Three benefits of higher income in fixed income

UBS Asset Management | Fixed Income views

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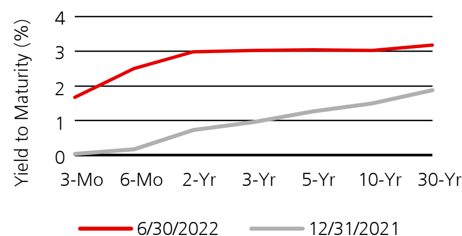
After an extended period of accommodative monetary policy, major central banks have ramped up their hawkish rhetoric to normalize policy by rapidly raising rates and shrinking their balance sheets. These moves, coupled with geopolitical concerns have translated into a sharp repricing higher of interest rates across the yield curve and a widening of risk premia. So how can higher yields benefit fixed income investors?

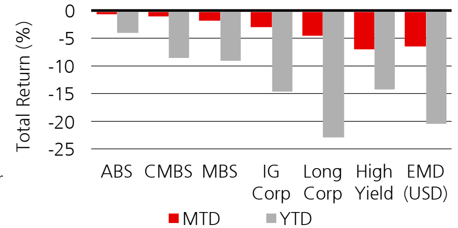
To say 2022 has so far been a difficult year for fixed income investors will be a gross understatement. Investors have had very little to cheer about as rising bond yields and widening credit spreads have conspired to deliver the largest losses across the fixed income spectrum in many years.

US Treasury yield curve movement since the turn of the year



Source: Bloomberg as at 30 June 2022

Total Returns of major fixed income asset classes



Source: Bloomberg as at 30 June 2022

Amid the chaos however, there has been one positive development; the current yields on offer in most fixed income sectors is considerably higher today, and the amount of negatively yielding debt has all but evaporated. Income is finally coming back to fixed income and here are three reasons for optimism:

- **Over the long-term, yield is by far the most stable and reliable component of total return for bonds.**
- **Higher break-evens (from higher yields) act as “shock absorbers”.**
- **Investors no longer need to reach for yield by taking unnecessary credit risk.**

Since the Great Financial Crisis in 2007/2008, G3 central banks have undertaken various forms of quantitative easing in response to economic shocks, including purchases of government and corporate bonds. This, combined with the demand for yield from ageing populations and secularly low inflation have kept a tight lid on bond yields. At the height of this ”mad dash for bonds”, a record USD 18 trillion of assets traded with a negative yield – a situation that became even more absurd when bonds of certain sub-investment grade European issuers traded at a negative yield.

More recently, however, markets have repriced yields meaningfully higher as central banks fight to keep inflation expectations from becoming unanchored amid the highest inflation recorded in the past 40 years. Additionally, credit spreads have widened as geopolitical uncertainty, fears of a global recession and continued removal of accommodative monetary policy cloud the outlook.

The mountain of negatively yielding date is shrinking

Source: Bloomberg Barclays Global Aggregate Index, data as at April 2022.

For fixed income investors, there is a silver lining: these developments mean that the starting point today – from a yield perspective – is, in our view much more attractive and here is why that matters:

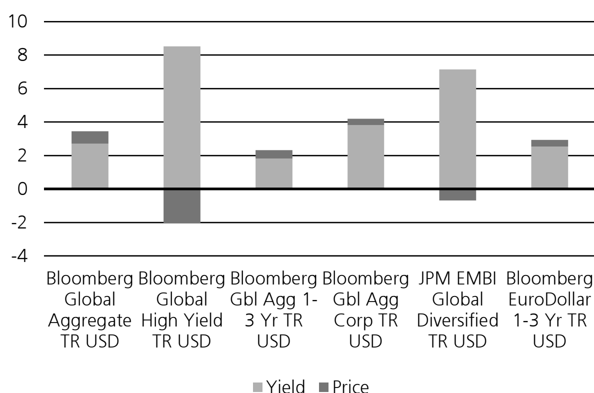
Reason 1

Over the long-term, yield is by far the most stable and reliable component of total return for bonds.

Over the past 20 years, yield (income) has been the dominant driver of total returns in bond portfolios, as evidenced in the chart below. For certain asset classes such as high yield and emerging markets, price return has been negative over the long term yet performance has been positive and very strong, demonstrating the power of yield.

Breakdown of fixed income sub asset class total return over the past twenty years

Total return by price and yield

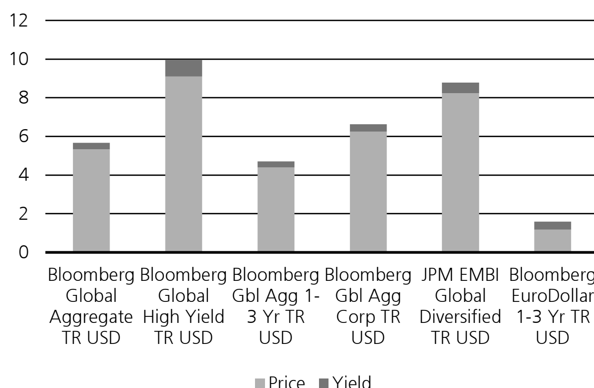


Source: Bloomberg, data period from 2 February 2001 to 30 June 2022.
Past performance is not a guide to future results.

Despite the large role yield plays in total return, it only contributes a minor proportion towards total return volatility. From the below chart – which simplistically displays yield and price as a proportion of total return volatility – we can see that while yield has contributed the most to total return over the past two decades, it has done so while contributing a lower percentage to the overall volatility. This high return and low volatility aspect of yield makes the recent increase in yield (income) a reason for investors to be cheerful.

Breakdown of fixed income sub asset class standard deviation over the past twenty years

Standard deviation by price and yield



Source: Bloomberg, data period from 2 February 2001 to 30 June 2022.
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Reason 2

Higher break-evens (from higher yields) act as "shock absorbers".

Break-evens in this context simply refer to the magnitude of rate increases needed to wipe out the head start provided by yield income from a total return perspective. In general, the higher the level of yield, the larger the magnitude of rate increases required to generate a negative total return (i.e., wipe out positive contribution from income). Take the Bloomberg Global Aggregate 1–3 Year Index for instance, at the end of 2021, this proxy for conservative fixed income investing required just a 38 bps rise in bond yields to generate a negative return. As a result of "income coming back to fixed income", this same benchmark now requires nearly 127 bps of yield increases to erase its higher yield advantage. Below we show break-evens for major fixed income asset classes and how much they have changed since the beginning of the year.

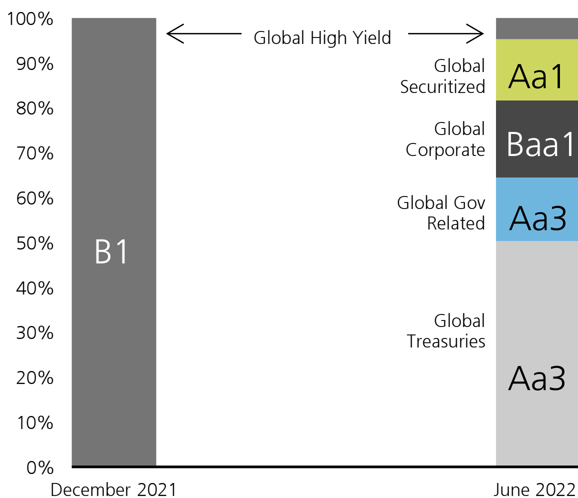
Index	Break-even in December 2021 (bps)	Break-even in June 2022 (bps)	Extra cushion to absorb rising yields (bps)
Bloomberg Global Aggregate Index	17	42	*+25*
Bloomberg Global Aggregate 1-3 Year Index	38	127	*+89*
Bloomberg Global High Yield Index	114	217	*+103*
Bloomberg Global Agg Corporates Index	25	65	*+40*
Bloomberg Eurodollar 1-3 Year Index	63	196	*+133*
JPM EMBI Global Diversified Index	66	126	*+60*

Source: UBS Asset Management, JP Morgan, Bloomberg. Data as of 30 June 2022.
Past performance is not a guide to future results.

Reason 3

Investors no longer need to reach for yield by taking unnecessary credit risk.
In a regime of ultra-low government bond yields and steep yield curves, investors in developed markets bonds were faced with a rather difficult trade-off: generate higher yields by going out longer on the curve and taking on more interest rate risk, or dip down the credit quality spectrum and be saddled with higher credit risk. As the below table shows, only as recently as December of 2021, the only major developed market fixed income asset class offering yields of 2% or higher in the all-encompassing Bloomberg Multiverse Index was global high yield. Today, on average, each major fixed income asset class offers a yield equal to or greater than 2%. Investors can therefore potentially build a globally diversified portfolio with an attractive level of income.

DM Fixed Income Sectors with 2% yields or higher



Source: Bloomberg, as of 30 June 2022.
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Risks in a world of rising yields
Although there are benefits to having higher yields today, we should keep in mind that with the Fed focused on stamping out persistently high inflation, the terminal Fed funds rate and US 10-year yields could settle at levels higher than their respective peaks in 2018. Kevin Zhao, Head of Global Sovereign & Currency provides an outlook in the latest edition of Panorama. Should this materialize, investors will likely experience further price declines from duration-sensitive bond holdings. However, as we noted earlier, bonds are better placed today to handle further price declines due to higher spread break-evens.

Secondly, with headline inflation in Europe and the US at multi-decade highs and the Fed's own preferred gauge of inflation, the core PCE, significantly above its long-term target, investors are feeling the squeeze from a real purchasing power standpoint. However, over the medium term, this measure should decline from current elevated levels.

Finally, an increased risk of global recession and ongoing geopolitical strife could present headwinds to total returns through further widening in credit spreads.

Bringing it all home
In summary, the stability and dominance of yield as a potential source of total return for bond investors, the additional buffers created by higher yields, and the diminished need for investors to chase income in riskier assets are all benefits of higher income returning to fixed income. However, a high starting income does not guarantee success. Investors need to embrace flexible, nimble and time-tested investment strategies to best navigate the choppy waters ahead.

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