

AEGON INSIGHTS

# Duration risk – if not now, when?

*After over a decade of being a friend, duration risk became the bond market's foe at the end of 2020. For the next two years, duration was a bogeyman for bond investors, causing sharply negative returns as government bond yields skyrocketed in response to higher inflation and aggressive rate hikes from central banks.*

Duration is a measure of how sensitive the value of a bond (or a portfolio) is to changes in yields. If yields fall - all things remaining equal - a bond with a higher duration should experience a higher total return than a shorter duration bond. Equally, they should fall more in value in percentage terms when yields rise.

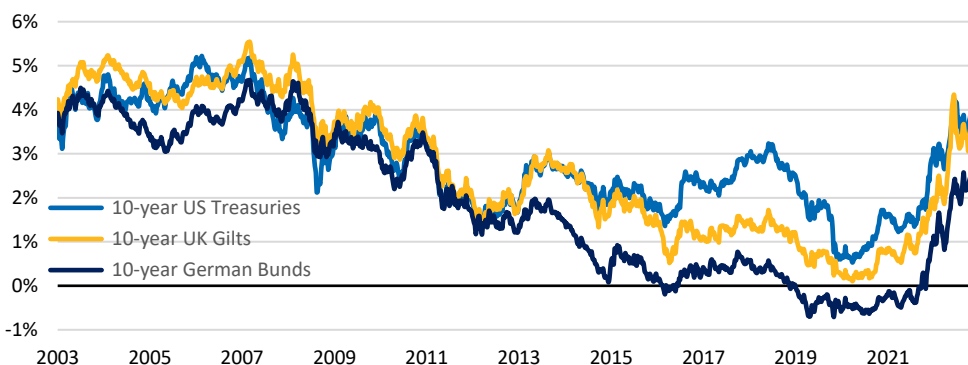
A cruel quirk of fixed income assets is that the more expensive they get (the lower the yield) the riskier they become, as their duration risk rises. This created the ingredients for the perfect post-pandemic storm that struck the bond market, causing it to have one its worst years on record in 2022.

Nothing lasts forever, though. Various factors have emerged that favour taking risk. So the question for investors is: if not now, when?

## Markedly improved valuations

As Exhibit 1 shows, government bond markets have experienced an extreme repricing since their yield lows of 2020. Since then, 10-year UK Gilt and US Treasury yields increased by almost 450 bps, with 10-year yields in Germany rising by around 350 bps over the same period. This repricing was necessary to reflect the macroeconomic backdrop of the time, and in many markets pushed yields to their highest levels since the financial crisis.

### Exhibit 1: 10-year yields on core government bonds



Source: Aegon AM. 20 years to 5 May 2023.



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Colin Finlayson, Investment Manager, is a member of the Global Rates and Multi-Sector portfolio management teams. He specialises in global government bonds and relative-value analysis. Colin is the co-manager of our absolute return bond fund as well as our strategic bond funds. Colin has been in the industry since 2000 and started with the firm in 2000 directly from the University of Strathclyde, where he studied Economics and Finance. Colin is a CFA charterholder.

The opportunity to buy ‘risk-free’ assets at yields around 4% is not to be sniffed, especially after years of investors being forced into taking ever more risk to achieve any sort of yield or income. As a key cornerstone for any investment decision, government bond market valuations are compelling again, creating a solid foundation for future total returns.

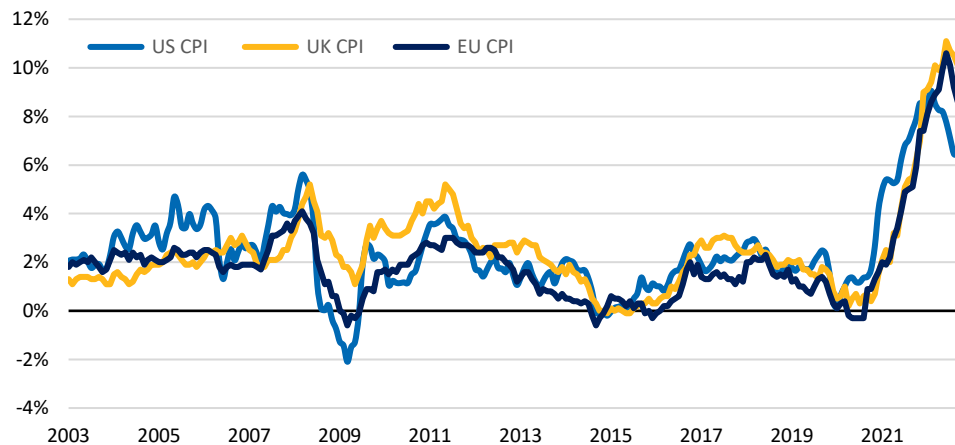
Another support for improved valuations is that duration can again act as a risk-off hedge. With a higher starting point than in recent years, yields now have room to fall in a flight-to-quality situation. We saw this when the US regional banking stresses emerged in March, and then again when First Republic failed in early May. With duration acting as a stabilising factor again, this adds to its attraction at a time of macroeconomic uncertainty.

### The turn in the data cycle

The unprecedented fiscal and monetary stimulus in response to the Covid-19 crisis drove the initial sell-off in government bonds. There followed a jump in commodity prices in 2022, which saw inflation reach multi-generational highs, with central banks increasing interest rates aggressively in response.

We are now seeing this in reverse. After peaking in the summer of 2022, US Consumer Price Inflation (CPI) has fallen steadily from over 9% to less than 5%. As Exhibit 2 shows, headline inflation in both the UK and Europe peaked in October 2022, with prices in Europe already falling sharply. In the UK, we expect the more modest falls so far will give way to sharper declines in the coming months.

**Exhibit 2: Headline consumer price inflation in the US, UK and EU**



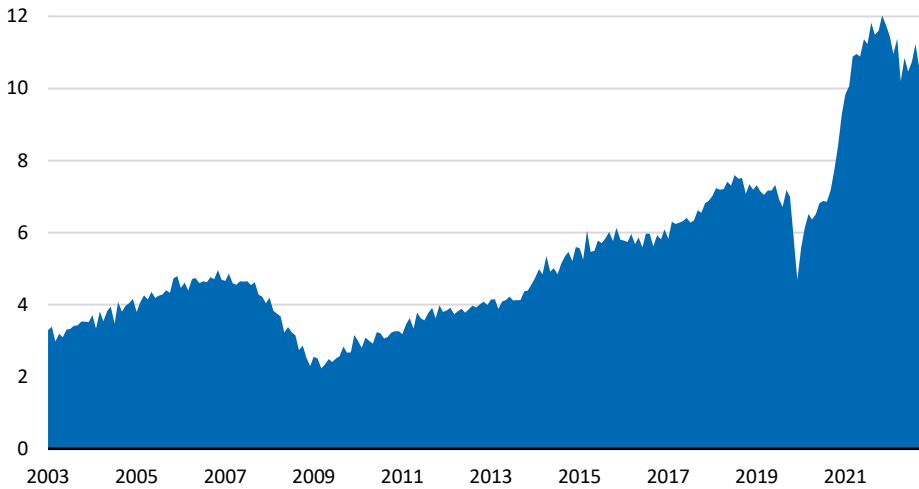
Source: Aegon AM and Bloomberg. 20 years to 31 March 2023.

On the growth side, the picture is similar. Economic activity is slowing, with forward-looking indicators and survey data highlighting that risks are skewed to the downside around the consensus view of a ‘managed slowdown’. Some recent data releases have stood out:

- German GDP slipping into negative territory in Q1, alongside a collapse in European lending.
- The sharp fall in UK mortgages, with net lending falling to zero in March.
- Cracks emerging in the US labour market, with the rise in weekly jobless claims and the fall in job openings, as measured by the US JOLTS report (Exhibit 3).

*“As a key cornerstone for any investment decision, government bond market valuations are compelling again, creating a solid foundation for future total returns.”*

### Exhibit 3: US job openings (millions)



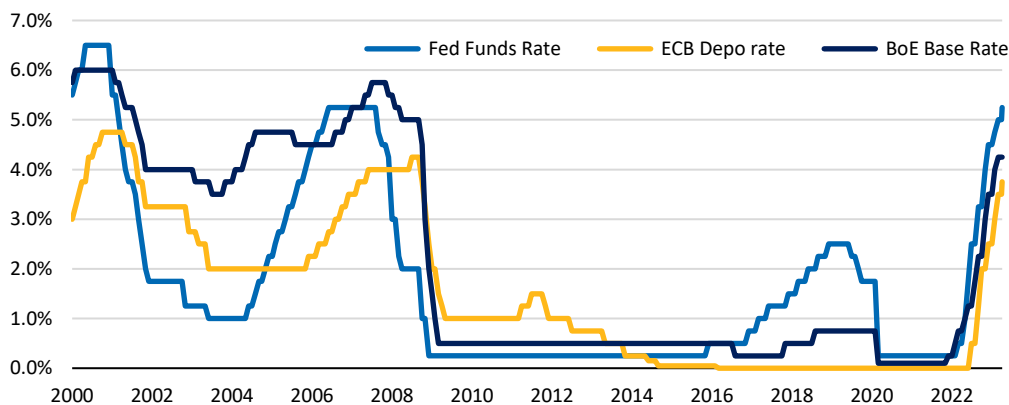
Source: Job Openings and Labor Turnover Summary Report. 20 years to 31 March 2023.

None of this feels consistent with the need for government bond yields to be higher. Instead, it increasingly supports the case for yields to be lower.

### The end of the rate-hike cycle is in sight

Falling inflation, weaker forward-looking data and tensions in the financial system all point to central bank rates not needing to move much higher. We believe we are now entering the end game for the hiking cycle of the major central banks. After almost 18 months of global rate hikes that were kicked off by the Bank of England, the lagged impact of monetary tightening is now starting to bite: the arguments against hikes and in favour of a 'pause' are growing.

### Exhibit 4: Key central bank rates (%)



Source: Aegon AM and Bloomberg. 20 years to 5 May 2023.

For investors in bonds with any duration risk, this is a crucial development. Central banks reaching their terminal rate helps to put a ceiling on yields, reducing the downside risk to holding bonds. The debate over whether to favour a short duration vs. long duration stance has become more clear-cut, with conviction now higher on the need for additional interest-rate risk.

The focus will then shift to how long central banks can keep rates on hold. Given the current macroeconomic outlook, the balance of risks would be biased towards interest rates being reduced rather than increased after they pause. Again, this would be supportive for duration risk.

## Duration risk – back in the tool kit

After the fall-out of the great-repricing of 2021-22, investors now no longer need to fear duration risk. With the risk of higher yields now much diminished - replaced with the potential for lower yields - and government bonds acting more like a 'risk-off' hedge again, the benefits to investors of embracing duration risk within their fixed income allocations are clear.

Of course, nothing ever moves in a straight line. The need to actively manage duration will continue to be key – both in terms of overall level of risk and which markets to get our duration from. But our starting point is to hold more rather than less duration risk.

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AdTrax: 5691266.1. | Expiry: 31 May 2025