



Broken Bonds - why are equities and bonds both falling?

Blog Post, June 2022

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Current Situation

The current situation is rare in that both equities and fixed income have been falling. High inflation and fears of a slowing growth rate have been headwinds to both asset classes and headaches to central banks.

Inflation concerns have rapidly increased in the first half of the year. While central banks thought inflation would partly normalise and take care of itself in 2022, they were blindsided by the sudden Russian invasion of Ukraine. Russia is also a major energy and commodity producer with it providing roughly 10% of the global supply of oil and supplying Europe with around a quarter of its crude oil imports and 40% of its natural gas imports. The sanctions put in place have therefore affected energy and commodity prices, pushing them exponentially to extreme levels. This has intensified the surge in inflation, supply chain disruption, and the risk to global growth. The biggest issue we are seeing is when certain industries can pass off inflationary pressures to the consumers: prime examples are the energy, automotive and retail industries.

Why are bond prices falling?

The main narrative is the shift in gears by the central banks on hawkish stances which has led to further downward pressure on bond prices. The market environment is rare in that bonds and equities are falling in the same direction due to inflationary pressures. The unfortunate events taking place in Ukraine have exacerbated inflationary pressures due to the unexpected inflation created.

For a bond, one of the risks incorporated into a bond's price comes from interest rates. Since we are currently in a high inflationary environment or heading towards a period of higher inflation, the increased inflation will tend to be countered by an increase in interest rates in an attempt to steer the economic growth rate to a sustainable level and soothe inflationary pressure. Bond prices have an inverse relationship to interest rates, therefore when the cost of borrowing money rises (when interest rates rise), bond prices usually fall, and vice-versa. The Bank of England has recently increased the base rate multiple times within a short period, with the market pricing in further increases expected throughout the year. ebi portfolios are well-positioned to weather this type of environment due to the effective duration of our bonds. Our average effective bond duration is short-dated (4.3 years compared to 7 years of the Bloomberg Global-Aggregate) and duration can be interpreted as the measure of the sensitivity of a bond's price to changes in interest rates. Therefore, the bond portion of our portfolio has reduced risk stemming from interest rate rises compared to longer-duration bonds. Short-duration bonds are closer to maturity and have fewer coupon payments remaining, nevertheless, they are not immune to market events.

Bonds are supposed to protect you on the downside so why are both equities and bonds falling?

While bonds do offer protection on the downside we are in an unfortunate market backdrop where equities are facing downward pressure due to growth and geopolitical tensions. While equities have their own battle on one side, bonds are also feeling the pressure due to the increase in inflation and interest rate hike prospects. This is why we have recently seen a spike in gold prices with investors scrambling to find some sort of safe haven. Nevertheless, this does not deter from the fact that bonds have been offering protection against the full blow of the economic downturn.

How much protection are bonds providing?

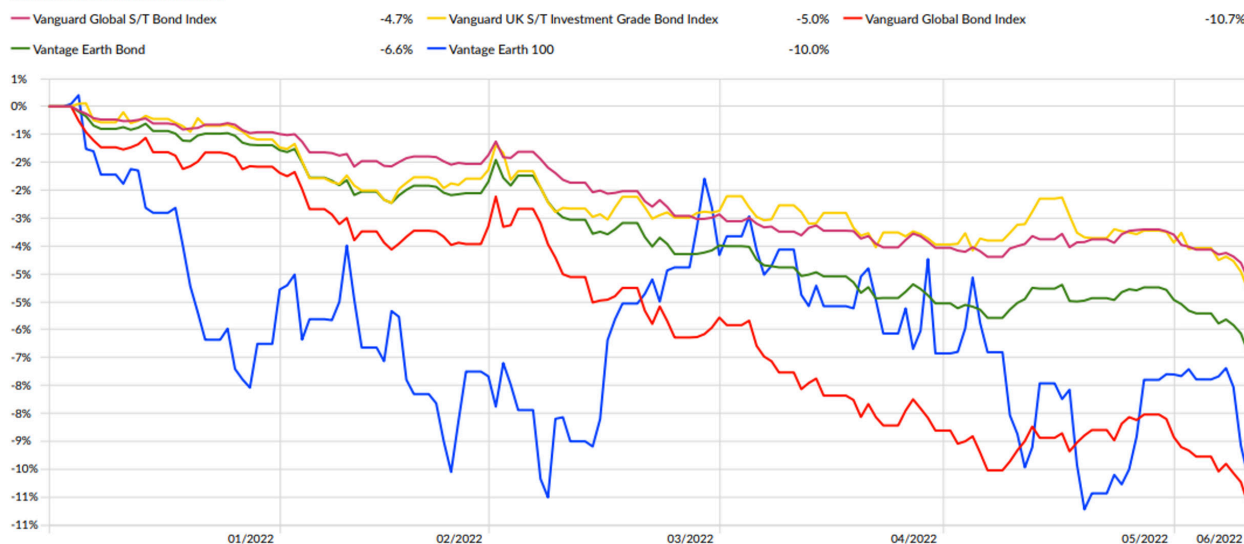
In times of chaos, it's worth taking a step back and asking what protection means for your portfolio. If you enter a phase where equities fall 20% and bonds fall 4% it's easy to say they both fell in the same direction but bonds fell materially less than stocks and offered somewhat of a cushion; In a 50/50 portfolio, this means your portfolio would have suffered a 12% loss rather than 20%.

The last few months' performance data is not a sufficient time period for concluding that bonds are no longer providing downside protection. Developed equities have seen a decline starting in 2022 and if we look at the graph below we can see a comparison between short-duration bond indexes, longer-duration bond indexes and equity markets. Now we can appreciate the protection the bonds have offered when looking at the MSCI ACWI IMI in comparison to the FTSE WGBI 3-5 years (1). Bonds are not only offering protection but the investment journey is smoother and less volatile. In addition, you can see the effect mentioned in the first question; there is a direct correlation between duration and bond performance (the lower duration bonds have performed better due to risk coming from inflation and interest rates).

Performance



Time Period: 01/01/2022 to 10/06/2022



Statistics

	Average Duration	Average Maturity
Vanguard Global S/T Bond Index	2.76	2.82
Vanguard UK S/T Investment Grade Bond Index	2.99	3.25
Vanguard Global Bond Index	7.31	9.05
Vantage Earth Bond	4.17	4.78

Source: Morningstar

Conclusion

With the current economic climate, it's easy to be sucked into flashfire reporting using a short-term lens. It's important to remember the primary role of bonds in a well-diversified portfolio, the bond portion of the portfolio is there to offer stability against the increased volatility of equity markets over the long-term, and shorter-duration bonds inherently have less inflation and interest rate risk and provide better protection and a smoother path.

References

- (1) The FTSE World Government Bond Index (WGBI) is the recognized leading benchmark for global treasury exposure followed by major fund managers and large asset owners around the world. The FTSE WGBI measures the performance of fixed-rate, local currency, investment-grade sovereign bonds from over 20 countries, denominated in a variety of currencies, and has more than 30 years of history available.



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