This is normal. Get used to it.

October 2023

Investment managers and investors hankering for a return to the ‘zero rates' world of much of the post GFC era need to get used to the kind of interest rates and bond yields we currently have because they are closer to normal than what previously prevailed.

Between 2012 and mid-2022, the yield on 10 year US inflation-linked bonds (or Treasury Inflation-Protected Securities, TIPS) moved narrowly between -1.0% and 0.5%, very out-of-step with the 2.3% to 4.3% range that existed between the mid-1990s and 2007. Looking at the recent rise in bond yields (falling bond prices) through this lens, leads us to conclude that rather than bemoaning “higher for longer” interest rates and bond yields, we should instead characterise both higher interest rates and higher bond yields as being akin to “higher is more a return to normal.”

So, what explains the most recent jump in bond yields? After a period of slowing momentum, the US jobs market gathered strength over the September quarter causing wage growth and inflation expectations to rise. At the same time, a jump in the oil price also helped to kick inflation forward.

Softer bond prices stem from large US budget deficit and bond demand/supply dynamics

That said, we think a stronger explanation for the weaker bond market comes from the widening divergence between the issuance of bonds by the US government and the decreasing quantity of bonds held by the US Federal Reserve (Fed), as part of the Fed's quantitative tightening program.

Through quantitative tightening, the Fed has been letting the bonds it bought during the period of quantitative easing expire, and is not deploying the sales proceeds to buy more bonds. This reversal means that demand for US government bonds is now not as strong as when the Fed was hoovering up bonds to drive long-term interest rates lower.

Moreover, the US budget is now roughly twice as great as it was before the pandemic, meaning the US Treasury department needs to issue a greater number of bonds to finance spending, at the same time the Fed is reducing its holding of US government bonds!

Offshore central banks' appetite for US bonds' is also weakening, which is contributing to lower bond prices. All up, higher US government bond supply, against relatively softer demand, has resulted in bond prices coming under downward pressure.

Additionally, China, the other global economic giant, is going through an economic transition from big-bang fixed asset investment to more subtle but targeted support for strategic industries and sectors. This is partly driven by the need to increase capital productivity as well as the longer-term strategic priority of higher quality growth and greater self-reliance, both of which are threatened by continued misallocation of capital under an old-school ‘bazooka stimulus' approach.

Upside of bond market weakness

While bond holders will be feeling battered and bruised, those who have been underweight bonds will appreciate the upside from recent events; they have increased the return potential from bonds. A caveat, however. While bonds are certainly better risk diversifiers now than they were at any point over the past 15 years, on a risk-reward basis, our investment process does not see them being cheap enough to warrant aggressive overweight positioning.

Inflation remains a threat to a further rise in yields, particularly if Organization of the Petroleum Exporting Countries (OPEC) continues to restrict output or the Middle East falls into a conflict precipitating stagflation. Inflation-linked bonds are desensitised from the direct impact of inflation, but it is not yet certain that the rise in bond yields has run its course, particularly if central banks continue to stay on the path of quantitative tightening.

Given the breath of upside and downside risks, we remain of the view that now is not the right time for heroic growth or defensive bets and instead prefer to focus on a well-diversified moderate level of risk exposure, and to exploit the relatively high level of yield on offer for short term income strategies as a consistent overweight across the Managed Account Strategies.

Portfolio positioning and activity

Following the recent meaningful change in our target asset allocation which was implemented over the June quarter across the suite of Managed Account Strategies, portfolio rebalancing activity returned to more typical levels during the September quarter. Beyond a handful of direct ASX securities in the Premium Australian shares, rebalancing activity was limited to essentially reinvesting financial year end Australian dollar cash distributions. Across the Value series, this involved re-establishing exposure primarily in unhedged global shares and for the Premium series, adding exposure to our real return Inflation Plus portfolios and selectively PIMCO global bonds.

We continue to position the portfolios for diverse and resilient returns across asset classes.

Beyond the Australian dollar cash redeployment in July and September, portfolio rebalancing activity over the September quarter was limited to the direct ASX sub-portfolio within the Premium series of model portfolios. This included the addition/upweighting of Brambles (BXB), Goodman Group (GMG) and James Hardie Industries (JHX) funded via a removal/reduction in exposure in IDP Education (IEL), NEC Entertainment (NEC) and Telstra Group (TLS).

For more information, please speak with your financial adviser.

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