Bond investors see light at the end of the tunnel

- After months of sell-down, most bond sectors enjoyed small gains in May.
- Bond issuers were also busy last week with the highest number of new issues since March 2022
- However, hopes of a smooth and broad-based recovery across all bond sectors may be premature
- Instead, opportunities lie within select sectors able to capitalise on ongoing inflationary and volatility themes.

Have bond yields peaked?

For a time during the course of 2022, it felt as if the bond market weakness would never end. Despite early reassurances that inflation would be "transitory", bond investors watched as one thing after another conspired to push up US inflation to its highest level in 40 years.

Faced with this unrelenting rise, the Fed was forced to signal a series of aggressive rate hikes. Meanwhile, liquidity is being withdrawn sooner and faster than expected as part of the Fed's quantitative tightening plan. This caused 2-year US Treasury (UST) yields to rise to a high of 2.73 percent in early-May, a level not seen since late 2018. Credit spreads also widened during this time.

Since then, 2-year UST yields have eased slightly, ending the month at 2.56 percent, making May its best performing month since November last year. 10-year and 30-year UST yields were flat for the month, while global investment grade bonds and emerging market sovereigns managed small positive returns. As a result, the iShares core US Aggregate Bond ETF, the world's largest bond exchange-traded fund, rose 0.4 percent last month against a drop of nearly 10 percent this year.

Slowdown fears taking over

These modest gains have been greeted by some bond investors with much excitement, with a few even claiming that the sell-off is over. Part of the reason for this optimism is the market's change of focus away from inflation and towards the prospect of slowing US growth. A scenario of slow (but positive) economic growth that is accompanied by subdued inflation and still-respectable corporate earnings, is generally good for corporate bonds.

Bond market bulls point to several recent indicators to make their case. Firstly, consumer demand and business sentiment are in moderately good shape across most major economies. Secondly, US inflation rose 8.3 percent in April compared to a year ago, but this was 0.2 percent less than the March figure year-on-year, and 1.2 percent less month-on-month.

Going forward, they believe that the Fed will be able to perfectly fine-tune rate rises, such that inflation and economic growth both trend down but not too much. This would be a sweet spot for high grade and even some high yield corporate bonds. Even if the Fed over-tightens such that the economy starts to contract, government bonds become attractive as a way to secure above-deposit returns via a relatively low-risk asset.

Attractive yields

Bond issuers seem to agree with this increased optimism. Last week, new corporate bond issuances in Asia totaled US$7.38 billion - more than three times higher than the previous week – from such high profile names as Korea Development Bank and the Industrial and Commercial Bank of China (ICBC).

This despite that fact that foreign investors continued to cut their holdings of yuan-denominated Chinese bonds in April, the third straight month of outflows. US investors chose instead to stay closer to home, given the erosion of yield differentials between US and Chinese sovereign bonds.

US bond yields are also thought to have risen to the point that they are able to attract both retail and institutional investors. With longer maturity high grade corporate bonds yielding as much as 5.0 percent, there appears to be renewed interest from pension funds and insurers, despite the potential for further short term volatility.

Not yet time to celebrate

While these factors may help to provide a bottom for bond markets, we do not see signs that bond markets are out of the woods yet. The May 31 announcement by European Union leaders that they intend to cut Russian crude oil imports by as much as 90 percent over the next few months could see oil prices climb to new levels. Shanghai's re-opening after two months of lockdowns is also expected to re-ignite the upward pressure on global commodity prices.

Meanwhile Fed Chair, Jerome Powell, left the door open to more intensive interest rate hikes, saying, "If things come in worse than we expect, then we are prepared to do more." At the same time, he warned that a soft landing for the US economy was dependent on factors beyond the Fed's control.

Selective opportunities

Against this backdrop, we believe there are opportunities for positive bond returns, but within select sectors and themes, rather than across-the-board. Here are three themes that look likely to retain their appeal over the medium term:

• *High commodity prices*

Given that commodity prices look set to stay high and may even rise further, bonds offered by corporates able to capitalize on this trend looks set to remain attractive. This includes upstream commodity producers, that is, those that extract or produce high-demand raw materials. In addition, credit offered by corporates within the industrial and food sectors, especially those able to draw on secured supplies and pass on cost price increases to their customers, are likely to see good demand.

• *Market volatility*

Financial sector bonds offer some resilience against volatile markets and heightened uncertainty. The spread (ie yield differential) for financial sector bonds versus sovereigns has barely changed since the start of the year, compared to an increase of over 400 basis points for bonds issued by real estate companies. In general, the Asian ex-China banking sector looks set to enjoy better margins and good profitability given the rising rates environment,

• *Recovery*

After the extended period of Covid restrictions, many Asian economies have re-opened their borders and normalised domestic activity. This has paved the way for a recovery of shopper traffic and tenant demand for office and retail space. A healthy list of Asian property developers and real estate investment trusts (REITs) are issuing bonds to tap this recovery, with the focus largely on commercial real estate and hospitality. REITs' bonds are sought after because they offer relatively attractive yields even at low maturity.

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