

Bonds – strong year ahead

After a historically long dry spell, 2024 could become a good year for bonds. A resurgence of inflation remains a risk, but the high carry provides some security cushion – especially for corporate bonds.

Is investing really that easy? Just two years ago most government bonds in Europe and the U.S. were yielding small or even negative returns. Today, government bonds are yielding almost 5% in the U.S., almost 3% in Germany and almost 1% in Japan. Investing in (government) bonds from other countries or companies even offers an interest premium to that.¹ It is therefore no wonder that so many people are saying that bonds are back.

Of course, investing isn't that simple. After all, bonds were already looking attractive again at the beginning of 2023, after they had experienced one of the worst crashes in post-war history.² Good entry point? No, some government bonds are likely to suffer their third negative year in a row. This is because the U.S. Federal Reserve (Fed) announced a "higher for longer" regime for key interest rates after inflation, growth and the labor market all proved more robust than expected. And even though the major central banks did not raise their key interest rates at the end of the year, they left open the possibility of further rate hikes in 2024. As disappointing as all this was for early investors in bonds, it has laid the foundation, in our view, for a good investment year for bonds in 2024.

Good year for bonds

We are anything but euphoric about the global economic outlook for the next two years – but a downbeat world is, in general, good for bonds. We believe the current economic downturn will be mild – and the subsequent upturn meagre. We see inflation falling below 3% by the end of 2024, getting closer to the Fed's and European Central Bank's (ECB's) comfort zone. This not very upbeat tune is music to the ear of bonds. It means the central banks are unlikely to turn to further bond-punishing interest-rate hikes. Instead, from mid-2024, interest-rate cuts and thus bond-price gains could be on the cards. At the same time there is little reason to expect that corporate bonds will come under pressure from a serious recession, because, as we have said, a big downturn is unlikely in our view.³

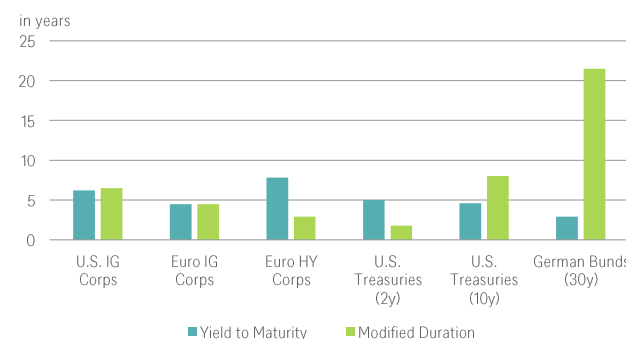
What duration to choose?

The choice of the optimal duration depends heavily on interest-rate expectations. All else equal, longer durations are best suited to a declining interest-rate environment, whereas shorter durations are best suited if fresh interest-rate hikes are expected. In an environment in which central banks are moving from data point to data point and U.S. yields remain volatile due to concerns about the government's high refinancing requirements, we prefer to avoid excessive risk and favor maturities of two to seven years.⁴

Regions and issuers

In addition to medium-term government bonds, we also like corporate bonds, particularly the investment-grade (IG) segment, due to its favorable risk/return profile. In the high-yield (HY) segment, we prefer Europe to the United States. A large number of elections in Emerging Markets add increased individual country risk to geopolitical risk that is already heightened. Therefore, we remain highly selective in this area. But we see an end to the strong momentum in dollar appreciation and U.S. yield increases as a positive.

Next to the yield, duration needs to be considered, too



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 11/13/23

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Footnotes

¹ Which normally come at an additional risk.

² U.S. treasuries suffered 2 negative years in a row for the first time since 1960.

³ Which doesn't mean that we don't believe in increasing default rates for less well capitalized, lower margin companies.

⁴ The following examples show how maturities (more precisely: duration) and the current yield affect the risk of loss: 30-year German government bonds would suffer a price loss of almost 20% if interest rates were to rise by 1%. With a current yield of 3%, a total loss of over 15%. European high-yield bonds, on the other hand, have an average remaining term of only three years and currently yield almost eight per cent. An increase in interest rates of 1% would only reduce the yield from 8% to 5% in this case.

Glossary

The **carry** (of an asset) is the cost or benefit from holding the asset.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The **European Central Bank (ECB)** is the central bank for the Eurozone.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Key interest rates stated by central banks to determine the most important rates of borrowing.

Modified duration is a formula that expresses the measurable change in the value of a security in response to a change in interest rates. Modified duration follows the concept that interest rates and bond prices move in opposite directions.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The **U.S. Federal Reserve**, often referred to as "**the Fed**," is the central bank of the United States.

The term **yield to maturity (YTM)** refers to the total return anticipated on a bond if the bond is held until it matures.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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