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by Standard Chartered's Global Chief Investment Office

The lure of government bonds

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The US Federal Reserve's Jackson Hole conference has a history of signaling big shifts in central bank policy. The event itself is not the most obvious place to signal policy shifts, given it is meant to be a symposium amongst major global central bankers to discuss key topics relevant to the time. However, markets have ended up watching speeches closely after former Fed Chair Bernanke's speeches at the symposium offered strong signals on policy in the years after the 2008 crisis. This was the event at which we first received signals about waves of Fed bond buying, also known as quantitative easing.

Hawkish, but data-dependent Fed

This year, Fed Chair Powell struck an arguably hawkish, but data-dependent tone. Recent inflation data prints have been heading in the right direction (lower) in recent months. However, Powell argued the job of taming inflation was not yet done and that there was a need to balance the risks of doing too much with the risk of doing too little.

The difficulty of the balancing act is visible in US economic data. Some growth data, such as the Atlanta Fed GDPNow estimates, still show a high degree of resiliency. However, survey and labour market data show tentative

signs of economic stress starting to spread from manufacturing to services. The softer growth data, in turn, should alleviate the risks of inflation rebounding once again. Therefore, we hold the view that the Fed is unlikely to raise rates further, short of a significant upside inflationary shock.

The risk/reward in bonds looks attractive

We remain positive on Developed Market government bonds within a



diversified portfolio, given cooling economic data and a likely peak in Fed policy.

Government bond yields have pushed higher in recent months on the back of a combination of factors: (i) resilient growth data raised concerns the Fed may need to keep rates high for longer (or peak at a higher level) in order to tame inflation; (ii) a surge of new bond supply as the US government sought to fund its widening fiscal deficit after the

bipartisan agreement to lift the debt ceiling earlier this year; (iii) longer-term concerns about the US's soaring debt following Fitch's downgrade of US credit rating; and (iv) a rise in Japanese government bond yields as the BoJ partly relaxed its ultra-loose monetary policy.

However, we see today's elevated bond yield offering an attractive opportunity. First, bond yields have historically tended to peak around the same time as the peak in Fed policy rates. In our assessment, we are likely at or very close to this point.

Second, the tentative weakening in economic data is likely to cap bond yields as markets eventually price a need for the Fed to pause its rate hiking cycle, and eventually cut rates in response to a weaker economy.

Third, today's bond yields offer an attractive cushion against the risk of yields moving higher still. Our analysis shows that the yield on a benchmark US government bond index would have to rise by over 0.7% from here before the fall in bond prices starts to outweigh the yield currently on offer.

These factors are why we believe the positives outweigh the risks when it comes to Developed Market

government bonds, and high quality bonds more broadly.

What could go wrong?

Our positive view notwithstanding, financial markets have thus far challenged our constructive view on high quality bonds this year. Is there a scenario where bond yields indeed push significantly higher before they peak?

One possible scenario where this occurs is where economic growth remains unexpectedly resilient. Some have argued that the US economy is less sensitive than usual to changes in interest rates either because companies and households front-loaded or refinanced borrowing during the post-pandemic period of ultra-low bond yields, or because some of the usual routes of transmission, such as higher home mortgage rates, are dampened because of longer periods of fixed mortgage rates. While we are not subscribers to this view, under such a scenario, the Fed could choose to hike rates further to cool the economy.

Another possible scenario for a rise in bond yields involves inflation relapsing higher. This could occur via a sustained rise in oil prices, for example, or a new shock to global supply chains. Several analysts have also pointed to the early

1970s where inflation returned in 'waves' before being finally tamed in the early 1980s. Again, we see a relatively low chance of this scenario developing, given the somewhat different context of the 1970s and the difficulty of energy prices to sustain high levels amid slowing growth and demand. However, this is also a scenario where the Fed may choose to keep tightening policy to contain inflation, even in the face of weak growth.

Benefits outweigh the risks

No investment view comes without its risks. On balance, however, we believe that high quality bonds offer an attractive reward for the risk given where bond yields are today. We believe the Fed is unlikely to hike significantly further from here as growth weakens. Today's yield levels also offer an attractive cushion even if the risk scenario plays out temporarily. Given this, we believe high quality bonds justify a larger than usual allocation today, within the context of a well-diversified portfolio.

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