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Volatility is back in bond markets – our approach to navigating choppy markets

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The decade-long, post-GFC regime of ultra-low yields came to an abrupt end in 2022 as central banks raised rates to tackle persistent inflation. An elevated risk of recession, continued interest rate hikes, geopolitical tensions, and energy shortages are just some of the factors complicating the financial and economic situation. Against this complex and divergent backdrop, we are cautiously optimistic, preferring to stick with so-called boring investments: investment-grade instead of high-yield, and shorter rather than longer durations on fixed income.

After years of very low – even negative – fixed-income yields, the tide finally turned in 2022 with a rise in global interest rates. Rising inflation brought about by soaring energy prices, supply chain issues, and a tight labor market led central banks to pursue a series of rapid interest rate hikes amid slower growth, falling risk asset prices, and even greater geopolitical uncertainties.

Since the end of summer, some of the concerns that central banks and investors have been grappling with have eased; headline inflation has fallen from peak levels, China has abandoned its zero-COVID policy, and a mild winter in the northern hemisphere has calmed fears of energy shortages in Europe. In addition, growth has proven to be the surprising upside in several major economies. Investors have taken notice of this, becoming more sanguine about the global economic outlook.

Once again, the start-of-the-year rally was a tide that lifted all boats, with last year's most battered sectors proving to be the best performers so far in 2023. The narrative of a shallow recession has given way to a new hope: that 2023 will be the year when central banks can successfully declare victory on inflation and deliver a "soft landing" for the global economy. We are skeptical about this newfound optimism and would proceed with caution from here until the skies become clearer. Therefore, against this backdrop, we would favor low-risk, fixed-income investments.

The case for bulls and bears

Optimists will find plenty of reasons to be bullish, with recent data proving better than expected. For example:

- The labor market remains tight in many countries, especially in the US.
- Higher-frequency growth proxies like the ISM Manufacturing and Services indices have been trending up since the beginning of the year, suggesting the economy can cope with these higher interest rates.
- Long-term inflation expectations remain well anchored resulting in flatter yield curves with the long end often inverted for European and US bonds.
- China's re-opening comes at a crucial time and will help to ease supply chain pressures and increase global trade again.

However, we see reasons for a more bearish case:

- Historically, the Fed has never managed a soft landing when inflation has been above its 2% target at the start of the hiking cycle.
- The effects from the growth-constricting interest rate hikes may still come with a lag since financial conditions are difficult to observe in real time.
- Tight labor markets amid a cost-of-living crisis increase the global risk of a wage-price spiral. Central banks have prepared markets for more interest rate hikes to come in what could be a nasty surprise for investors who have dismissed rate hikes beyond 2023.

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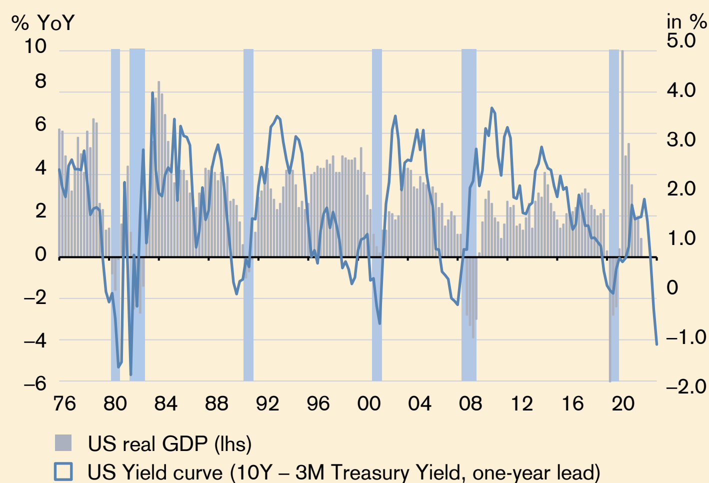
Value is in investment-grade, not high-yield bonds

Given where we stand in the tightening cycle, we think that there is a compelling case for fixed income as an asset class in 2023. Nonetheless, investors need to be selective. As we have stated above, while there may be good arguments on both sides, it is our view that the risks are tilted toward the downside.

US yield curve inversion typically followed by a recession

(US real GDP vs. US yield curve steepness)



Source: Bloomberg, Credit Suisse/IDC
Last data point: 14.04.2023

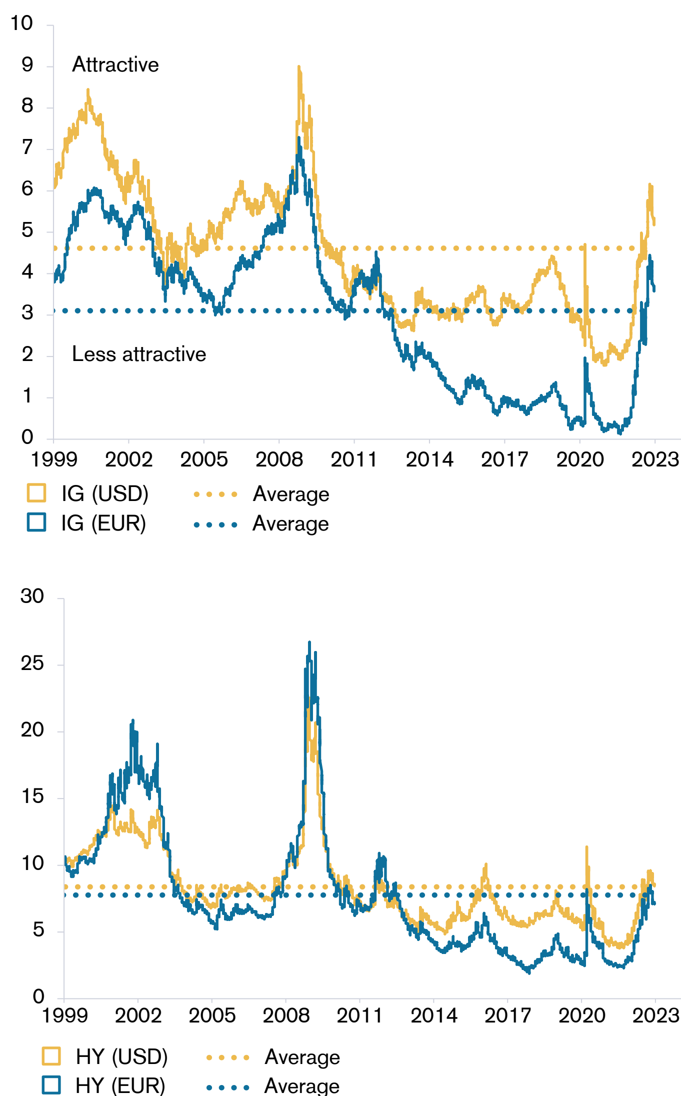
Firstly, it is hard to dismiss evidence from historical correlations. The US yield curve has inverted before each of the six recessions since the 1980s, with an average lead time of about 18 months.

Secondly, risky assets are likely to feel pressure at the short end from higher rates. By distributing higher lending costs and short-term rates such as SOFR (Secured Overnight Funding Rate), leveraged financing becomes less compelling and high valuation multiples become harder to justify. The hunt for yield led many investors who are used to the previous decade's goldilocks years to become increasingly addicted to credit risk. When it comes to investment-grade debt, we believe that the risk of losing capital due to corporate defaults is tolerable for most investors, with Moody's reporting an average default rate of 0.14% p.a.

However, the default rate rises significantly if one includes high-yield debt (1.6% p.a.). Even though credit spreads rose across the board last year, we would argue that high-yield spreads are now at the tight end of valuations should we enter into a recession later this year. As the chart below shows, yields (in %) for investment-grade and high-yield bonds in both EUR and USD suggest that high-yield debt trades just at or slightly below the long-term average yield level.

Investment-grade debt currently valued attractively over high-yield

(All-in yields [%] for IG and HY in both EUR and USD markets)



Source: Deutsche Bank, Bloomberg Finance LP

Currently, long-term government debt is yielding less than short-term rates due to inverted yield curves. Both the higher volatility and lower carry of long-duration bonds diminish their attractiveness, at least in the near term. Another factor that will come into play later this year is quantitative tightening (QT). The Fed has already started to reduce the volume of debt kept on its balance sheet, while the European Central Bank (ECB) will start to do this in March 2023. Asset allocation shifts in favor of fixed income, to a large extent, will have to make up for the lack of a marginal buyer – a role that central banks took on during the last decade. We would therefore look for opportunities in short and intermediate maturities in the corporate bond market as it offers a combination of low interest rate risk and decent carry in all but the most bullish of our main scenarios.

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Most scenarios favor focusing on shorter durations

Scenario 1: Global recession. Risky assets to underperform, corporate bonds vulnerable due to rising credit spreads. Long duration, high-credit bonds to outperform.

Scenario 2: Return of inflation. Risky assets and long-duration bonds to underperform as central banks need to raise rates until they become more restrictive.

Scenario 3: Persistent core inflation. Central banks cannot afford to cut rates as continuing high inflation threatens to eat into savings and may create second-round effects. Long-duration bonds to underperform.

Scenario 4: Soft landing. Inflation falls to or below the central bank target of 2%. Growth remains positive. Central banks can afford to cut rates; bonds rally and risky assets rally.

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