Institute

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Time to refocus on bonds

Rethinking portfolios after the great repricing

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Amundi ASSET MANAGEMENT

Investment Insights | Market Stories

Time to refocus on bonds

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*"Inflation has risen to levels not seen in 40 years, leading to a repricing of financial markets this year, which has been particularly severe in the fixed income space. Central Banks have already started to hike rates and turn to the hawkish side to avoid de-anchoring inflation expectations. The era of low or even negative interest rates is over. We strongly believe that this new market context provides a **new paradigm for bonds**, with more attractive valuations and a renewed outlook.*

- ***Valuations:** fixed income valuations are now as attractive as equities' from a relative standpoint, as a result of higher inflation figures coupled with CB actions.*
- ***Outlook:** although we expect more volatility in the coming weeks, as investors process central bank actions and communications, and weigh up the trade-offs between the risk of higher inflation and slower growth, interest rates are not going back into negative territory.*

On top of this new environment, we see 3 main factors supporting the renewed interest for bonds:

1. ***Higher yields**: current levels have become attractive; being invested in fixed income is paying off once more.*
2. ***More diversification**: negative correlation between bonds and equities may return in a more uncertain economic environment, making bonds more appealing as a portfolio diversifier.*
3. ***A macro hedge** in the case of increased risk of Eurozone fragmentation or political uncertainty, bonds could provide some portfolio protection. This would also be the case if aggressive tightening by the Fed prompts a recession (and the Fed has shown its commitment to do whatever it takes to fight inflation).*

At this point, we think that the asset class is becoming attractive again and offers interesting entry points. It makes sense to allocate to bonds within a diversified portfolio allocation, but selection remains important, favouring market segments – such as core government bonds – with a flexible approach, while looking for quality in the credit space."

Back to bonds: a journey through the regime shift

We are here

The Great Repricing

Markets and Central Banks react aggressively to the inflationary environment. Rates volatility rises, and visibility is poor as this monetary shift takes place and the stagflation story gains ground.

Stabilisation

Markets gradually shift their attention away from inflation and onto growth. The repricing of rate curves is mostly done, and yield volatility gradually decreases. Growth concerns affect low quality credit.

Normalisation.

Less uncertainty about future inflation, growth and Central Banks' monetary policies suppresses rates volatility. Credit spreads fully reprice, offering attractive entry points in a context of higher dispersion.

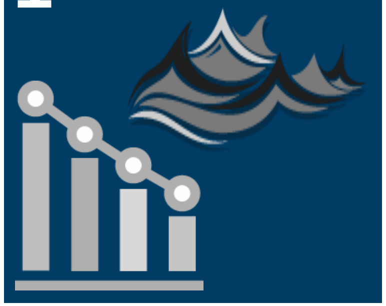
With inflation becoming a dominant feature of the regime and Central Banks starting to act, we see three phases for bond markets: the great repricing (that played out in H1), stabilisation and normalisation. We currently stand at the beginning of the second phase, where some curve repricing is already done, Central Banks have become more hawkish to fight inflation and the growth picture has deteriorated. In this context, bond yields are stabilising and could again be seen as a source of diversification and protection against recession fears.

Source: Amundi. Data is as of 26 September 2022. CB: central banks.

4 reasons to look at bonds

Four main themes for investors

1 Lower growth ahead



The global growth outlook has materially lowered for 2023, with a clear loss of growth momentum worldwide and **stagflation risk rising.** The current juncture of **weak global growth and tighter financial conditions could lead to recession,** especially in the Eurozone. Market attention is turning to growth, considering the possibility of recession. Bonds could serve as a diversifier in an economic downturn.

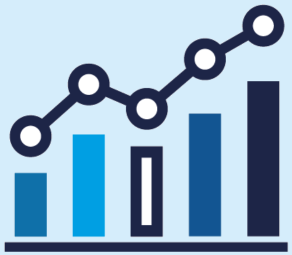
2 Committed Central Banks to fight inflation

Although CBs have started their rate hiking cycles to curb inflation (nearing its highest level in four decades) which may be close to a peak, inflation would still be above CB targets. Some **CBs will need to move further towards the normalisation of monetary policy** (with higher interest rates and reduced balance sheets), which could also hamper growth moving forward. This calls for an agile approach to bonds.

3 Attractive absolute and relative valuations

After yield repricing, Bonds offer more **attractive valuations in absolute and relative terms**. Valuations have dropped due to the recent fast rise in global rates coupled with wider credit spreads, opening up fresh opportunities for investors.

4 Higher yields



Investors have a good reason to buy bonds again: **yield**. The repricing in bonds is advanced and **yields have surged back toward more 'normal' levels** from a historical standpoint. Higher yields give investors the opportunity to re-engage in both the government and high quality credit markets, but selection remains important for the latter.

Source: Amundi Institute as of 22 September 2022. CB: central banks.

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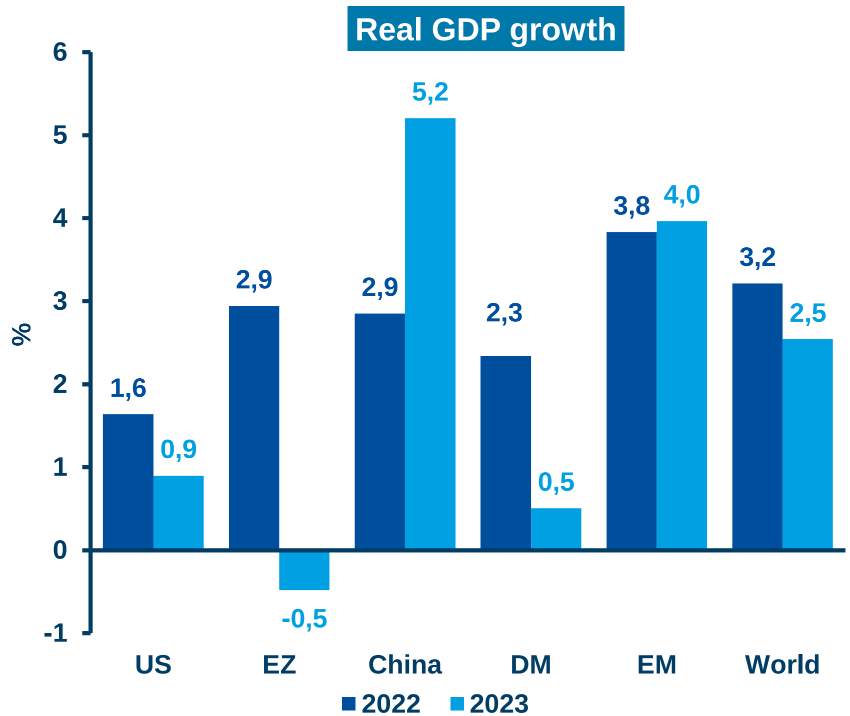
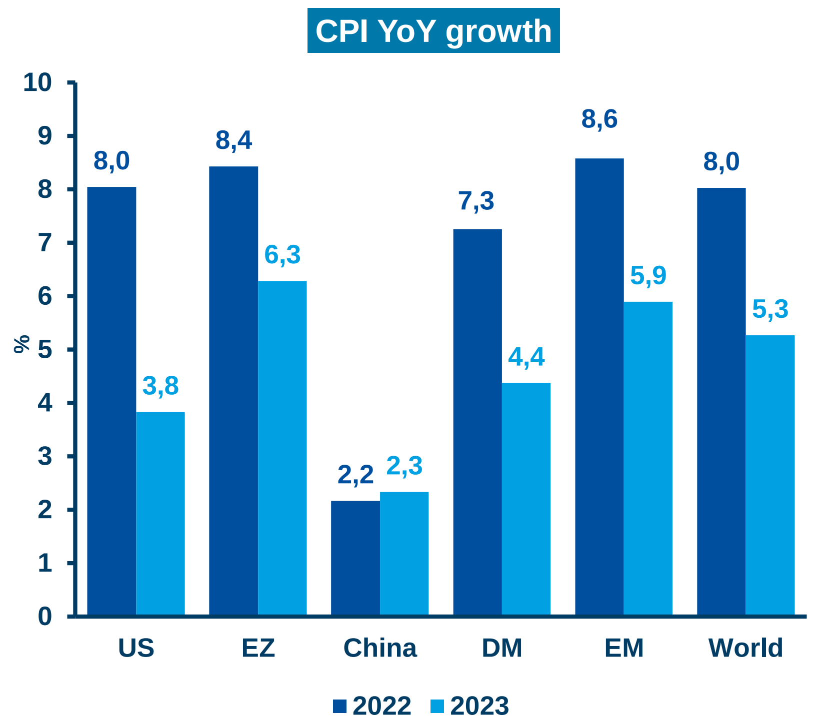
Material slowdown in growth, high inflation and divergences

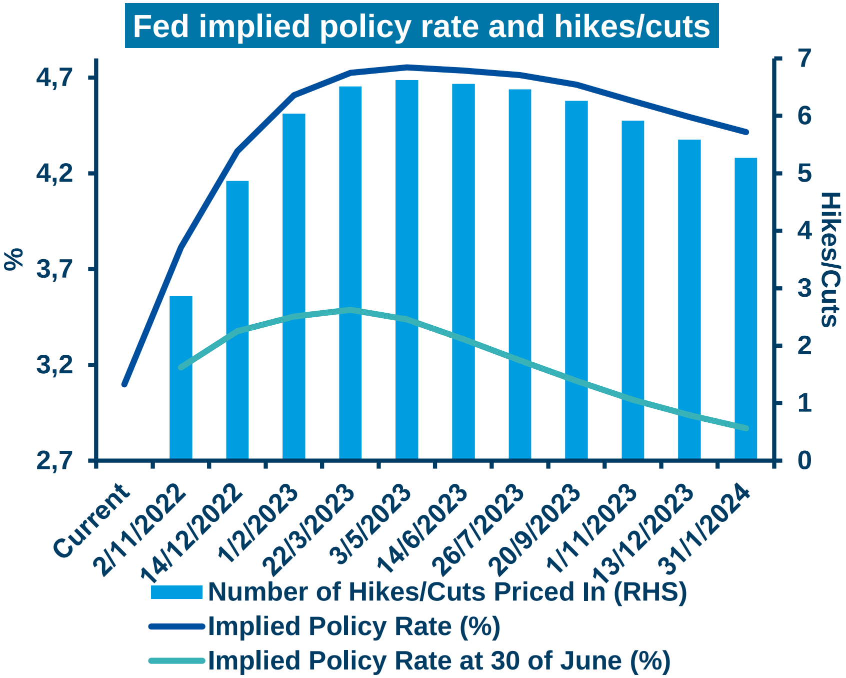


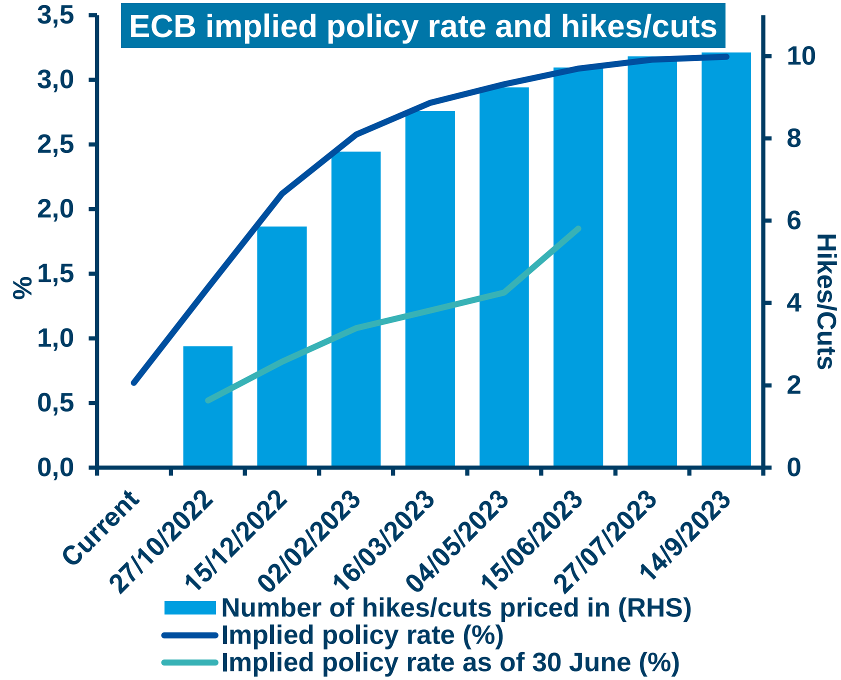


The latest macro forecasts confirm that the *stagflationary* scenario is gaining momentum and affecting all geographies but with a differing intensity. DM should bear the brunt of such an evolution, especially the Eurozone both in growth and inflation for 2023, while the US should be more impacted on growth. With regards to EM, the overall picture confirms weak Chinese growth ahead.

Source: Amundi Institute, Datastream, Bloomberg. Data is as of 21 September 2022. Forecasts are by Amundi Institute and are as of 21 September 2022. CPI: consumer price index. DM: developed markets. EM: emerging markets.

The Fed is committed to doing whatever it takes to fight inflation; more challenges for the ECB



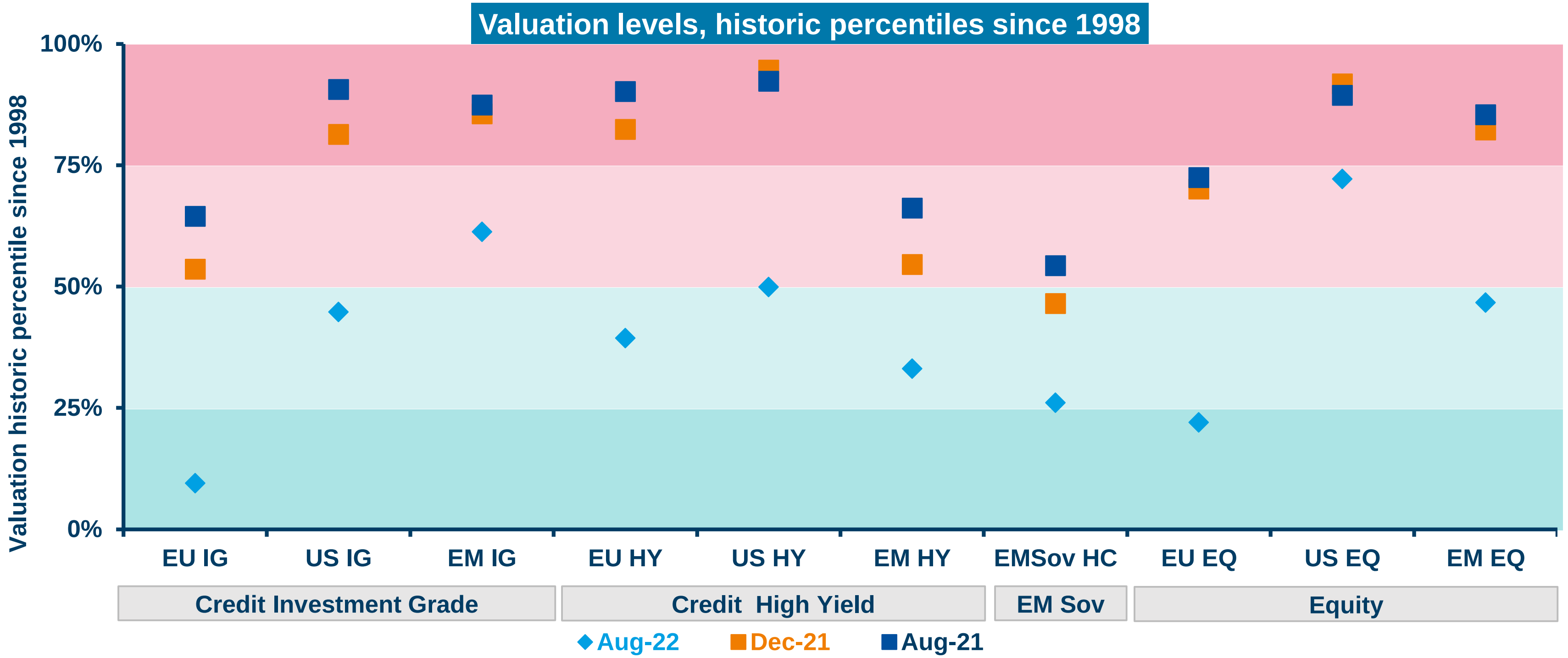


Higher terminal rates in both the US and Eurozone, compared to the end of June, show that the inflation element still dominates CB monetary policy rhetoric on the growth / inflation dilemma. However, the risk of recession could require a more balanced approach by CB moving forward.

Source: Amundi Institute, Bloomberg. Data is as of 26 September 2022. CB: central banks. Specific date refers to upcoming FOMC by the Fed.

Source: Amundi Institute, Bloomberg. Data is as of 26 September 2022. CB: central banks. Specific date refers to upcoming ECB meetings.

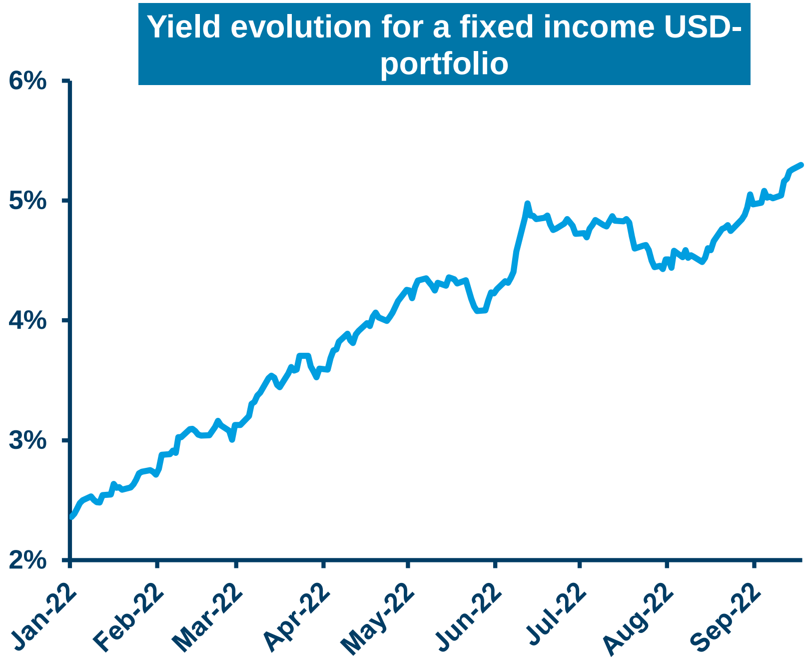
Valuations have become attractive, particularly in IG



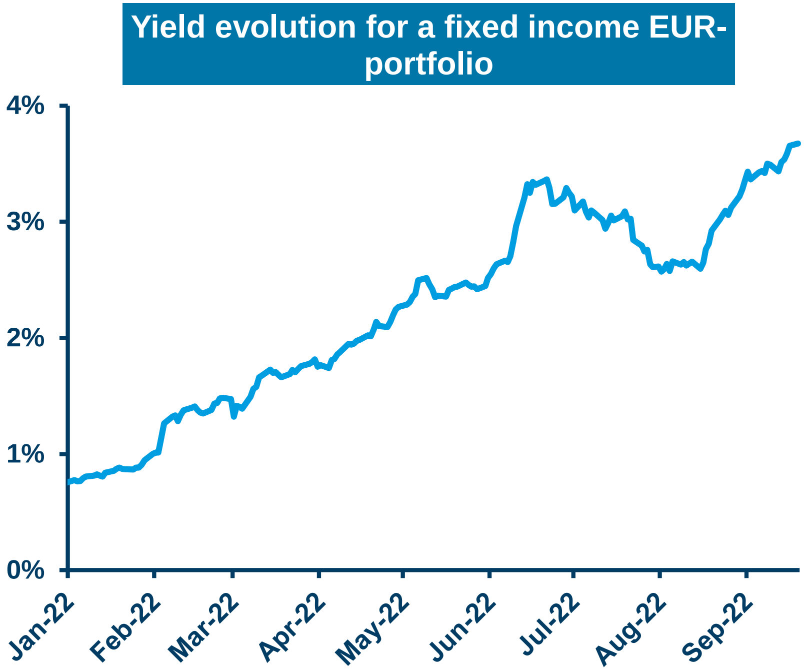
Rising rates and widening credit spreads have caused credit valuations to drop from recent peaks. Offering new opportunities for investors, who may find it appealing to step into the IG market.

Source: Amundi Institute, Bloomberg, DataStream, latest monthly data as of 31 August 2022. EU IG, US IG, EM IG, EU HY, US HY, EM HY are ICE BofA corporate bond indices. IG: investment grade. HY: high yield. EM Sov HC: JP Morgan EMBI Global Diversified. EU EQ, US EQ, EM EQ are MSCI indices for equity markets. All indices refer to a specific region (EU: Europe, US: United States, EM: emerging markets. Analysis is based on spreads for bond indices and on twelve-month forward PE ratio for equity indices.

The yield of a diversified bond portfolio is now attractive



Portfolio composition: 50% US Aggregate, 20% Global US Credit, 10% US SUB, 10% US HY and 10% EM



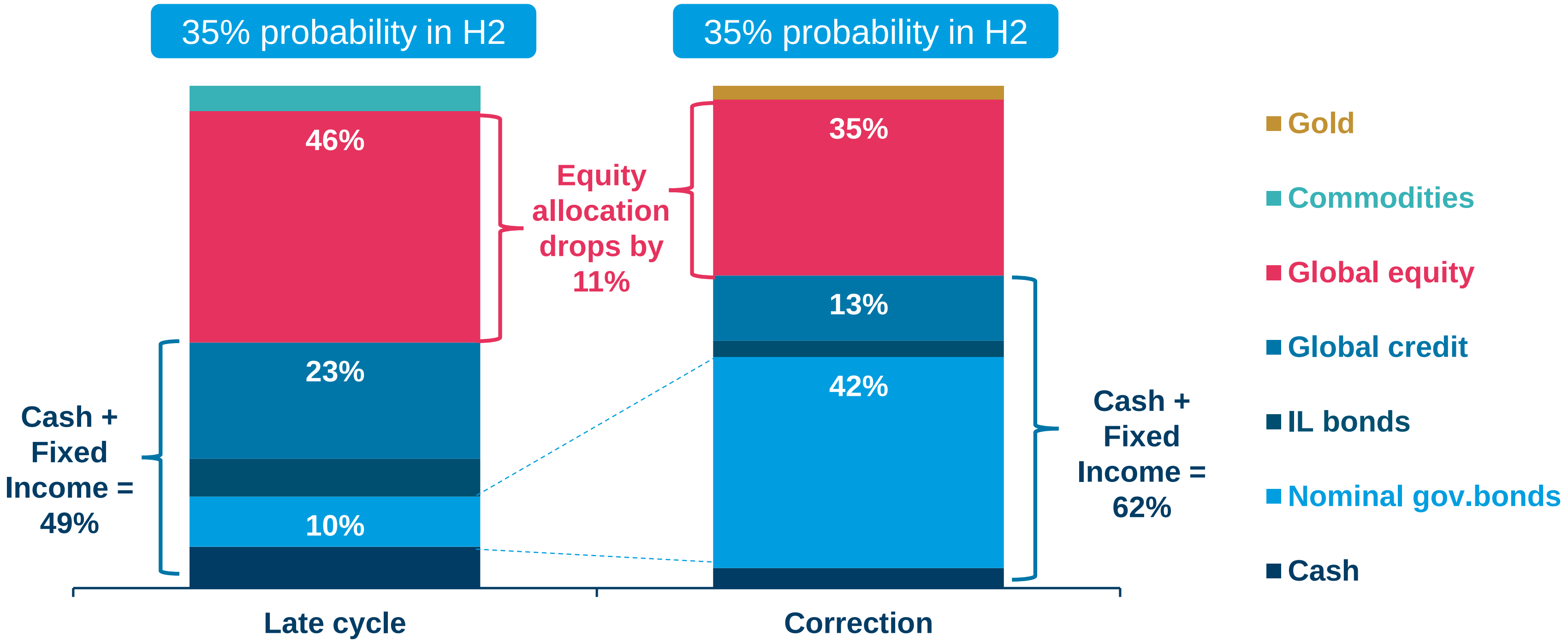
Portfolio composition: 50% Euro Aggregate, 20% Global Eur Credit, 10% Eur SUB, 10% Eur HY and 10% EM

Bond portfolios have increased their yield both in USD and EUR, becoming particularly rich especially in US fixed income. Current carry in a well diversified 100% fixed income portfolio is compelling as shown by these yield evolution charts.

Source: Amundi Institute on Bloomberg, Data is as of 20 September 2022. For illustrative purposes only.

Source: Amundi Institute on Bloomberg, Data is as of 20 September 2022. For illustrative purposes only.

Bonds deserve a higher allocation, as a diversification tool and a hedge against an uncertain macro outlook



Bonds, especially government bonds, are one way to hedge risk during a recession or financial crisis. Investors should raise nominal government bond holdings significantly if markets move towards a correction phase, while the equity share of the portfolio should shrink.

Source: Amundi Institute, Bloomberg. Data is as of 29 August 2022. Analysis based on the Amundi Institute Advanced Investment Phazer (AIP), which allows to identify regimes based on a clustering algorithm applied to a comprehensive set of macro-financial variables split over four dimensions: growth, inflation, monetary policy and financial leverage. There are five phases – Correction, Contraction, Recovery, Late cycle and Asset reflation – each featuring reference values for the aforementioned macro-financial measures. For further information please see the paper: [Advanced Investment Phazer: a guide to dynamic asset allocation](). For illustrative purposes only.

Key convictions summary

US Fixed Income	Euro Fixed Income	EM Fixed Income
Valuations have become more interesting. Inflation remains high, and could be close to a peak, but we expect inflation numbers to remain volatile, complicating the Fed's assessment.	Growth concerns with the energy crisis in the Eurozone. In the case of a deteriorating growth / inflation profile, the ECB could go to the lower range of neutral rates.	In a fragmented EM space, some CBs are more advanced in their monetary policy normalisation. Explore opportunities in selective EM offering real returns. Focus on high carry countries.
Flexible duration approach.	Flexible duration approach.	Given the moves seen year-to-date, less defensive on duration.
Credit: preference for US IG, owing to a relatively more benign macroeconomic backdrop.	Neutral on European peripherals.	Favour hard currency bonds: valuations are more attractive in HY vs IG given the macro cycle.

Source: Amundi Institute as of 7 September 2022. CB: central banks. IG: investment grade. HY: high yield. EM: emerging markets.

Rethinking bond allocations

How to play

Core Bond Allocation

- Focus on high-quality assets: core govies (US in particular) and IG credit for buy and hold purposes
- Include Chinese bonds in the core as a diversifier
- Look at sustainable bonds to benefit from green QE
- Adopt a flexible approach to get the most from aggregate bond markets

Yield enhancement satellite focus

- Explore opportunities in selective EM offering real returns
- HY only with a very selective approach

Include liquidity considerations in the selection of investment ideas

Source: Amundi Institute as of 26 September 2022. CB: central banks. IG: investment grade. HY: high yield. EM: emerging markets.

Indices references and definitions

Yield and duration indices

German Govt Bonds = JP Morgan GBI Germany Index; US Govt Bonds = JPMorgan GBI US Index; Euro IG Bonds = Bloomberg Barclays Pan European Aggregate Corporate; US IG Bonds = Bloomberg Barclays US Aggregate Credit; Euro HY bonds = Bloomberg Barclays Pan-European High Yield ISMA; US HY Bonds = Bloomberg Barclays US Corporate High Yield; EMBI Div = JPMorgan EMBI Global Diversified Blended; CEMBI BD = JPMorgan CEMBI Div Broad Composite Blended; CEMBI BD HY = JPMorgan CEMBI Broad Div High Yield; Euro Corp Short Term = Bloomberg Barclays Euro Corporate 1-3Yr; US Corp Short Term = Bloomberg Barclays US Corporate 1-3Yr; EMBI Corp Short Term = J.P. Morgan CEMBI Broad Diversified 1-3 Year. European govt. bonds = JP Morgan GBI EMU YTM Index, Japanese govt bond = JP Morgan GBI Japan YTM index, US govt bonds = JP Morgan GBI US YTM index, UK = JP Morgan GBI UK YTM index, Europe dividend yield = MSCI Europe Index, Japan dividend yield = MSCI Japan Index, US dividend yield = MSCI USA Index, UK dividend yield = MSCI UK Index, Europe high dividend yield = MSCI Europe High Dividend Yield index, Japan high dividend yield = MSCI Japan High Dividend Yield index, UK high dividend yield = MSCI UK High Dividend Yield index, US high dividend yield = MSCI US High Dividend Yield index.

Definitions

- **Basis points**: one basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Breakeven inflation:** difference between the nominal yield on a fixed-rate investment and the real yield on an inflation-linked investment of similar maturity and credit quality.
- **Carry:** The carry of an asset is the return obtained from holding it.
- **Correlation**: the degree of association between two variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (perfectly negative correlated) through 0 (absolutely independent) to 1 (perfectly positive correlated).
- **Credit spread**: differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **Default rate:** The share of issuers that failed to make interest or principal payments in the prior 12 months. Default rate based on BofA indices. Universe consists of issuers in the corresponding index 12 months prior to the date of default. Indices considered for corporate market are ICE BofA..
- **Duration:** a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.
- **FX**: FX markets refer to the foreign exchange markets where participants are able to buy and sell currencies.
- **Green bonds**: A green bond is a type of fixed-income instrument that is specifically earmarked to raise money for climate and environmental projects.
- **High yield:** High yield paying bond with a low credit rating due to the high risk of default of the issuer.
- **Investment grade**: Refers to securities issued by an issuer of negotiable debt securities (Treasury bonds...) or bonds for which the Standard & Poor’s rating is greater than or equal to BBB-. 'Investment grade' bonds are considered by the various rating agencies as having a low risk of non-repayment.
- **Liquidity**: Capacity to buy or sell assets quickly enough to prevent or minimize a loss.
- **Quantitative tightening (QT):** The opposite of QE, QT is a contractionary monetary policy aimed to decrease the liquidity in the economy. It simply means that a CB reduces the pace of reinvestment of proceeds from maturing government bonds. It also means that the CB may increase interest rates as a tool to curb money supply.
- **Social bonds**: Social bonds are use-of-proceeds bonds that raise funds for new and existing projects with positive social outcomes.
- **Sustainability bonds**: Bonds where the proceeds will be applied exclusively to finance or re-finance a combination of both green and social projects.
- **Volatility**: a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.
- **Yield to maturity (YTM):** Annualised return that a bond investor would receive from holding the bond until maturity.

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