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Benstead on Bonds: stock market wobble shows why we own bonds

Recession fears and stock market nerves have boosted bonds. Sam Benstead explains why.

Sam Benstead from **interactive investor**

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Why own bonds? In theory, the answer is income and diversification from equities. But in practice, bond investors have not received either of these for some time – until now.

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As interest rates fell around the world, settling at 0.1% in the UK, bond prices rose along with equity prices. A long period of low inflation allowed central banks to make money as cheap as possible, which was great news for asset prices.

Rising bond prices as interest rates fell squeezed yields, meaning that bond investors were paid next to nothing for holding fixed income. Yields got as low as 0.2% on 10-year UK government bonds (gilts) in mid-2020, therefore promising investors a return below inflation. Until the beginning of 2022, similar gilts paid less than 1%.

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And then when rates finally rose, bond and equity prices fell in tandem, just as they had risen in lockstep when interest rates fell.

For the 2022 calendar year, the Bloomberg Sterling Aggregate, which is an index of high-quality corporate bonds issued in sterling, as well as gilts, fell 23%. Over the same period the MSCI World index, in sterling, dropped 8%. So, not only did bonds move in the same direction as equities, they actually performed far worse, hurting cautious investors who thought that fixed income would protect them in a downturn.

But recent events suggest that bonds are once again doing what they are supposed to do: protecting our portfolios and bolstering our income component. Their "safe-haven" status appears to be back.

Unless you've been on holiday and cut off from the internet – or taking a news detox – you will have seen that stock markets wobbled recently as a result of economic data from the US showing that the labour market was weakening, which hints at a coming recession.

Other causes of investor pain were a flash crash in Japanese shares due to interest rate rising and the yen strengthening, as well as worries that tech giants are over-investing in artificial intelligence (AI) and can't justify the billions they are spending.

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But as equity markets tumbled, bonds rallied. An index of UK corporate bonds jumped 1.5% in the last week of July, as global shares dropped about 4%.

Demand for gilts and US government bonds also rose, causing yields to fall, which is a result of rising prices.

With yields at about 5.5%, there's also income on offer from corporate bonds, and UK gilts pay just below 4% currently – that's not bad when inflation is at 2% (as of June 2024).

James Athey, manager of IFSL Marlborough Global Bond fund, explains: "The mood has shifted in markets. We can't say how many rate cuts and exactly when they will come, but the direction has changed and the Bank of England has cut rates. Plus, volatility and weakness in other markets has also been good news for bonds.

"Economic bad news is good news for bonds. Bad news for risky assets is also good news for bonds."

BlackRock's global chief investment strategist Wei Li says bonds are back to being a good hedge only because inflation worries earlier in the year have given way to economic growth worries.

Fears about slowing economies are good news for fixed income as interest rates will fall, but higher than expected inflation could hamstring bonds again.

What bonds to buy

Athey's view is that government bonds from the US, Germany, Japan and the UK present some of the best opportunities currently in the fixed-income world.

This is because government bonds should perform best in the event of a recession, as they are an effective safe-haven asset because these developed world governments are highly unlikely to default.

"I expect all these government bonds to perform well and it is worth diversifying across them all.

"Corporate bonds may not make a loss in a recession, but government bonds will outperform them. No one knows exactly what will happen with the economy, but government bonds are the best hedge and would return more than corporate or high-yield bonds if there was a recession," he says.

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The income from bonds is also exciting for investors. Even if interest rates do not fall much further, investors still pick up coupons from their bond allocation, which now yields more than most dividends from equity markets.

Athey says that he thinks high-quality bonds are where you get the best income currently.

"With slower growth, and lower earnings for companies, you want to look for high-quality bonds that won't fall dramatically in price or see defaults. Investors should look to quality over yield in bonds, then think about sterling assets to avoid currency risk, either with a hedged portfolio or by investing in bonds issued in sterling."

This means that even if economic data unexpectedly improves, investors can still generate a good income from bonds. Owning a range of maturities in a diversified portfolio of bonds helps mitigate the risk that all your bonds will move in the same direction at the same time.

What about gilts?

For investors looking to maximise profits from falling interest rates and rising bond prices, they could look at long-dated gilts, which have the greatest "duration", which is their sensitivity to interest rates.

Ian Williams, manager of the WS Charteris Strategic Bond fund, likes long gilts, as he believes the 4.5% yield on offer currently is too high. Therefore, he expects its yield to fall, which will cause its bond price to rise.

His gilt positions include **4% Treasury Gilt 2060 TR60** ↑ **0.64%** , **UNITED KINGDOM 4 22/10/2063 TR63** ↑ **0.00%** and **UNITED KINGDOM 0.5 22/10/2061 TG61** ↑ **0.64%** – all gilts that mature in the 2060s.

"Investors looking whether to buy 30-year gilts on around 4.5% should take their cue from the general conditions in the money market rather than wait around for the Bank of England to fall into line and cut rates further.

"The latter approach risks potentially missing out on what could be significant capital gains among the longer-dated bonds, as the market will usually move in advance of any rate cutting by the central bank. You have got to be in it to win it, as investors who wait until the Bank of England makes its further cuts run the risk of missing out."

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Gilts also have an advantageous tax status, with capital gains being free from tax. Coupons received are taxed at your marginal tax rate, if the gilts are held outside a tax wrapper such as an ISA or SIPP.

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