correlation. And like I said, our research suggests that it may be related to the level of inflation.

Gillian Kemmerer (11:03):

Well, Andy, thank you so much for taking the time to unpack the fixed income environment from the macro forces at play to an asset allocator's perspective as well. We appreciate your time.

Andy Sparks (11:12):

Well, thank you very much, Gillian. I appreciate the opportunity.

Gillian Kemmerer (11:16):

And thank you for tuning in. From our studios in New York, I'm Gillian Kemmerer for Asset TV.

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