How to position for the next bond bull market

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The end of the interest rate hiking cycle could mark the beginning of the next bond bull market, fund managers argue, following a torrid 18 months for fixed income.

Interest rates in Britain have gone up 14 times in a row, moving from 0.1% in November 2021 to 5.25% today. In America, rates are at a target range of 5.25% to 5.5%, following 11 hikes in 12 meetings.

This has had a devastating impact on bond prices, with the Bloomberg Sterling Aggregate falling 25% and the Bloomberg Global Aggregate falling 10% since January 2022.

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But the end could be near for rate rises. Markets expect UK rates to peak at 5.75% before settling at around 4% over the medium term. In America, investors think the Federal Reserve may have one more rate hike left. But whether there are one or two more rate rises, due to inflation falling rapidly, the consensus is that central banks will not have to go much further in their fight against inflation.

Markets tend to begin rallying not when the last rate hike takes place, but when the last rate hike is in sight. This means that a turnaround for the bond market could be near.

Multi-asset investors have already begun buying bonds. According to Morningstar, in the 40% to 60% equity category, where a typical "balanced" fund resides, the average weighting to bonds increased to around 40% at the end of May 2023 from around 30% at the start of 2022.

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The area of the bond market in favour is corporate bonds, which makes up 51% of the bond allocation, up from 44% at the start of 2022.

"Managers we have spoken with in 2023 have generally been constructive on investment-grade credit, despite the likelihood of an economic downturn, citing that companies are fundamentally in good shape and feeling that default risk was more than compensated by wider credit spreads, on top of a higher risk-free rate adding up to a compelling yield," it said.

For Ariel Bezalel, manager of the Jupiter Strategic Bond fund, which appears on interactive investor's Super 60 investment ideas list, the current macroeconomic backdrop sets up an "extremely promising investment environment for fixed income".

His view is that central banks will soon have to worry far more about growth than inflation as lots of leading economic indicators are pointing to recessions.

Bezalel says: "An environment in which inflation keeps rolling over, growth falters, and the employment picture worsens is one in which continued hawkish policy from the Federal Reserve will rapidly become untenable and cuts will follow."

His £2.9 billion portfolio is invested in government bonds in developed markets, especially the US and Australia, balanced with an allocation to developed market high-yield corporate bonds.

"We believe that in a proper recessionary environment, high-quality government bonds should provide once again diversification," Bezalel said.

Stuart Chilvers, manager of the Rathbone Strategic Bond fund, believes that interest rates are near their peak, but will stay high for some time.

"That may mean calling the start of the next bond bull run is a bit premature, but with yields at current levels we are being compensated for the risk, and can earn a positive return on a 12-month basis even if yields rise a bit further from here," he said.

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Chilvers says that while inflation in the UK is higher than in other developed countries, at around 8% compared to 3% in the US, it should come down.

"We, like the Bank of England, expect inflation to fall significantly through the rest of the year, with the likes of energy bills becoming a significant negative contributor to headline inflation by the end of the year," he said.

In response, Chilvers has been buying long-dated gilts. Longer maturity bonds are most sensitive to interest rates changes and are expected to rally the most if interest rates fall.

Chilvers said: "Historically, long-dated gilts have tended to outperform after the last rate hike. We also have a significant weighting to investment grade credit where we think issuers are more likely to be able to manage the impact of the rate-hiking cycle and any potential economic weakness without debt affordability becoming an issue."

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He says that at current yields, gilts should offer protection to the portfolio in the event that there is a "hard landing", where inflation falls but the economy stagnates as well.

Another backer of long-dated gilts is Ian Williams, manager of the Charteris Strategic Bond fund. He says buying long-dated gilts, those maturing in 40 or 50 years, is a "once-in-a-generation opportunity".

"We could see huge capital gains in the long end of the gilt market because these bonds fell so much in 2022. It's the first time I've been positive on long-dated gilts rising in value since 2007," said Williams.

Williams' view is that central banks have set interest rates too loose for too long and have now gone too tight too quickly, and haven't allowed for time lags for policy to take effect, which will lead to a recession.

The case against bonds

So, what could upset the bond market recovery? While Bezalel says he has a high conviction in his view, it could be undone by a number of factors, such as China experiencing a rapid economic recovery, governments stepping in to shield the public from the impact of higher rates (e.g., mortgage rate relief), and a new spike in food price inflation perhaps driven by adverse weather or Russia/Ukraine abandoning existing grain agreements.

His Jupiter colleague Hilary Blandy adds that wage growth remains high and labour markets are tight, which could lead to higher inflation towards the end of the year.

But given where yields are now relative to their 10-year history, she says that the income bonds offer makes it worthwhile.

"This represents an attractive carry trade, with investors being 'paid to wait' for the macro situation to develop, while simultaneously offering upside potential if the rate cycle does decisively roll over," she said.

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