Yield is Destiny: Bonds are Back

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Investing through the arc of the COVID recovery has hardly been a cakewalk, and the event horizon is hardly clearing for 2023. But as bond investors, we shouldn't lose sight of the fact that bond yields have experienced a historic increase to what will likely prove to be generational highs. This is the positive side of the 2022 market rout: with bonds, yield is more or less destiny. These higher yields should easily push bond returns in the coming decade to twice, if not three times, higher than those recorded over past decade (Figure 1).

As a result of the COVID recovery, markets have turned back the clock 20 years, pushing yields back up to 2002 levels and setting bonds up for solid returns in the years ahead. While current conditions suggest yields may remain around current levels in the weeks and months ahead, longer-term fundamentals suggest some decline in yields is likely as growth and inflation eventually recede from their current generational highs. In the event, some of the future returns embodied in current market yields will be pulled forward in the form of capital appreciation. In other words, we appear to be at a strategic buy point for bonds.

FIGURE 1: Yield is destiny (more or less) for long-term fixed income over extended periods of time. Returns from 1992-2012 ended up slightly higher than starting yields as rates generally fell, while returns from 2012 to 2022 were a bit less than starting yields as rates rose at the end of the period. At present, we see the near-term outlook for rates as finely balanced, but mildly bullish longer term. Based on past relationships, broad bond market returns could easily be two to three times those of the last decade. (%)

Periods	1992-2002	2002-2012	2012-2022	2022-
Starting yield	6.76	4.38	1.75	4.38
	⬇	⬇	⬇	⬇
Aggregate return	7.45	5.29	1.27	?

Source: PGIM Fixed Income.

Looking back over the decades, we can see that yields have passed through various paradigms, as indicated by the low, moderate, and high periods in Figure 2. Reviewing the factors that drove the transitions between outlier periods may give us some insight into where we are now, how we got here, and where we are headed.

FIGURE 2: Pegging Yields: Where Should They Be? (%)

Source: PGIM Fixed Income; 1875-1961, Robert Shiller, Yale; 1962-Present, Bloomberg.

WHAT'S NORMAL?

Over time, the central tendency for long-term U.S. Treasury yields seems to land in the vicinity of 4% (I: the "normal" range in Figure 2). Conceptually, this might stem from the relationship between nominal GDP and private sector borrowing rates as Treasury yields in this zone generally allow a natural equilibrium in debt markets' supply and demand.

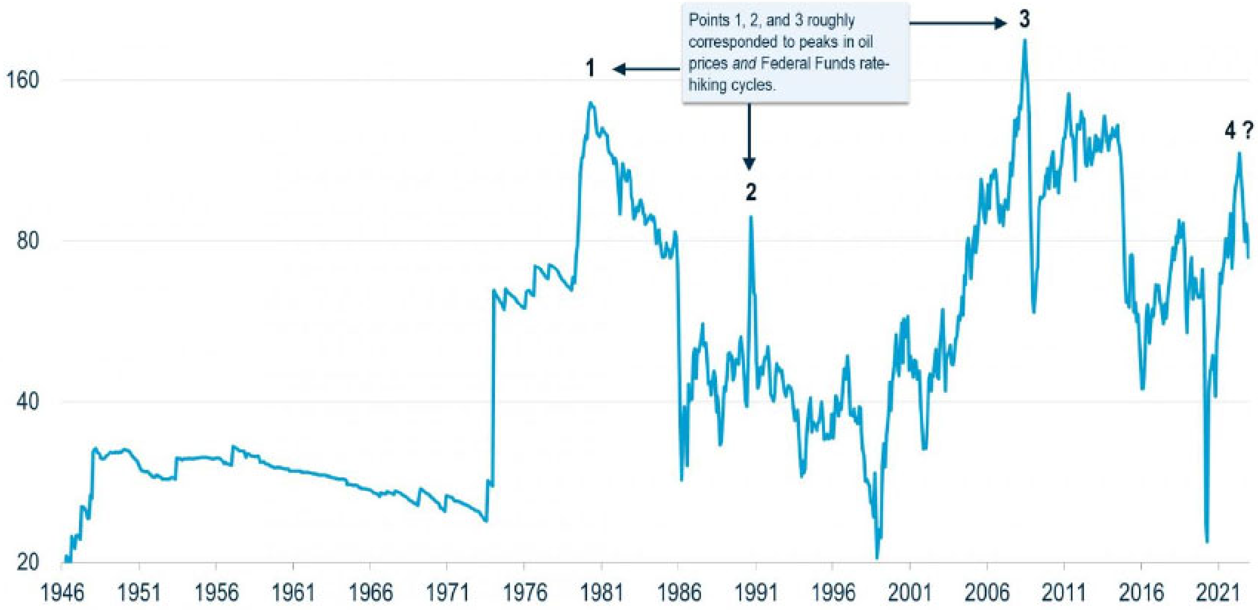
WHAT CAUSED THE ULTRA-LOW YIELDS DURING WORLD WAR II?

The low yields of the Great Depression continued through the second World War as the Fed capped Treasury yields to facilitate government borrowing (Period II in Figure 2). This policy continued into the 1950s as the government feared that without ongoing monetary stimulus, the economy might slip back into recession or even depression. However, the Fed - more concerned with inflationary pressures - eventually won its independence and began shifting policy back towards higher rates and running the kind of counter-cyclical monetary policy observed in subsequent years.

WHY WERE RATES SO HIGH IN THE 1970S-1980S?

Most of the blame for rising rates in the 1970s is cast on the pre-Volcker Fed chiefs allowing inflation to get out of control. The 1980's high, albeit falling, rates were regarded as the legacy of Fed Chairs Volcker and Greenspan waging and finishing the war on inflation. Yet, it's worth highlighting another major part of the story: rising oil prices in the 1970s and falling oil prices in the 1980s (Figure 3). While this may seem superfluous, the fact of the matter is that the COVID recovery has seen negative supply shocks from supply chain disruptions and the Russia/Ukraine war, both of which are analogous to the oil shocks of the 1970s. As a result, we should not under-estimate the potential for inflation to decline if and as these supply constraints and higher input costs ease, just as inflation receded in the 1980s as the price of oil fell.

FIGURE 3: The COVID recovery has seen negative supply shocks from supply chain disruptions and the Russia/Ukraine war, both of which are analogous to the oil shocks of the 1970s. As a result, we should not underestimate the potential for inflation to decline if and as these supply constraints and higher input costs ease, just as inflation fell in the 1980s. ($)



Source: In real U.S. dollar prices. PGIM Fixed Income and MacroTrend.

The post-GFC period left homeowners and financial institutions in weakened financial positions, necessitating low interest-rate policies from the world's central banks. These accommodative monetary conditions were initially combined with fiscal stimulus that boosted growth, enabling individuals and institutions to right their financial positions. The 2012 budget sequestration in the U.S. - and more profoundly the European debt crisis of the same period - resulted in a powerful wave of fiscal consolidation that dampened growth and inflation. Add in globalization's downward pressure on prices, and inflation from 2009 through 2020 fell to what central bankers deemed to be concerningly low levels of around 1.5% in the U.S. and 1% in Europe, both of which were below the central banks' 2% targets (Figure 4).

FIGURE 4: With inflation persistently below target in the post-GFC period, central bankers took interest rates to unnaturally low levels. (%)

Source: PGIM Fixed Income and Bloomberg.

As a result of this inflation shortfall, central banks' administered rates were kept at unusually low levels. In some cases, they were complemented by aggressive quantitative easing and low-rate lending programs, the combination of which drove developed market term structures to unnaturally low levels (Period IV of Figure 2). With inflation seemingly stuck below target and central banks determined to ease policy until they achieved their targets, it looked like interest rates were doomed to an ultra-low future for as far as the eye could see.

THEN CAME THE POST-COVID EXPLOSION IN GROWTH, INFLATION, AND INTEREST RATES…

The emergence from the COVID crisis provided two reasons for higher rates. The first was the booming growth and inflation. The combination of stimulus and reopening enthusiasm boosted demand, while supply remained muted due to a host of factors, including labor shortages and supply chain interruptions. The second "enabler" of higher rates, if you will, was the repaired damage from the GFC and its sluggish, debt-laden, Reinhart-and-Rogoff conditions.[1] Consumer balance sheets and financial institutions' capital positions were once again strong. That combination has resulted in surprising economic resilience even in the face of substantial central bank tightening in many countries and the higher repricing in long-term interest rates.

RATES ARE UP; BUT THEY ARE JUST BACK UP TO NORMAL LEVELS …

Although rates have risen, a quick review of history reveals that they are not particularly high. Rather, they have just reverted to more normal levels. With the problems of the post-GFC era in the past, maybe the time has come for rates to transition, and the COVID recovery simply provided the impetus for that normalization. If that's the case, we should not be surprised to see the expansion continue despite the shift back to a higher range of interest rates (Period V of Figure 2).

ARE POST PANDEMIC PERIODS STRONGER THAN USUAL, AND WILL THAT KEEP RATES HIGHER FOR LONGER?

Another element worth considering: Are post-pandemic periods - such as the plague years as well as the 1918 and 1957 flu pandemics - different? History shows that post-pandemic periods have tended to experience extended periods of strong growth and, in some cases, higher inflation.[2] While this is a more speculative aspect of current conditions, nonetheless, it could be playing a role in the resilience of growth in the face of higher rates, inflation, and geopolitical uncertainty.

SO, WHERE TO FOR RATES? SHORT-TERM OUTLOOK BALANCED …

At present, the rate outlook appears quite balanced. High inflation, ongoing growth, and low unemployment will keep central banks biased to raise rates. But the combination of significant hikes to date as well as signs that growth and inflation are beginning to moderate suggest that most of the rate hikes are behind us and that upside risk from current levels is limited. Should growth or inflation decline, however, the potential for a drop in rates would also seem limited given the high starting point for inflation and the low level of unemployment.

BUT LONGER TERM? BULLISH BIAS …

Near-term uncertainties notwithstanding, looking a few years into the future, it seems clear that given the demographic and productivity paths of most DM economies, the pace of growth and inflation will be lower. Therefore, rates may maintain a downward bias, albeit in the normal range. In the event, fixed income returns could not only consist of current yield levels but may also be topped off by capital gains.

CONCLUSION

Yields progress through varying regimes, and 2022 brought a jarring revaluation. The repricing triggered by the COVID recovery catapulted rates from the unnatural lows of the post-GFC era back into the historically normal range. Over the near to intermediate term, rates are likely to hover around current levels until inflation pressures abate and central bank rate-hiking cycles end. But from a longer-term perspective, DM economies are almost certainly at what will prove to be generational highs in growth, inflation, and bond yields. While the growth uncertainties created by the surge in rates may be a liability for more growth-sensitive investments, the opposite is likely to hold for fixed income where a growth shortfall may very well boost performance.

In summary, the historic increase in long-term rates from the COVID lows to levels not seen for decades will provide a formidable tailwind for fixed income. After all, for bonds, yield is tantamount to destiny, and the recent explosion in yields has turned back the clock two decades, setting bonds up for strong returns in the decade ahead.

[1] Reinhart, Carmen M. and Rogoff, Kenneth S., “This Time is Different Eight Centuries of Financial Folly,” Princeton university Press, 2009.

[2] “Social and Economic Impacts of the 1918 Influenza Epidemic,” The Digest, No. 5, May 2020, National Bureau of Economic Research.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of December 20, 2022.

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