Investment Management

13 December 2022

5 Key Themes for 2023

As each year draws to a close, it's common for investment managers and banks to publish predictions for the year-ahead. In fixed income, these notes tend to be heavily focused on yield forecasts.

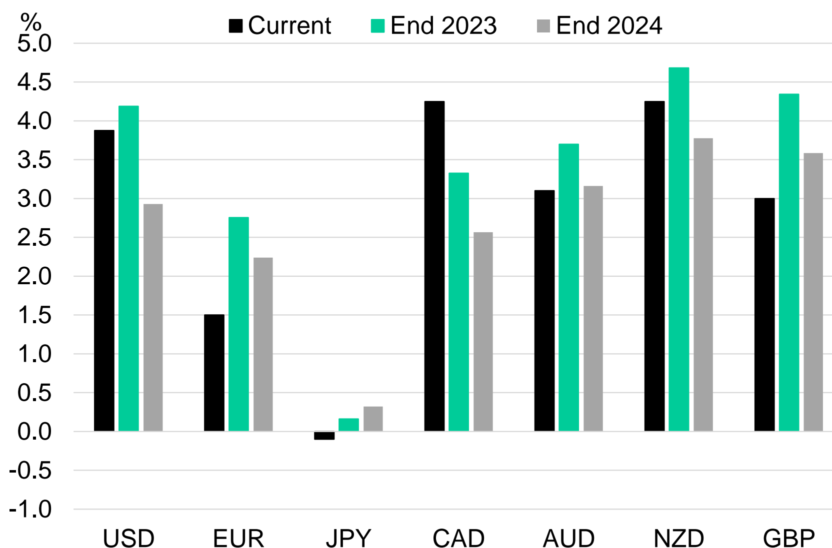
At Ardea Investment Management, macro forecasting is not part of our investment process because we adopt a pure relative value investment approach that aims to be independent of the level of bond yields, the broad direction of interest rates and the macroeconomic factors that dominate the performance of conventional investments.

Therefore, instead of the traditional year-ahead forecasts, in this note we discuss the substantial risks around consensus views and highlight 5 key themes that will impact global interest rate markets in 2023: 1) The peak in central bank rates; 2) The improved risk/reward balance for duration; 3) QT and rising net bond supply; 4) Large tail risks limit scope for volatility to fall; 5) Macro uncertainty supports the RV opportunity set.

1. The peak in central bank rates

2023 is widely expected to mark the end of one of the fastest and most synchronized G10 central bank tightening cycles on record. In the face of surging inflation, central banks had to be aggressive in 2022 to get rates from ultra-accommodative to restrictive through outsized monthly hikes. Rate hikes delivered so far ought to buy central banks some time to pause and assess. Markets are well priced for the consensus peak rates theme in 2023.

Chart 1: Current and market-implied policy rates for 2023 and 2024

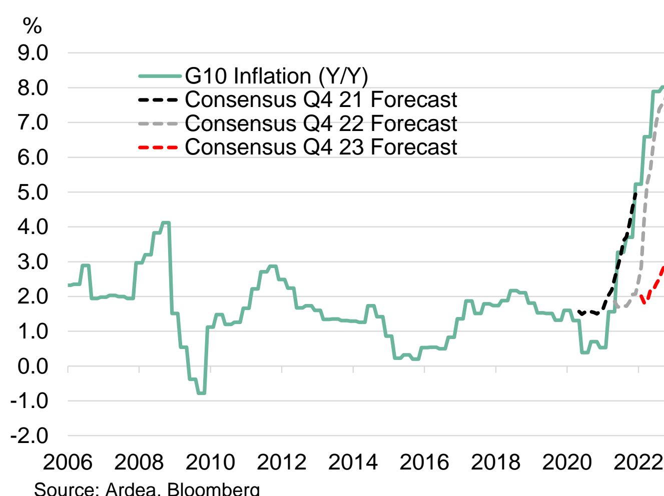


Source: Ardea, Bloomberg
*Pricing reflects 1y and 2y forward 1m OIS rates

The justification for central banks to pause on rates is expected to come from slower inflation and growth. After a year of large upside surprises, there are reasons to think inflation will fall materially, based a few broad factors:

- Global supply chain price pressures have fallen sharply and are at least a quarter of the levels reached at the start of 2022.
- A fading of large base effects from food and energy supply shocks.
- A further material slowdown in global growth, as the impact of policy tightening to date flows through.

Chart 2: G10 inflation and consensus forecast evolution



Source: Ardea, Bloomberg

The effects of surging rates and inflation in 2022 have contributed to a significantly weaker global growth outlook for 2023. On IMF numbers, global growth is expected to be 2.7%, but with advanced economy growth of just 1.1%. For the world this would mark the weakest outcome since 2001 outside the global financial crisis and the onset of COVID. Many market economists have more bearish growth forecasts, and the UK and Europe are widely expected to experience recessions.

The risks to current market pricing and consensus views on rates are significant in both directions, leaving central bank policy uncertainty a major issue for investors to navigate next year. One of the biggest risks – as with 2022 – is the outlook for inflation, where forecasting errors have reached record levels. While it's not hard to see headline measures falling from the current high levels of 8% y/y or higher, by the end of next year inflation is still broadly expected to remain above central bank target levels. Widely held views for a cycle pause are about central bankers gaining comfort in the trajectory more than the level of inflation. Ultimately, economies and in particular labour markets could hold-up better than currently anticipated, so there is a risk central banks become more concerned about ongoing high inflation becoming entrenched. This outcome would see rate hike cycles extend for longer than currently anticipated. In the other direction, a faster fall in inflation or sharper downturn in growth could see rate cuts brought forward.

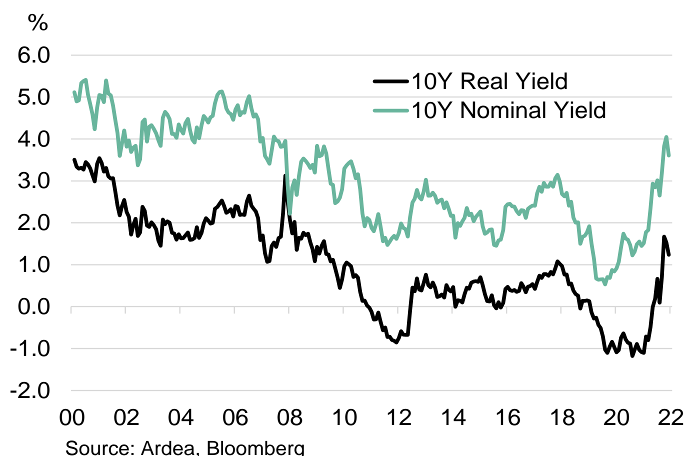
Cross market differences could also turn out to be very large next year, as central banks have varying attitudes on the risks of overtightening. The Fed has been ultra-aggressive in its reaction to higher-than-expected inflation this year, while smaller central banks such as the BoC and RBA have already slowed the pace of tightening.

2. The improved risk/reward balance for duration

2022 has been one of the worst ever years for duration heavy portfolios. So the bar for 2023 being better is low and there is a growing chorus of market participants calling for a bond rally next year. We examine three factors that suggest an improved outlook for duration in 2023:

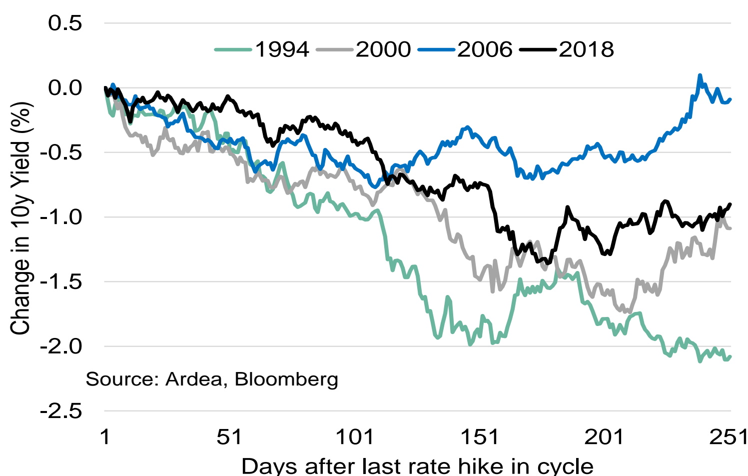
- **The return of yield.** Cheaper valuations following the big sell-off through 2022 improve prospects for bonds, albeit a bit less since the peak in long term yields in October. Nominal yields of 3.5-4.0% and real yields over 1.0% for 10y US Treasuries offer investors a level of pickup for the safest of assets unseen in over a decade. Through 2020 and 2021, long term government bonds were better described as return free risk (as we noted here).

Chart 3: US 10y real and nominal yield over the long term



- **Peak inflation and rates.** The path for bonds through 2023 will come down to the resolution of the tension between slower global growth and rising inflation. If the consensus is right that the Fed, ECB and other central bank rates peak in 2023, then history suggests long duration bonds tend to perform well. Chart 4 shows owning US 10y Treasuries is reliable post the last hike, whether we see a soft or hard landing in the economy. A quicker transition to rate cuts would favour outperformance of shorter maturities - steepening the yield curve after relentless flattening in 2022.

Chart 4: Change in US 10y yield after last rate hike in the cycle



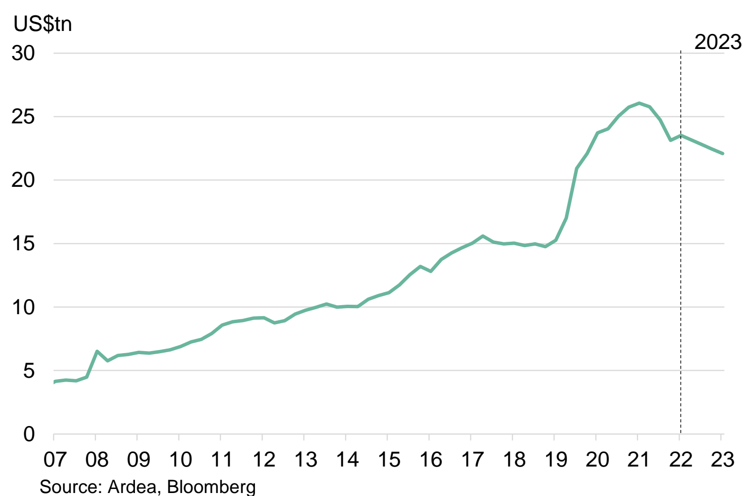
- **Improved risk asset hedge:** The last hike in the cycle also tends to be good for equities, but markets could well be underestimating the significance of an impending slowdown or recession. Bonds yields are now high enough to offer a more attractive buffer in multi-asset portfolios. This hedge value of duration is one reason why longer maturity bonds still appeal to many investors despite global yield curves being steeply inverted or historically flat (depending on market).

Much like we described in our key themes note this time last year, the level of global macro uncertainty is still very high. By far, getting the call on inflation wrong could again prove most costly for investors. The potential for persistent high inflation to set into wages or another surge higher in commodity prices could be enough to see the market jettison peak policy views in a hurry. These and other issues may not be resolved quickly next year, which means yields are likely to track quite wide trading ranges.

3. QT and rising net bond supply

Central banks have ended their massive covid QE programs and are transitioning quickly into quantitative tightening (QT) or actively reducing balance sheets. This marks a big shift for bond markets. Across markets, central banks hold anywhere from 25% to 50% of bonds outstanding. The next year is likely to see over US$1tn of QT from the largest central banks.

Chart 5: G4 central bank assets set to decline in 2023



Source: Ardea, Bloomberg

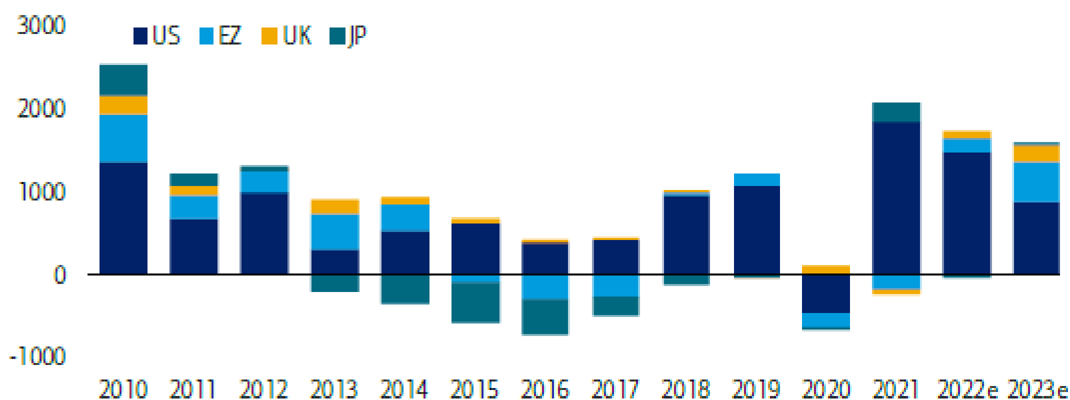
The main implication of QT for government bond markets is increased net bond supply for private investors to absorb (there are other effects such as reduced excess cash reserves, which can impact money markets). The shift in the demand burden to private investors to take down more of the net issuance next year poses risks for markets. For their part, central banks generally aim to implement QT in a consistent and predictable manner, in contrast to the more aggressive removal of duration from the market when entering QE. Still, the impact of QT is likely to be quite profound in 2023. The magnitude of the extra issuance will vary considerably by region and could see bond underperformance and steeper curves in markets where the relative net supply increase is largest, such as Europe and the UK (Chart 6 shows one projection of how global net supply for 2023 could evolve).

In the US, the Fed is set to continue its existing pace of QT, which consists of allowing steady maturities of $60bn in US Treasuries and $35bn in MBS per month. For 2023, that implies an extra $720bn of bonds the Treasury will have to refund and investors therefore absorb, up from $150bn in 2023. The market impact is somewhat mitigated by an improved fiscal position.

The relative size of the increase in the free float supply is expected be largest in Europe and the UK. Over the last decade, previous larges waves of European government bond supply came at a time of simultaneous large increases in ECB purchases. For the seven years prior to 2022, negative net issuance was the norm in Europe. The tide is now turning. Many analysts anticipate the increase in the net supply of bonds after QE in 2023 to be the largest on record at €400-700bn. There is a lot of variation around estimates given underlying assumptions about the timing and pace of ECB actions, as well as assumptions on new government spending initiatives.

Since 2008, the UK has also only seen large issuance tasks at times of QE. The BoE has resumed its QT plans after the government credibility crisis in September drove EM-like moves in Gilts (see this note for further details). Even with new leadership and plans, the 2023 increase in bond supply is substantial. Many analysts look for issuance net of QE to rise to £250-300bn of gilts next year, compared with prior peaks closer to £100bn in the last decade.

Chart 6: Government bond supply, net of QE and maturities (US$bn)



Source: BofA Global Research, Bloomberg, Treasury, Federal Reserve, Note: numbers exclude historical & expected changes in central bank holdings, US figures exclude T-bills.

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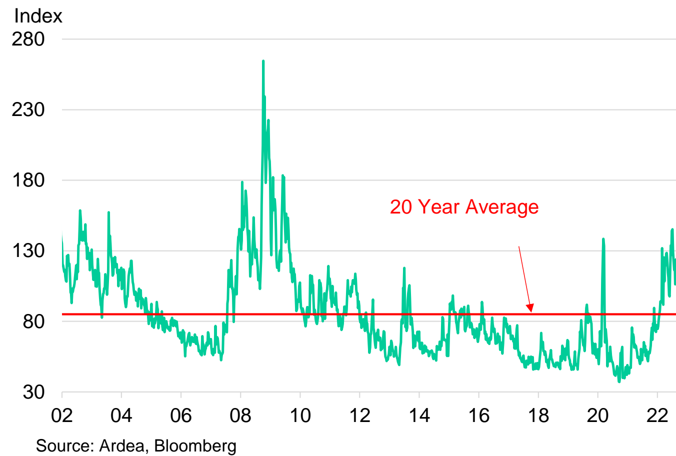
4. Large tail risks limit scope for volatility to fall

The shock and awe of constant inflation upside surprises and outsized interest rate increases has driven global interest rate volatility to historically high levels in 2022. As Chart 7 illustrates, the MOVE index of US Treasury option implied volatility reached the highest level since 2009, triple the late 2020 lows and the upper end of a 20-year range. Comparable measures of volatility in EUR rates eclipsed the 2008 peak and in GBP volatility surged to new record highs through the September UK market crisis.

Chart 7: US Treasury Market Implied Volatility (MOVE Index)



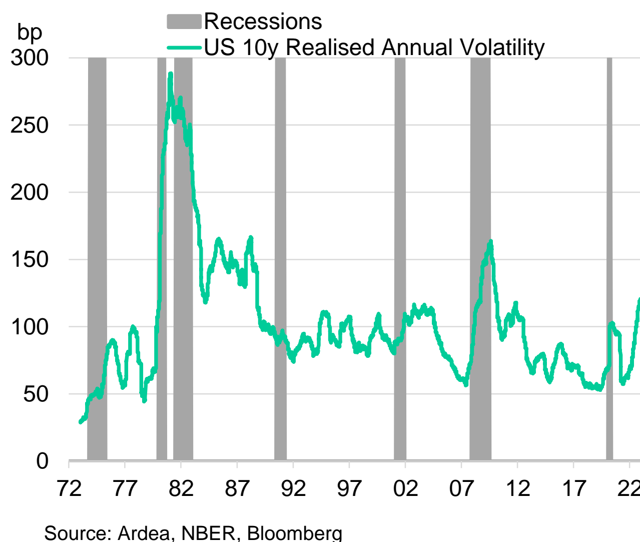
Source: Ardea, Bloomberg

The last month has seen volatility retreat from those extremes, to what are still high levels. The catalyst has been speculation central banks will slow the pace of tightening. As discussed in Themes 1 and 2 above, if central banks are nearing a cycle peak in rates, then the recent downshift in volatility could continue into 2023.

However, as also outlined above, the scale of macro uncertainty in both directions on rates remains substantial and not easily resolvable in a stagflationary regime. Therefore, volatility seems unlikely to fall back to the 2020-2021 lows in a hurry and could remain elevated in 2023. Of course, if inflation fails to fall meaningfully, then elements of the 2022 regime could linger next year. But even if inflation does fall as the consensus expects but remains above target, a policy pause could push up volatility if markets ponder a policy mistake.

In a broader recession scenario, a faster move to central bank rate cuts and flows into bonds from riskier assets could drive a substantial bond rally. As Chart 8 shows, in a long run US context, the current level of realised volatility in the US 10y yield of over 100bp is historically consistent with recessions. The peak in volatility tends not to be seen until the recession is in full swing. Major corrections in equities also tend to occur as recessions unfold.

Chart 8: Rolling annual realised volatility in US 10y yield



Source: Ardea, NBER, Bloomberg

5. Macro uncertainty supports the RV opportunity set

Opportunities in interest rate RV don't rely on the broader level and direction of rates, risk asset performance or macro variables like growth and inflation. While there isn't an absolute clear good or bad market for pure RV portfolios, in general the links with broader market environments are as follows (as outlined here):

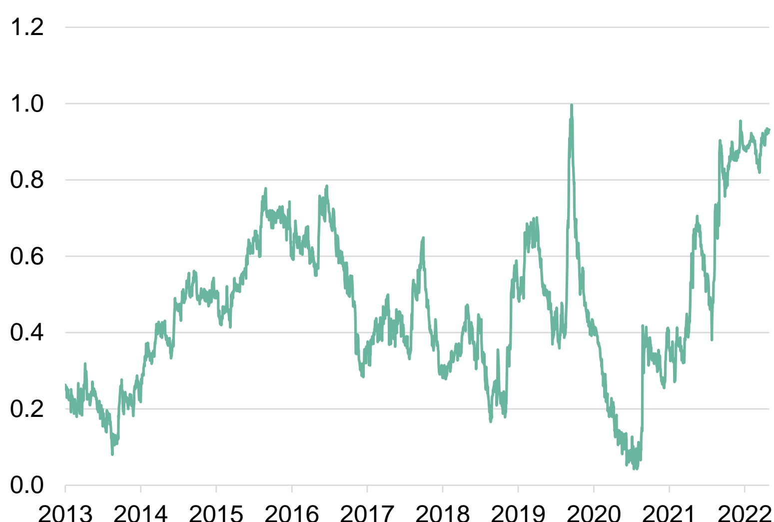
1) Extreme low rates volatility (such as the Japan experience) is a negative.

2) Higher rates volatility is generally positive, but not in all situations.

3) RV alpha is structural, but the mix of opportunities changes with underlying market factors such as bond supply/demand dynamics.

However, the pressures on RV over the last year have been unusual. In a September note, we outlined how the nature of the surge in macro market volatility in 2022 spilled over into unusually high levels of stress in global interest rate relative value. We showed how measures of stress in micro yield curve and bond RV reached 2-4 times normal levels. As outlined in our prior note, RV pricing relationships are unlikely to remain at 2022 extremes indefinitely, even if volatility remains higher than normal.

Chart 9: US rates RV stress index*



**5y rolling percentile - equal weighted index of bond RV mis-pricings based on model, PCA for micro yield curve distortions, Swap-bond spread curve variation, money market spreads and option vol.*

Beyond an anticipated easing in stress indicators from extremes, the high level of underlying macro uncertainty is likely to create new RV trading opportunities in 2023. The tension between high inflation and weaker growth can further distort yield curve shapes as the market struggles to price a wide distribution of rate outcomes. High macro uncertainty also gives rise to flows which leads some sectors of bond curves to cheapen or richen relative to others. The rise of net supply and QT discussed in theme 3 is already leading to increased risk premiums in government bonds and we anticipate this to continue next year.

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