The Evolution of bond markets and where to next?

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To commemorate our Exchange Traded Fund (ETF), the ActiveX Ardea Real Outcome Bond Fund (Managed Fund)'s 5-year anniversary, ASX: XARO, we are reflecting on the evolution of bond markets over the period. Over the past five years, bond markets have witnessed remarkable transformations, reshaping the investment landscape. From a pandemic to growing global macro-economic pressures, the role of fixed income in portfolio construction remains important. To maximise the benefits of bonds for today's investor, it is crucial to understand what has driven this market evolution and where to next.

Chasing stability amongst global uncertainty

In 2018, cash rates and bond yields were at very low levels, having been in decline since the 1990s. The RBA cash rate was at 1.5%, 3-year yields had declined to just under 2% and 10-year yields to 2.5%. However, an unprecedented storm was brewing, COVID-19, which swept across the world and along with it triggered a seismic shift in bond markets, driving investors towards the safety of government bonds, resulting in record-low yields globally.

Central banks reacted to rescue their economies from the pandemic's economic impact by cutting interest rates aggressively and launching massive bond-buying programs to inject liquidity into financial markets. These actions drove yields to historic lows in 2020. In Australia, 3-year bonds reached a low 0.08% and a 10-year low of 0.61%. While in other countries, negative yields appeared.

At this point, the threat of inflation was not on the radar. These extremely low interest rate levels along with government fiscal stimulus measures and a vaccine brought signs of economic recovery.

Growing expectations of inflation started to move longer-term bond yields higher as investors sought higher yields to protect against potential return erosion. These inflation concerns triggered fears of a tapering of central bank support and led to periodic volatility in bond markets, causing fluctuations in yields. Major central banks, such as the US Federal Reserve, communicated their intention to maintain accommodative monetary policies despite the 'temporary' spikes in inflation. Such reassurances aimed to stabilise markets and mitigate volatility in bond yields.

Inflationary pressures continued to grow as labour markets around the world tightened. This pushed wages higher, leading to a sustained and aggressive tightening of monetary policy by central banks through 2022 and 2023. Short term interest rates in Australia are now over 4% higher than in 2022, while the US Federal Reserve and other central banks have increased their cash rates by over 5% over the same timeframe. As at Mid January 2024, the Australian 3-year yield sits around 3.85% and the 10-year at 4.3% having rallied sharply since the end of October, as the markets attention turns to rate cuts as inflation begins to fall. These yield movements have caused bond market indices to reverse from negative returns to having positive returns for calendar year 2023, following the negative bond market returns for calendar years 2021 and 2022.

A calm surface, underlying volatility

Today, the bond yield story continues to evolve. On the surface, bond markets appear to have calmed considerably, relative to the historic extreme turmoil of 2022. However, beneath the surface, bonds remain highly volatile by historical standards. This is due to elevated macro uncertainty, stemming from the tension between inflation versus recession risk. Despite inflation generally surprising to the upside of consensus forecasts over the last two years, markets are now pricing a forward-looking expectation that inflation, and by extension interest rates and bond yields, has peaked and will fall relatively quickly from current levels.

The current consensus view about future inflation is a key reason most equity markets (and riskier assets more broadly) resisted the gravitational pull of higher rates over 2023. Markets are currently priced for a benign scenario in which inflation and interest rates have already peaked and economies will avoid recession.

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Where to next? From volatility suppressors to amplifiers

We are now in a regime where central banks have flipped from being volatility suppressors to volatility amplifiers. Since the GFC, the dual policy objectives of most central banks were aligned in the same direction. Inflation was generally running well below target levels, which justified monetary policy stimulus to lift inflation and support economic growth. Any time economic growth was at risk, it was easy for central banks to justify more stimulus to quickly get things back on track, which meant they acted as a safety net or a volatility suppressor.

With the regime shift to higher inflation, the dual policy objectives of central banks were in opposition to each other as monetary policy tightening to control inflation, slow economic growth and risked tipping economies into recession. As a result, central banks became volatility amplifiers.

For portfolio construction, the result of central banks becoming volatility amplifiers, combined with inflation uncertainty, the market is now in a regime of structurally higher bond market volatility and more variable bond versus equity correlations. This has implications for multi-asset portfolio construction. While it used to be sufficient to just rely on government bond duration to diversify equity beta exposure, this is no longer enough. With duration now more volatile, and having more variable correlation to equities, additional portfolio diversification levers are important. Employing strategies, such as XARO's pure relative value approach, which are uncorrelated with lower volatility when compared to conventional bond investments of duration or credit can provide positive performance benefits.

Amid these stormy market conditions, defensive asset allocations still have an important role to play for investors. As global macro-economics continue to shift and central bank priorities evolve, it will be important to carefully consider the role of fixed income in portfolio construction. To mitigate volatility and risk, a diversified, high quality bond strategy that prioritises liquidity and capital preservation will be important.

XARO ETF

Since its inception in December 2018, the ActiveX Ardea Real Outcome Bond Fund (Managed Fund) (XARO) has ascended to become one of the largest actively managed fixed income ETFs in Australia. Its launch marked a paradigm shift, being the first actively managed fixed income ETF in the Australian market not constrained by an index. It was specifically designed for investors seeking to diversify from traditional equity and fixed income products and to deliver stable and can provide higher returns than those provided by term deposits and cash[1].

Over this period, XARO has had a track record of delivering returns exceeding cash and inflation since inception, while maintaining minimal correlation to fixed income, credit, and equity market performance. Returns generated are independent of level of bond yields, the direction of interest rates and the macro factors that dominate conventional fixed income, highlighting its potential to navigate uncertain financial landscapes.

Head to ActiveX Ardea Real Outcome Bond Fund (Managed Fund) (XARO) to find out more.

[1] ActiveX Ardea Real Outcome Bond Fund (Managed Fund) ETF primarily invests into the Ardea Real Outcome Fund which launched in 2012.

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