KK Asset Consulting

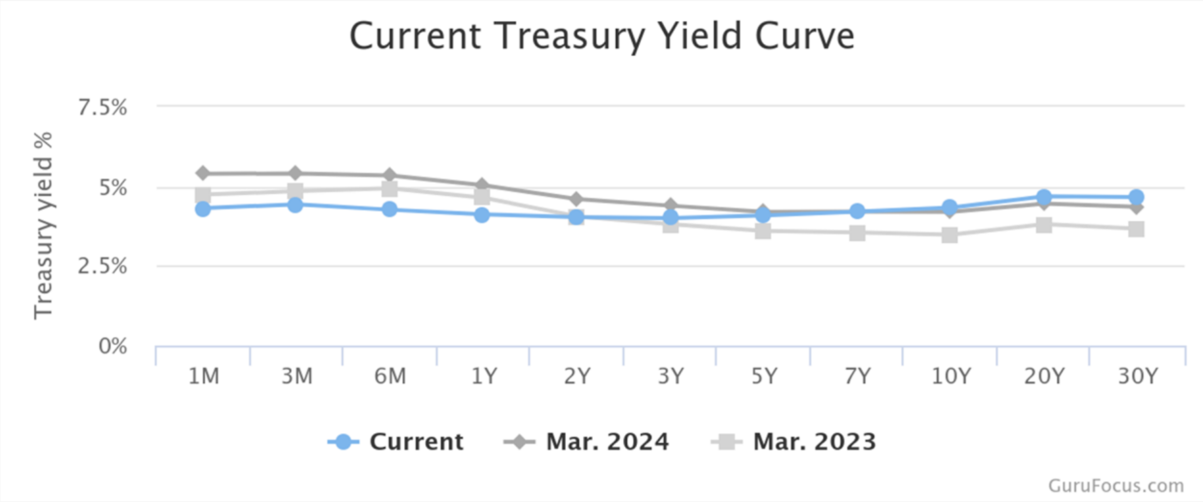
Fixed income diversifies once again

With rates having risen from historic lows investors are once again able to consider bonds to provide their traditional role as a diversifier within a portfolio. When market participants' risk appetite falls bond yields tend to fall too, providing scope for capital gains to bond holders. As risk appetite falls the desire to hold equities also falls, leading to easing equity prices. Holding equities together with fixed income can smooth returns as bonds tend to give positive returns when equities are delivering negative returns. This can help investors to manage portfolio volatility, in line with their particular risk appetite.

However, when bond yields sat at or near zero, up to early 2022, bonds and equities delivered much more correlated returns than they had historically. Hence when equities were off as central banks increased rates, bonds failed to provide offsetting positive returns. This was an outcome of fixed income security face values falling to reflect rising rates, while the rate increases failed to offset the fall in the face value of the debt security. But the rate rises have seen markets "normalise" versus the unusual period of zero or near zero rates.

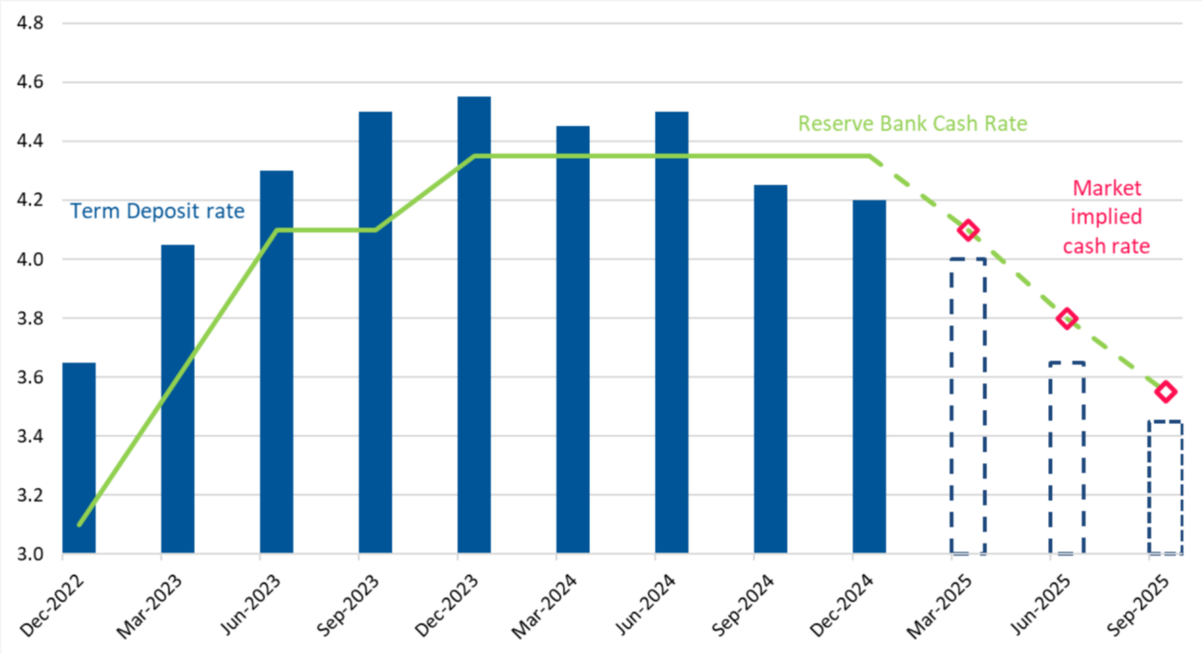
So, with more "normal" markets returning the next question to ask is where should we be investing within fixed income markets? Let us consider government bonds which are constantly being issued and traded so investors may buy into 30-year bonds (and longer) or bonds that mature in less than one year. If you buy a bond with a longer maturity term it would be reasonable to receive a higher level of interest to be paid as you are taking on more risk, lending for 10 years as against for six months, quite simply because more can go wrong in 10 years versus six months.

Currently we favour shorter term bonds over longer dated bonds as, in our opinion, the differential in interest paid does not justify the increased risk of holding longer dated bonds. The following chart shows the US Treasury Yield Curve across one month to 30-year maturity, as at the time of writing.



In the chart above you can see that bond holders are being paid more interest against short dated maturities versus longer dated maturities. Given the extra risk, we see no reason to take on longer dated maturities at this point in time. This may change in time, but for now we are biased in our portfolios towards shorter dated maturities as, in our opinion, the risk return trade off favours this shorter dated segment.

The below chart shows where term deposit rates have been and where the market is predicting they will be during 2025. At this point it is worth noting that fixed income investors can source capital gains during periods when rates fall, while term deposit holders are left with reinvestment risk if their term deposits are maturing. Hence fixed income is looking somewhat more favourable versus term deposits at this point in time.



Source: Franklin Templeton, Bloomberg, RBA

We see fixed income as serving its traditional diversification purpose within portfolios once again, which is good for investors. We currently favour shorter dated bonds as we feel that is where the best risk return trade off can be found. We also see the outlook improving for fixed income relative to term deposits, versus more recent experience.