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Sovereign bond yields begin to resist gravity

In our 2022 Investment Outlook, published back in November, we acknowledged that we were entering a global tightening cycle. However, the short-term continuation of this theme was very dependent on how Covid evolved over winter. The view from January suggests that Omicron could be less severe than previous strains, resulting in fewer hospitalizations. As the threat of this new wave derailing the global economic recovery retreats, central banks have more room to manoeuvre when it comes to dialling back support in order to cool red-hot inflation.

As such, sovereign yields throughout the world have begun to grind upwards again, with a major milestone reached this week: the yield on Germany's 10-year Bund (the Eurozone's benchmark bond) turned positive for first time since 2019, reaching 0.021%. The equivalent US Treasury note yield sits at over 1.8% after rising steadily in recent weeks.

The uptick in yields, led by the US, is largely founded upon the belief that central banks will need to act swiftly to curtail price increases. In December 2021, headline US CPI came in at 7%, the highest level since 1982, while the Eurozone reading came in at 5%, the highest level the single currency was created more than twenty years ago. The UK print, released on Wednesday, added to investor angst about price pressures, jumping to 30-year high of 5.4%. Oil price increases due to geopolitical tensions and an explosion affecting operations of a key pipeline between Turkey and Iraq have not helped either.

Central banks are under increasing pressure to act. In the US, the market is today pricing a Fed rate hike in March with almost 100% probability and at least 4 full hikes in 2022. It also expects the Bank of England (BoE) to raise interest rates three times by August, with a 92% chance of a hike at the its next meeting in early February.

The European Central Bank (ECB) has been more dovish. At its December meeting, Lagarde announced that the governing council had decided to continue its asset purchases after its Pandemic Emergency Purchase Program (PEPP) expires in March, albeit at a slower rate than had been anticipated. Markets are now pricing in two 0.1 percentage point interest rate hikes from the ECB by the end of 2022, despite the ECB's iteration that higher borrowing costs in 2022 are not consistent with its guidance. The ECB has a more arduous task of trying to ensure that the recovery continues to play out across *all* member states: A positive 10-year Bund yield could make German debt more attractive to investors, thus affecting borrowing costs in other Eurozone member states and the companies located therein.

Ultimately, we believe that 2022 will be the year when monetary policy turns more hawkish – albeit to differing degrees across regions. The Fed is a clear leader of the pack as it comes under increasing pressure to cap price gains, especially with the US Midterm elections just around the corner. Any move the Fed makes will not only affect US yields; other yields around the world are likely to move in sympathy, albeit to a lesser extent.

After years of suppressed yields, the sands are shifting in the investment landscape and investors have to be ready. So long as economic growth continues at a healthy pace, we believe equities can still deliver performance. Contrary to this view, some investors are concerned that higher yields could detract from the relative attractiveness of this asset class, and indeed, this could be the case if yields were to go much higher. For now, we would argue that because yields are rising from all-time lows, zooming out, they are still very low relative to historic levels. Moreover, while history usually doesn't repeat itself, it tends to rhyme and past taper episodes have shown that equities can still go up as yields are rising. However, not all companies thrive in such an environment. Those that tend to do best are generally congregated in sectors like Financials, Energy and Materials. We are overweight on all three, with the addition of Healthcare in order to strike a balance between cyclicality and defensiveness – particularly since we see the potential for higher volatility ahead. With yields poised to grind upwards, we are reluctant on government bonds and highly selective in other tranches of the fixed income market.

Upcoming central bank monetary policy meeting dates are as follows:

25th-26th January – The Fed

3rd February – the ECB and the BoE

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