Outlook: prevailing under pressure

Investors have reason enough for concern. Markets are volatile. Inflation is persistent. Recession risk looms. But there is a bright spot: with yields now higher, bonds are attractive again.

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Geopolitical tensions, elevated market volatility and the fastest pace of central bank tightening in decades are contributing to an unusually uncertain economic environment. Shallow recessions across developed markets are most likely, especially in the euro area and the United Kingdom, which face disruptions from the war in Ukraine, although the real GDP in the US will also likely experience a period of modest contraction.

Core inflation rates that are above central bank targets now appear more entrenched. Although headline inflation is still likely to eventually moderate meaningfully over our cyclical horizon, it now looks likely to take more time. The combination of higher unemployment and stubbornly above-target inflation has put central bankers in a tough spot, but their overall actions to date suggest they are squarely focused on bringing inflation down.

Potential for capital gains

With higher yields across maturities, the case is now stronger for investing in bonds. We believe high-quality fixed income markets can now be expected to deliver returns much more consistent with long-term averages and we think the front end of yield curves in most markets already price in sufficient monetary tightening. For example, investors could combine exposure to high-quality benchmark yields – which have increased significantly in the past year – with select exposure to high-quality spread sectors. This might add potential alpha from active management.

Further, in addition to higher income potential, yields are high enough to provide the potential for capital gains. We expect that more normal negative correlations between high quality bonds and equities will re-assert themselves. At the same time, the higher yields offered in bond markets today could help compensate those who choose to wait out this period of uncertainty.

Caution is warranted

Still, caution is warranted, and if inflation is more sticky than we expect, central banks could be forced to hike rates by more than is priced in currently. If recessions are as shallow as we expect, then policymakers may be slow to cut policy rates to boost growth, given the high inflation starting point. Thus, in core fixed income portfolios, this is an environment where we are prepared to take the active and deliberate decision to reduce risk across a range of risk factors.

The anticipated real economic and financial market volatility will lead to attractive opportunities for investors with patience and fresh capital. The gap between private and public asset valuations remains extreme, but as private markets adjust and challenges become apparent across the corporate credit and real estate space, there should arise opportunities to potentially generate outsize returns. This is one of our highest conviction views. ■