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Nomura Global Dynamic Bond Fund

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Our View on Bond Yields and Inflation

In recent weeks, bond yields have been rising. This has provoked concern from investors about the move prompting a sell-off in risk assets. Our view is that investors should not be concerned about this – yet.

Equity markets are close to all-time highs. Corporate bond spreads are tight. Return opportunities have reduced and the potential for volatility is high as a result. We therefore believe that investors are right to be cautious, but volatility should, for the time-being, be seen as an opportunity to add risk. Treasury yields can move higher, but will not accelerate from this point to a level where the funding of future growth becomes problematic.

The key to this view is our expectations for the future behaviour of the central banks, in combination with the fiscal measures of global governments, as we emerge from pandemic lockdowns.

The Short Term

Thus far, the reaction from central banks to higher rates has been muted, with only the ECB attempting to calm markets with increased bond purchases. There will be more definitive moves toward yield curve control if economic growth is threatened by significantly higher yields. So far, this has proved unnecessary. Meanwhile, vaccinations are proceeding at pace, with reduced cases of severe symptoms and infection rates where the rollout has been successful. Economic growth can be expected to return, so it is only right that real yields (which are still negative in the US, let us not forget) move higher.

Steeper yield curves are beneficial for some sectors of the economy – notably banks, whose share prices have performed relatively well of late. The recovery will benefit many cyclical sectors of the economy and emerging markets also – there are many potential sources of attractive returns, particularly if volatility offers good entry points.

With the recovery comes the potential for inflation. US fiscal stimulus in particular is being targeted at lower income households whose marginal propensity to consume is high. Demand for goods and services will come. However, sustainable, embedded inflation will only occur if we begin to see wage inflation. At present, large swathes of the workforce receive government support whilst their ability to work is impaired by measures against the spread of Covid-19. It will take time for wage pressure to feed through into a workforce that exhibits considerable slack. It will therefore be some time before the Federal Reserve (or indeed other central banks) feel the need to control inflation, particularly since they have indicated that they are willing to tolerate much higher rates of inflation than are currently discounted by bond yields.

It is therefore unreasonable to expect any interest rate rises from the Federal Reserve or elsewhere in the short term. Certainly not this year, and very likely not until late 2022 at the earliest. This view fits the rhetoric of the Federal Reserve itself and the future rate expectations of the FOMC members.

The Longer Term

Eventually, increased inflation (or, possibly, just inflation expectations) will force the Federal Reserve to raise rates. This will likely result in a scenario similar to that seen in 2018, when rate rises impacted the cost of funding investments, effectively leading to a margin call on risk. As in 2018, there will likely be significant falls in equity markets, with strong correlations to other risk assets. Ironically, such price falls are likely to result in outperformance from the long end of yield curves, even as the short end rises.

The Federal Reserve will be understandably reluctant to initiate such a move. However, the longer inflation is left to take hold, the longer their rate rises will be perceived to be “behind the curve” and markets will price in larger and more rapid hikes in rates, exacerbating the negative implications for risk markets.

Summary

For now, investors should be comfortable to hold risk in portfolios – indeed volatility through temporary concerns over higher yields should be seen as an opportunity to add risk.

Inflation expectations will rise, but inflation will take time to become truly embedded, especially through wage increases, which central banks ultimately want to see. Once inflation does force the Federal Reserve’s hand and interest rates start to rise meaningfully, investors will find it increasingly expensive to fund risk positions and equity markets in particular will most likely suffer sharp falls. However, this is unlikely to happen in the short term, and there are many opportunities to generate attractive levels of return before the pain of higher interest rates becomes a reality.

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