Elston

Elston Insights

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Time to look at (short-dated) bonds again?

- Bonds have been hammered by increases in policy rates
- Unlikely that inflationary pressure will abate any time soon
- Less sensitive short-dated bonds are starting to catch the eye

The unexploded bomb

Since the financial crisis of 2008, the combination of quantitative easing and ultra-low interest rate policies has meant that yields on traditional safety assets like cash and bonds across all maturities has been consistently underwhelming. This forced investors into higher risk assets to achieve returns.

The fact that policy rates could not go any lower meant that any effort to normalise monetary policy by increasing those same rates was inevitably going to throw the decades-long bond bull market into reverse. For this reason, bonds were the "unexploded bomb" in traditional 60/40 portfolios going into the 2021/22 inflation crisis.

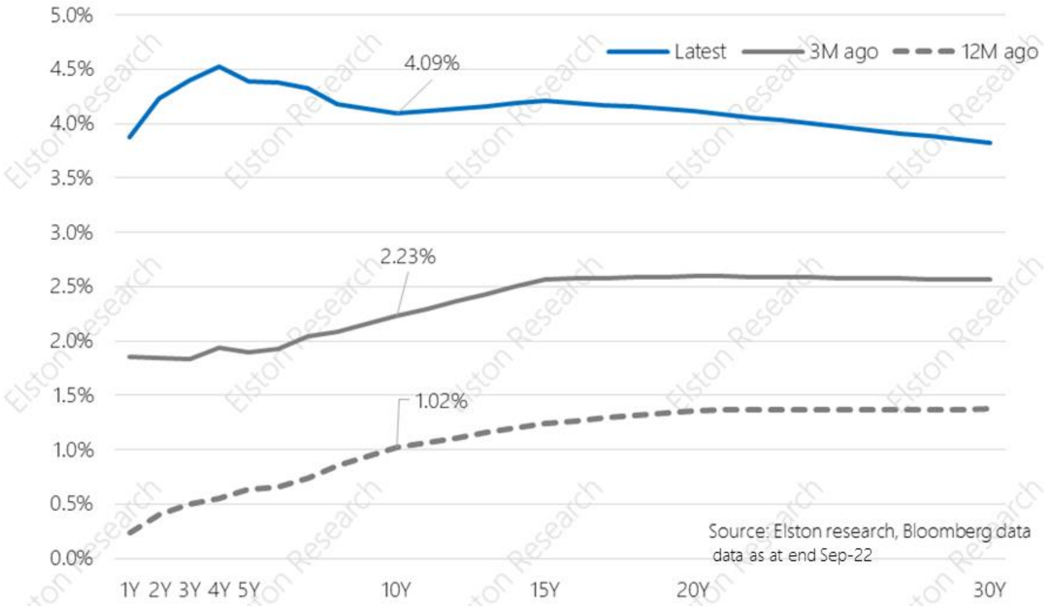
Bonds: long- or short-dated?

As central banks have ratcheted up policy rates, the casualty has been bonds, which suffer from rising rates and inflation, albeit that equity markets have also come under pressure from the negative growth outlook. Bonds have provided nowhere to hide. And unlike equities, bonds don't bounce: if the direction of interest rates and inflation are against them, their valuation continues to get crushed, irrespective of a recent stretch of dire performance.

It is too early to pile into long-dated bond exposure while there is still upside risk from rates and inflation, in our view. For short-dated (less rate-sensitive) bonds, yields are beginning to look more attractive - at least in nominal terms.

The UK yield curve – which represents the yield on Government bonds across all maturities has shifted upwards dramatically over the last 12 months, particularly at the short-end. This shows how Government borrowing costs (and investors' required return to lend) have increased across the board).

Fig.1. UK yield curve as at 30-Sep-22



What are the investment options?

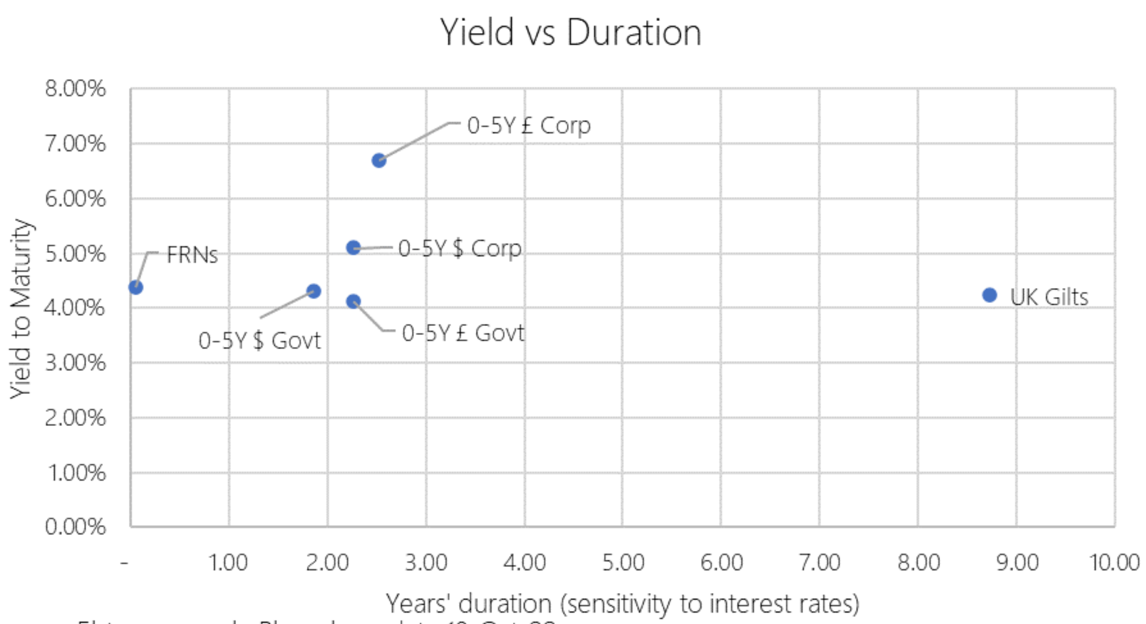
The upwards shift in the yield curve and its relatively flat structure means you can get similar yields with shorter-dated bonds as you can with longer-dated bonds, but without taking the interest rate risk. This is important because with Bank of England rates at 2.25% and market expectation of 5-6% interest rates within 12 months, there is an expectation that more hikes are to come.

Using Bond ETFs, investors can look to get exposure to short-duration bonds in a number of different ways, whilst ensuring access to a more liquid format to direct bonds or funds, owing to the secondary market for Bond ETFs.

If you want to avoid currency risk or think that Sterling may stage a recovery against the US dollar, then focus on funds of 0-5 year Gilts or corporate bonds. If you prefer to keep faith with the US dollar, then funds of short-duration T-bills or US corporate bonds can be found.

For particularly short duration bonds boasting a more direct relationship with US Federal Reserve policy rates, then there are funds of floating rate note ETFs, either dollar-denominated or hedged into Sterling.

Fig.2. Short-dated bond yields vs duration



Source: Elston research, Bloomberg data 10-Oct-22

Summary

Bonds are not yet back in vogue, but they are back on the horizon. Via the liquid ETF format which can offer targeted exposure via diversified holdings, there is no shortage of more nuanced products and providers to choose from. Credit quality, yield, duration and currency should always be the primary considerations.

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