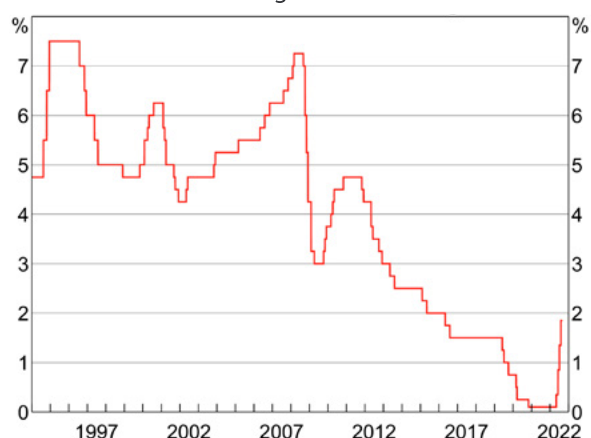
October 2022

What has happened to Fixed Interest markets in 2022?

Fixed Interest in 2022 has had its biggest sell-off in living memory. This has been driven by rising bond yields, as a result of the rapid increase in inflation and interest rates. Over the long-term, we still expect this asset class to deliver positive returns and diversification benefits.

To understand this current bear market in Bonds, it is important to explain that if yields rise rapidly, the value of a Fixed Interest investment falls. This is because the fixed yield on an existing investment is now lower on a relative basis, and therefore considered less attractive, than a new investment which attracts a higher yield. Small corrections happen frequently in the Fixed Interest market when we get a rise in bond yields. The magnitude of this current sell-off, however, has been driven firstly by the fact that yields were exceptionally low in 2021.

Australian Cash Rate Target

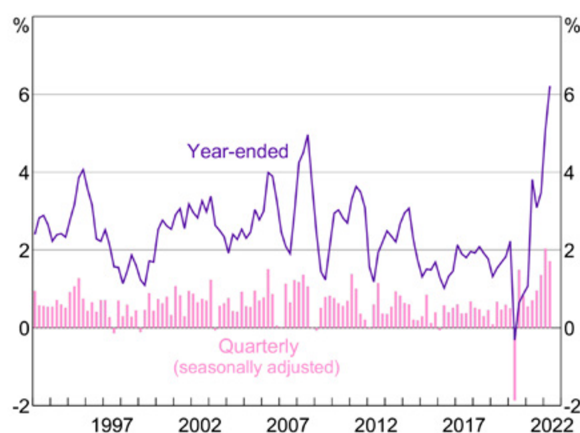


Source: RBA, September 2022

The lower the starting yields, the more painful a 1% rise in bond yields is for Fixed Interest investments. That is, if yields are at 2% and rise to 3% in quick order, the paper losses will be more significant than an equivalent 1% move from 5% to 6%. As can be seen above, Fixed Interest assets were especially exposed to a sell-off given interest rates were at zero through 2020-2021 and bond yields were at historic lows.

We subsequently have seen the sharpest sustained rise in inflation across the Organisation for Economic Co-operation and Development (OECD) in a generation. This was driven by a combination of COVID-19 related supply side issues, the war in Ukraine and its impact on commodity prices and increasing consumer demand.

Consumer Price Inflation*



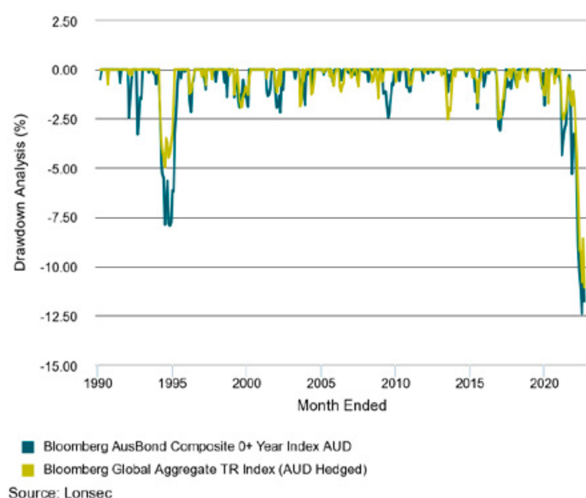
* Excludes interest changes prior to the September quarter 1998; adjusted for the tax changes of 1999–2000.

Sources: ABS, RBA, September 2022

This sudden spike in inflation and subsequently interest rates have driven these large losses across Fixed Interest markets as Bond markets reacted, pricing in higher yields. Both Australian and US 10-year Government Bond yields have risen to around 4%, having been between 1.5–2% at the beginning of the year. What this means is that the AusBond Composite Index, which is the most common measure of the Australian Fixed Interest market, is down approximately 9% from late 2021 through to now. Meanwhile the global equivalent, the Bloomberg Global

Aggregate Index (AUD Hedged), is down approximately 11%. These are the largest corrections seen in this asset class in at least the last 40 years and eclipses the 1994 Bond market sell-off. The following charts illustrate these indices drawdowns since 1980.

Drawdown Analysis



Source: Lonsec, September 2022

Shouldn't my fixed interest allocation be the defensive part of my portfolio?

Yes and typically high quality Fixed Income assets have been the defensive anchor in a portfolio. It's important to note, however, that short-term losses have occurred frequently over the years, albeit they have typically been limited to 2% in normal sell-offs. This time, however, the losses have been far greater than recent market experience, driven by the sharpest rise in both inflation and interest rates for decades. The result has been the worst Bond market sell-off arguably ever, and certainly since the 1970s. While it may be cold-comfort in some regards, it is worth noting that this record sell-off of around 10% in Fixed Interest, still compares favourably to Equity market sell-offs where we have had drawdowns as large as 50% in the past.

What's the outlook and should I still have a Fixed Interest allocation in my portfolio?

Historic sell-offs have typically represented strong buying points across both Equities and Bonds when considered from the long-term perspective. The current situation, while uncertain, would not appear to be fundamentally different in this regard. The expected return on Bonds is now far higher than it was. Purchasing an individual 10 year Government Bond today would provide around a 4% per annum return if held to maturity, whereas a little over six months ago a similar purchase would have only offered somewhere between 1.5–2% per annum. Furthermore, while there may still be some further downside risk in the short-term with Bonds, that downside is more limited than it was six months ago. As explained above, further increases in rates and yields will have less and less of a negative impact on Fixed Interest returns as it becomes a smaller move in percentage terms when compared to the current interest rates and yields.

Over the long term, Insignia Financial Research still view both global and domestic Bonds as important in the context of an overall diversified portfolio and would expect them to deliver positive returns. It remains important to manage your portfolio in line with your long-term objectives, aligned to your risk tolerance and to that end we would encourage clients to discuss their portfolio with their adviser.

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