Mid-year manager roundtable: bond market reflections

We have reached the halfway mark in what has turned out to be a tumultuous year for financial markets. After weeks of intense discussion, the investment management team will soon be finalising UOBAM's 3Q22 Quarterly Investment Strategy report, to be released in early July.

We ask three senior bond managers involved in these discussions to share their thoughts on what has happened so far, and how they are gearing up for the rest of 2022

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Joyce Tan, Senior Director, Head of Fixed Income Asia/ Singapore Team

Joyce joined UOBAM in 2007. She has over 24 years of investment experience and has received multiple industry awards. She is a Chartered Financial Analyst and graduated from the Nanyang Technological University of Singapore.

Dharmo Soejanto Chief Investment Strategist, UOBAM Invest

Dharmo is the investment lead for UOBAM's digital platform and concurrently heads the Investment Partnerships & Solutions (IPS) unit at UOBAM. He has over 20 years of investment and research experience in the finance industry.

Chester Liaw Vice President, Fixed Income

Chester joined UOBAM in August 2017 as the lead FX and rates analyst and heads the Global Emerging Markets (GEMs) team. He has over 17 years of industry experience and has a Masters of Finance from Singapore Management University.

Bonds are regarded as relatively safe assets. Yet in the first half of 2022, bond markets were far more volatile than they have been historically. What are the lessons that bond managers should take away from this period?

Joyce: This year has been a reminder that perfect storms can and do happen. As we speak, inflation has hit levels not seen in 40 years and the political conflict in Europe is the largest since World War II. Also, we are only just emerging from a once-in-a-century pandemic that rampaged through humanity for two years. There are no silver bullets for such events. But they bring a heightened awareness that we, as investors, walk the tightrope between the need for cheap resources and the long-term sustainability of humankind. Unfortunately, we can only learn our lessons after the lessons are behind us. For now, we are all still like ships in an ongoing storm. At least bond managers, many who were not even born when equivalent events took place decades ago, now have this real life experience. Yes, we can analyse all sorts of data and theorise all we want. But reading a car manual is nothing until the car hits the road!

Chester: The takeaway from the last six months is that there are no immutable truths in financial markets. We had assumed, as did the Fed and most bond managers, that inflation would be "transitory". But as we emerged from Covid and started to break out of decades of structural disinflation, we realised that this concept was no longer valid. Instead, inflation can become a self-fulfilling prophecy – high inflation begets higher inflation. While most of the issues remain supply-side related, factors like climate change, labour shortage, war and sanctions all combined to deepen the crisis. We now believe that many of these issues cannot be resolved in the short term. In fact, it is possible that high inflation will be with us for a few more years.

"This year has been a reminder that perfect storms can and do happen"
Joyce Tan

Dharmo: I think the rate hike shock stems for the ultra-low interest rates that we have enjoyed for so long. But we know that interest rates cannot stay at near-zero forever, and that distortions start to take hold – from company cashflow projections to homebuyers' mortgage repayment estimates. So when rates begin to rise, even a small move can cause a big reaction. After all, an interest rate increase from one percent to two percent is effectively a doubling in borrowing costs. Moreover, once in motion, financial markets tend to over-react. This often means a sharper pain for investors than the true situation warrants.

There is still plenty of confusion in the markets. Bond yields are looking attractive, but rate hikes point to more downside. In your view, what is the one big potential surprise of 2H22 that investors may not have discounted?

Chester: We have seen so many black swans over the last two years that perhaps no surprise is perhaps the "best" surprise. However, one thing that sticks out is the market's complacency when it comes to the Fed's ability to engineer a soft landing. A recession is still not the consensus view, whether in 2022 or 2023. But the ingredients for a hard landing exist. While conventional wisdom suggests that recessions occur 12 to 18 months after the yield curve inverts, I would not be surprised if it happens earlier this time round.

"A recession is still not the consensus view. But the ingredients for a hard landing exist"
Chester Liaw

Dharmo: I take a more optimistic view. I think we may be past peak inflation fear – not peak inflation, which may continue to persist for a while – but the fear of runaway inflation. With that, markets may start to move away from the stagflation/recession narrative that seems so prevalent at the moment. If indeed growth slows in the second-half of the year, and supply chains begin to normalise, the Fed may not need to hike as aggressively as bond markets are expecting. This would pave the way for a strong second half in bond markets as yields fall and credit spreads tighten.

Joyce: We have witnessed many surprises over the last six months, and these are unlikely to be the last. However, the unknown unknowns that particularly concern me are the deep structural shifts in world economic and political order. We have counted on globalisation for our common economic advancement. But this may start to give in to protectionism. If so, the interdependence needed for global supply chains to function efficiently may be replaced by duplicated and overlapping resources. And the relative peace we now enjoy may erode in the name of self-preservation. These complex and mounting challenges will need to be managed with extreme care.

What advice do you have for bond investors bruised by falling markets in the first half and now wary about the second half of the year?

Joyce: 危机。Do not be afraid of being bruised. Instead, give thanks that you lived through 1H22 to tell the tale. Every difficult market comes with investment opportunities. For bond investors, it is worth remembering that Fed rates hike expectations tend to be front-loaded. With 2-year US Treasuries hovering at about three percent, the market has already priced in significant rate increases till end of 2022 or early 2023. Further interest rate movements will also be better accommodated by bond portfolios that now have higher yield-to-maturity. If you are very concerned about rising interest rates, stay with fixed income portfolios that are shorter in duration.

"Going forward, there are attractive returns to be had in the bond market as yields have risen to pre-Covid levels"

Dharmo Soejanto

Dharmo: Going forward, there are attractive returns to be had in the bond market as yields have risen to pre-Covid levels. In the last few years, we struggled to get more than 2.5 percent yield from high grade bonds. Now, short-term high quality corporate bonds are offering almost four percent yield, stable returns, and are not subject to much interest rate risks. This is a pretty attractive return-risk profile, especially in today's volatile market. If rates begin to fall as inflation fear ebbs, that would be icing on the cake.

Chester: Bond prices have fallen to historically low levels and even longer duration bonds now have an attractive risk reward profile. While investors might have been scarred by market weakness in the first half of the year, current levels present a rare opportunity to invest in high quality bonds for a decent return over the short term. Even a potential recession might not derail returns given the likely rise in US Treasury yields.

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