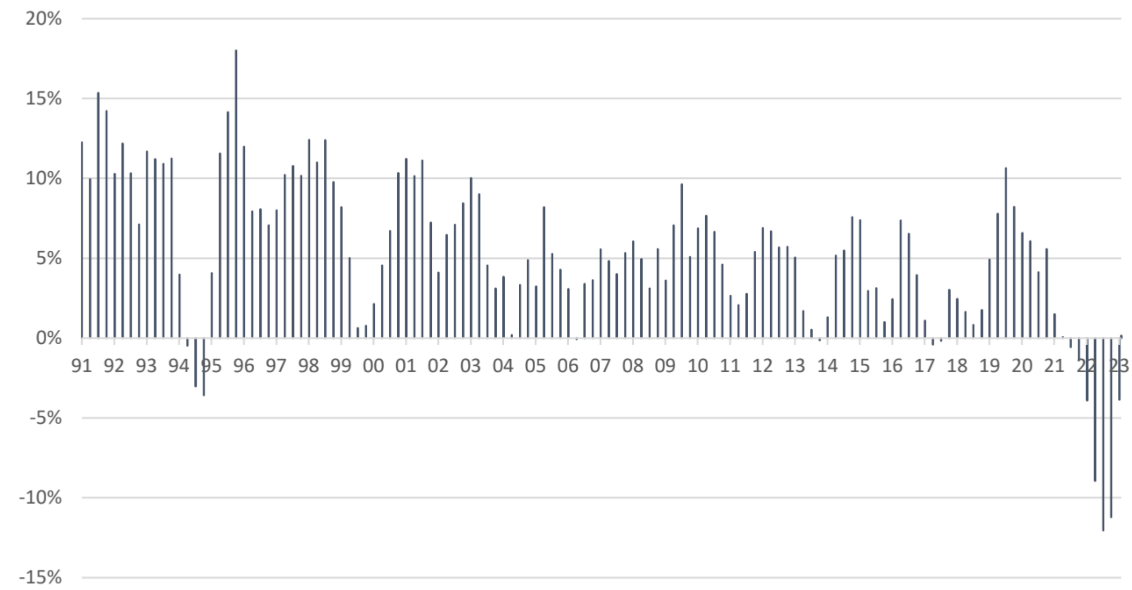
Legacy Wealth Advisors

Bonds Losses in 2022 - That Was Extraordinary, Wasn't It?

2022 saw a marked break in a 30-year trend of largely positive returns for high-grade bonds. The global aggregate index of high-grade bonds generated positive annual returns every quarter from 1995 to 2022, and then bang, investors suffered heavily. Even in 1994/95, the previous period of negative returns losses was limited to minus three or four per cent. What created these extraordinary losses?

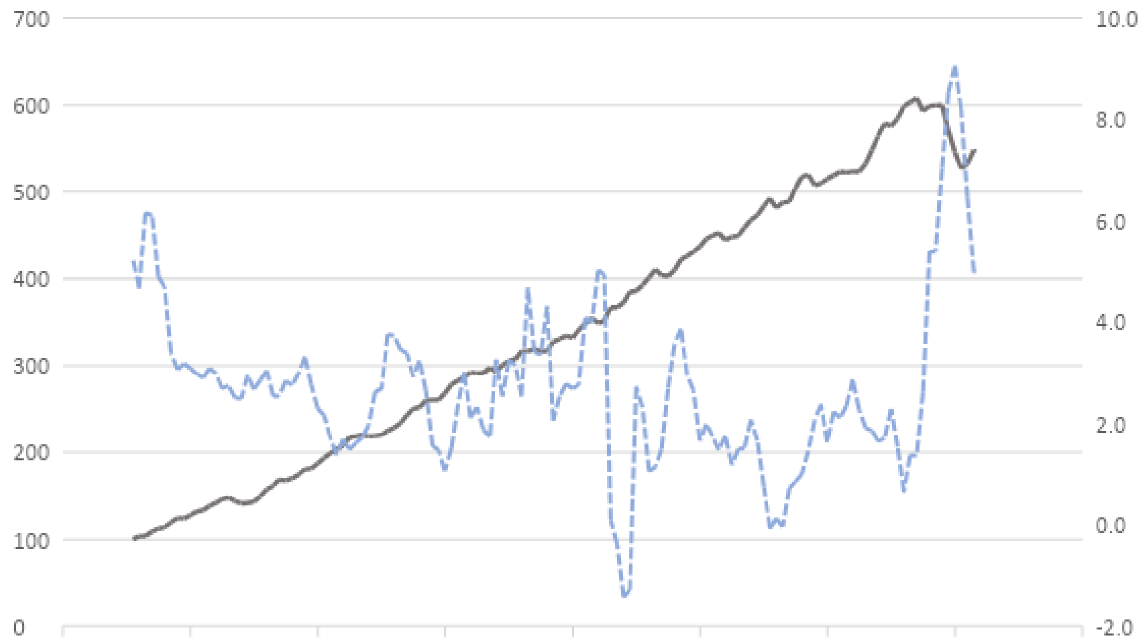
Chart 1: Annual returns from the Global Aggregate Bond Index (%)



Source: Bloomberg and GCIO estimates

From 1990 onwards, global bonds benefitted from a persistent drop in global inflation. In the case of the US, inflation fell from 6.0% to a 2% to 3% range. As inflation fell, central bankers around the world were able to cut interest rates regularly, and over some time, they ratcheted down. Lower policy interest rates from central banks and lower expected inflation allowed bond yields to drop. As bond yields fell, this implied that bond prices rose, generating some extraordinary increases in the capital value of the longer-dated bonds. For example, a one percentage point drop in the yield of, say, a 10-year government bond could lead to around a 7-8% increase in the capital value of the bond.

Chart 2: The Global Aggregate Bond index benefits from the structural drop in inflation until inflation reversed.

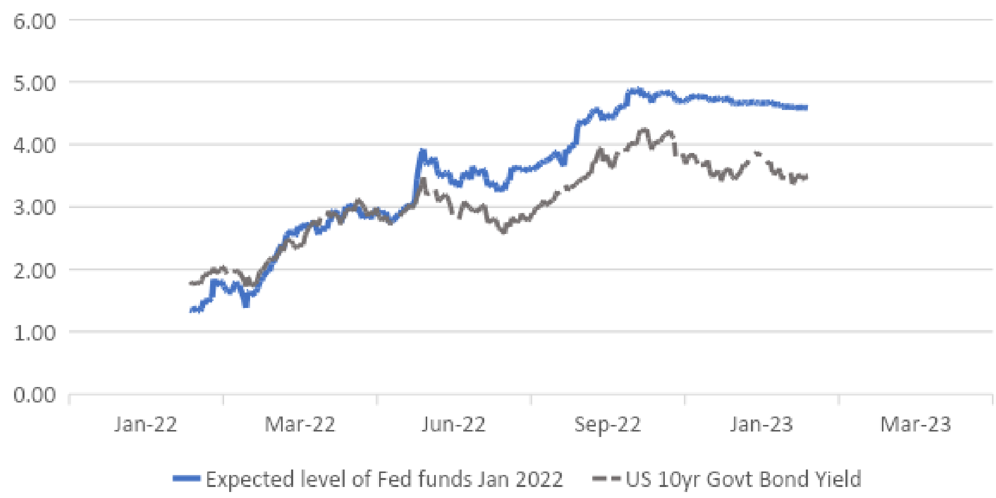


Source: Bloomberg and GCIO estimates

Times, unfortunately, have changed. And they changed dramatically in 2022. Inflation took off to levels well beyond those that the Federal Reserve had expected. Remember, the US Fed's Chairman Powell used the word' transitory' repeatedly. However, at the start of 2022, he had to concede that inflation was no longer transitory, and that the Fed would have a battle to control inflation. That Fed's battle with inflation would require them to raise rates much higher than the market had expected. Unfortunately, the market had had a blind faith in the Federal Reserve's 'transitory; view of inflation and hence it was only when the Fed changed its mind did we see a violent sell off of the bond market

Market expectations for where the Fed funds rate would be in January 2023 increased from 1.25% to a peak close to 5%. The change in market expectations for the Fed funds rate led to a significant sell-off in US government bonds, leading to losses across bond markets. The US Government's 10-year bond yield rose from 1.5% to end the year near 3.5%. Such a rise in yields led to a near 15% fall in the capital value of the US 10-year government bond price. It was indeed an extraordinary year!

Chart 3: Market expectations for where the Fed Funds rate would be in Jan'23, and the level of US 10-year yield



Source: Bloomberg and GCIO estimates

2022's very poor performance of bond markets should be seen as largely a one off. A relatively unique set of circumstances led to the losses that are unlikely to be repeated in the coming years. Now that the dust has settled, bond yields have risen to more attractive levels.

A US 10-year bond yield of 3.5% contrasts with a ten-year range of 0.5% to 3.25% with yields averaging just 2%. Relative to a central bank inflation target of 2%, a 3.5% 10-year bond yield represents a real return (less the target inflation) of 1.5%. The jury is still out on whether the US Federal Reserve will achieve its inflation target but at least investors have the comfort that the bond correction is behind us and that investors can likely look forward to a more positive environment for bond investing in the future.