That '70s Show

Stagflation, Bonds… and the Space Hopper

When you think of the 1970s, what images come to mind?

For me, it's the space hopper – as I had trouble balancing on the thing as a child. Other standout memories include Disco, Flares and Star Wars. But let's save those for another day.

Equally, the seventies heralded a time of high inflation, slow economic growth and political instability. For investors, high inflation is detrimental to bonds, as it erodes the value of the interest payments and principal component of the bond, especially those with longer terms to maturity. It should be no surprise, therefore, that the seventies were also a period of elevated bond yields, as investors sought extra return to compensate for this additional risk.

As inflationary pressures start to increase again across the world today, I can't help but think of the famous Mark Twain quote - "History doesn't repeat itself, but it often rhymes". So, one area to watch closely is the possible impact on bonds and, particularly, "60/40" (equity/bond) portfolios that are popular with investors. Speaking of difficulties in trying to balance, where are investors to turn if the bond allocation in these solutions does not provide protection in equity market downturns that investors expect?

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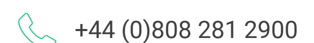

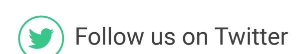

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The glory days of bonds

Over the last six months, bond investors must surely be harking back to better times. For years, decades in fact, fuelled by increased globalisation, improvements in technology, falling central bank base rates and looser monetary policy, the environment and approach to inflation has been positive for bonds. This was accentuated following the global financial crisis in 2008, and the COVID crisis in 2020, as central banks used every weapon in their arsenal to support the global economy. The use of extraordinary measures, such as quantitative easing and yield curve control, helped keep interest rates at extremely low levels. In some instances, interest rates even went into negative territory (for example, in German Bunds). With yields falling, the result was a thirty-year bull market in bond prices (as demonstrated by the fall in the US Treasury 10-year yield in Chart 1).

Chart 1 - Source: Bloomberg

This long bond rally is now under threat and bond investors are faced with the prospect of higher inflation and increasing interest rates. The reasons for this inflationary environment are numerous - years of loose monetary policy, increased spending power and pent-up demand post-COVID, supply line constraints accentuated by the Russian invasion of Ukraine. This is demonstrated by the 5-year/5-year forward inflation expectation rates shown in Chart 2.

Chart 2 - Source: Bloomberg and Collidr. (Green is 5Y5Y UK, Purple is 5Y5Y US and Blue is 5Y5Y Germany).

It would appear bond investors and central bankers have reacted slowly to the change. Initially the US Federal Reserve ("Fed") called the increase "transitory", while expecting it to revert towards their self-imposed inflation target of 2%. However, as inflation continued to increase (as shown in Chart 3 for the US), investors have slowly and surely changed their view of the longer-term implications. To try to bring inflation back towards their targets, central banks have started on a course – by unwinding quantitative easing measures and increasing interest rates – to tighten monetary policy. In May, the Fed raised interest rates by 50bps; an increase in magnitude not witnessed since 2000.

Chart 3 - Source: Trading Economics and the US Bureau of Labor Statistics

What does this mean for bond investors?

An inflationary environment is detrimental to bond returns. Therefore, as inflation rises, bonds (typically longer duration bonds) are likely to fall. With investors starting to realise

that this increased inflationary environment is here for the longer term, bond markets have come under severe pressure lately. Chart 4 shows how much bond markets (represented by the generic Bloomberg Barclays Global Aggregate Index) have fallen since the end of August 2021. The drawdown for bonds is around 8% over this period.

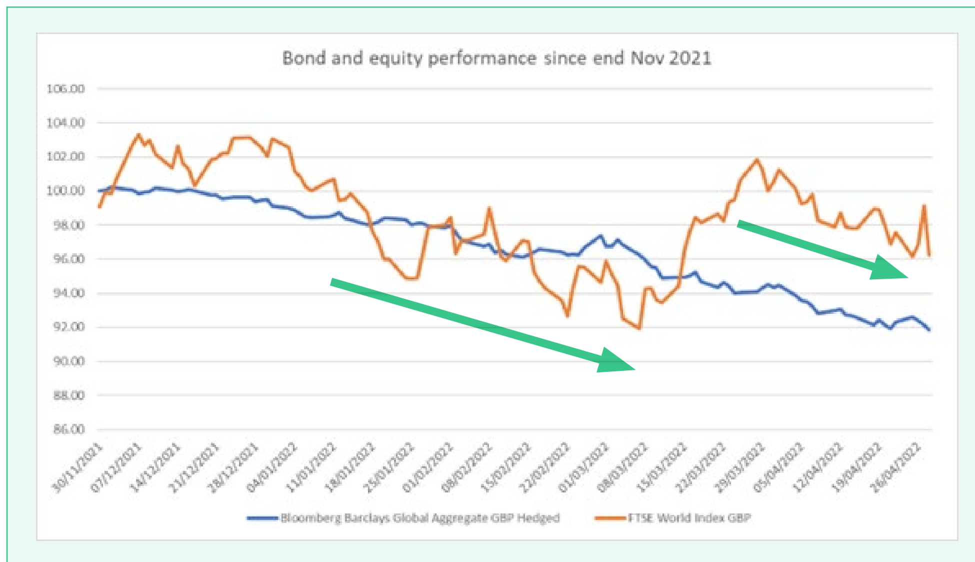


Chart 4 - Source: Bloomberg and Collidr. The two arrows highlight times when both bonds and equities fell at the same time.

In addition, volatility has increased in the bond market, as shown by the MOVE (the Merrill Lynch Option Volatility Estimate) Index in Chart 5. Volatility in the equity space, as represented by the VIX Index in the same chart, has increased too. Bond market volatility is at the highest level for ten years.

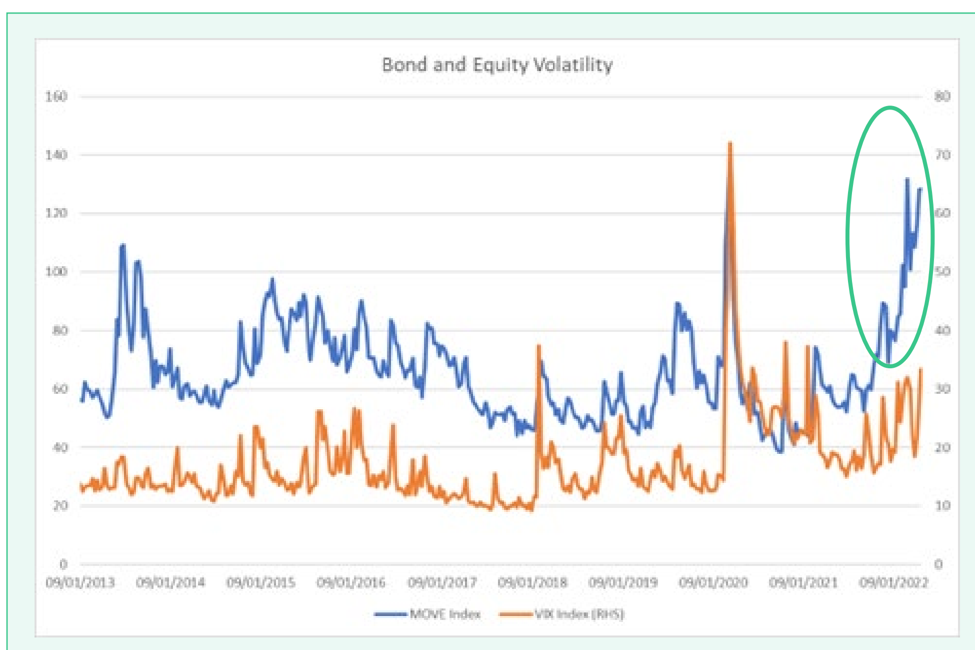


Chart 5 - Source: Bloomberg and Collidr

It seems clear over recent months that the investment world has entered a place we have not been in for a long time, a "new normal", where increasing inflation and rising interest rates are now the norm. In this new world, bonds have increased volatility. They also have large drawdowns, in some cases larger drawdowns than equity markets. For example, as seen in Chart 6, the Markit Iboxx GBP Gilts Index has returned -12% since the start of August 2021, with a volatility of 9% and a drawdown of almost 15%. If investors are using bonds in their portfolio for protection, and to diversify away from equity risk, then they may find themselves in trouble.

	Models	Total Returns	Period Volatility	Max Drawdown
	Vanguard LifeStrategy 60% Equity A Acc	-3.35	6.49	-8.47
	FTSE 100 Total Return GBP	10.62	12.94	-8.90
	FTSE World Equity	0.61	11.85	-11.34
	Markit iBoxx GBP Gilts TR	-12.09	9.07	-14.76
	Bloomberg Barclays Global Aggregate Total Return...	-8.80	3.12	-9.00

Chart 6 - Source: Collidr

Where to go?

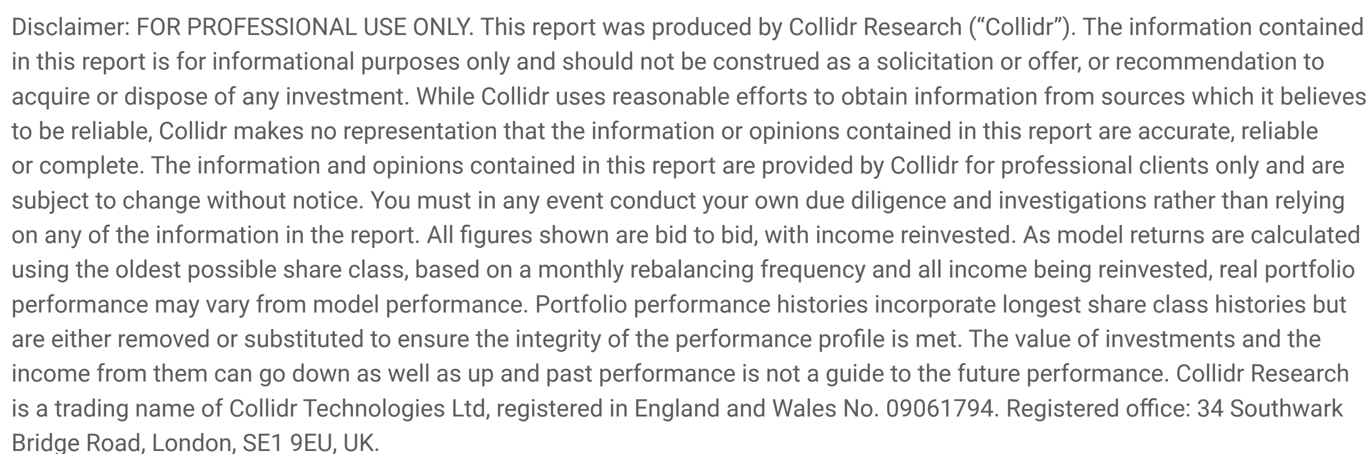
In a world where bonds and equities increasingly move in the same direction, where do investors in a traditional "60/40" portfolio find protection? These portfolios have been extremely popular in the last 30 years, especially as bonds were in a long bull rally. However, in this new environment, a "60/40" portfolio is likely to struggle. This can be clearly seen from Chart 6, where the typical 60/40 fund (using Vanguard LifeStrategy 60% fund as an example) has underperformed equity markets. When compared to the FTSE World Equity, it is the allocation to bonds that have pulled the performance of the "60/40" portfolio down. In addition, note that the maximum drawdown of the "60/40" portfolio is in line with the FTSE100 Index, suggesting that the bonds have provided no protection over this period.

So, what can investors hold in their portfolios to insulate returns in this environment?

Alternatives are one possible option – including alternative funds. For example, long/short funds may – if the fund manager has a good track record of making returns on the short positions and controlling risk – help to diversify a portfolio. However, it's important to understand that not all alternatives are expected to behave the same. Indeed, some alternative funds might struggle, depending on the circumstances. Therefore, full research into how the funds work and behave is of paramount importance. In this new normal, funds that benefit from an inflationary environment may outperform. Some trend following funds may also provide positive uncorrelated returns. Market neutral funds, currency trading strategies and other assets like commodities, oil and real assets, i.e., asset classes that can have a proper differentiation to equity and bond returns, may also help to protect.

The world has changed

Increasing inflation and rising interest rates are likely to remain for some time, as economies deal with continuing supply chain issues, pent-up demand following the COVID pandemic, and an end to quantitative easing. Bond markets have transitioned from the relative tranquillity of recent years into a period of the unknown, where volatility and drawdowns are the norm. Investors need to consider the unusual, where bonds and equities fall at the same time. They may need to reconsider the traditional "60/40" portfolio and look for alternatives to help diversify their investments and protect on the downside. On this, Mark Twain was correct – there are elements of this new environment that rhymes with what happened in the seventies. However, there are substantial differences too, and investors need to learn from the past but prepare for what lies ahead and aim to remain balanced on the space hopper.



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