Global Matters Weekly

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Making money in bonds

by Richard Stutley, CFA

Last year, US Treasuries suffered one of their worst years this century[1]. Treasury Inflation-Protected Securities (TIPS), on the other hand, returned +6%, making 2021 a pretty good year for these bonds versus their long-term average[2]. So how did investors like us make money in TIPS; was it purely down to QE-fuelled irrational behaviour; and what do we expect from here?

TIPS respond to real interest rates (the rate you receive after inflation) in the same way as regular bonds respond to nominal interest rates. Real yields went down last year meaning bond prices went up. Driving this was an increase in inflation expectations with no corresponding rise in interest rate expectations (something we don't see very often): while investors came to realise that inflation in the US was running faster and for longer than they had predicted, they nonetheless staunchly held onto the view that it would come down without the Fed having to do much at all.

10-year TIPS started 2021 yielding -1.0% and by August were yielding -1.2%. Is there any justification for paying away 1.2% a year in real terms? If you're not compensated for lending your money you should...: 1. Spend it. Ah but wait; you've got a retirement to fund so you have to save some of your money. 2. Hold it in cash. In that case you'd stand to make -2.4% per annum in real terms, assuming inflation expectations were roughly accurate in August last year.

The theoretical lower bound to nominal interest rates (not real) is probably somewhere around -1 to -2%: beyond this level, I'd imagine it becomes cheaper for people to hold their money in a vault. From that, deduct inflation. So real interest rates on 10-year TIPS approaching -4.5% last year would have been within the bounds of what's theoretically possible – you don't need 'QE-fuelled irrational behaviour' to achieve that, despite what you may think.

Why don't we always and everywhere have negative real interest rates of -4.5%? It would seem a much cheaper way for governments to fund themselves. The answer is the same when we ask the question why we don't we have interest rates of +20%: because it would collapse the economy.

In the case of negative interest rates, if the difference between the riskless rate and the growth rate is large enough, everyone will rush to invest their savings (plus any borrowings) into new ventures, and we'll quickly run out of spare capacity and the economy will stall. While people ascribe a lot of power to central banks, growth rates and risk appetite ultimately determine interest rates: central banks' only job is to try and gauge what these variables are and to set policy accordingly.

At the start of 2021, the market and the Fed's narrative was that inflation would come down of its own accord. Come the start of 2022, the view has shifted and the consensus now is that it will take a few hikes to get us there. We think the hiking cycle discounted by markets may still be too benign to bring inflation down. Hence we're expecting further tightening and remain underweight duration. As we head into the second half of the year, the picture is likely to become more balanced if we're right and there has been a further leg-up in the path of interest rates. In the long run, interest rates are determined by growth and risk appetite, as stated above. Unless you think Covid has increased one or both of these variables, then it is not clear why the economy will ultimately settle at materially higher interest rates than prevailed pre crisis. In the short run, interest rates may need to overshoot this long run neutral level to arrest the current surge in inflation. As we head into H2, we may find we're looking for interest rates to roll over again if consumers are under too much pressure from the combination of higher interest rates and higher prices, which would therefore require a pivot in our duration positioning.

1 J.P. Morgan GBI US Unhedged USD; source Bloomberg Finance L.P.
2 Bloomberg US Govt Inflation-Linked All Maturities. Data on Bloomberg Finance L.P. goes back to 1997

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Important notes