

Daily: Finding income opportunities amid higher yields

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Thought of the day

US Treasury yields rose across maturities on Wednesday, as the Treasury's announcement that it planned to buy back up to USD 6bn of longer-dated debt did not meet market expectations. Higher oil prices amid fresh strikes between the US and Iran also added to upward pressure on yields. The 10-year yield climbed as high as 4.85%, its highest level in nearly three years. The 10-year German government bond yield also hit a post-2011 high of 3.44%.

The buyback was three times the originally scheduled amount, but it fell short of market expectations for a USD 7-8bn operation. Given that the vast majority of the Treasury's buybacks this year have been concentrated in a relatively small set of less-liquid bonds, questions remain over how effective the program will be in bringing down long-term yields.

Yield volatility is likely to stay elevated in the coming days. The European Central Bank is expected to raise interest rates by another 25 basis points today, while the US producer and consumer price indices for August are due today and tomorrow respectively before the Federal Reserve's decision next week.

We expect the US central bank to raise interest rates by 25 basis points on 16 September, followed by another 25-basis-point hike in December. While this would likely narrow the relative advantage of short-duration bonds over cash, we still see reasons to hold bonds in portfolios. We also see ways investors can diversify their sources of portfolio income.

Look beyond the shortest maturities for diversification. The potential for capital gains in short-duration bonds may become more limited as the Fed moves onto a hiking path, but these bonds continue to offer healthy income at current elevated yields. Meanwhile, we see a growing diversification role for bonds beyond the shortest duration, as they may ultimately benefit if Fed tightening reinforces confidence in the central bank's inflation commitment, reduces longer-term inflation expectations, or slows GDP growth. This part of the market may therefore offer both attractive income and useful portfolio diversification against any adverse growth outcome.

A diversified fixed income approach can broaden opportunities. For investors relying on their portfolios for income, we see merit in strategies that seek to earn higher returns by combining government and investment grade bonds with allocations to high yield, emerging market, and subordinated debt. The knowledge, minimum investments, and risk management required to invest effectively in these more growth-sensitive segments of the market, however, can be demanding. Diversified approaches could offer investors a risk-controlled way to gain exposure, with the potential for enhanced yields, while leaving professional managers to rebalance and manage credit, interest rate, foreign exchange, and other risks.

Structured and multi-asset strategies can provide alternative sources of income. Investors with the willingness and ability to consider instruments that combine bonds and options can also look at

structured strategies for alternative sources of yield. Reverse convertibles, for example, may provide a return stream that is less correlated with traditional investments by monetizing market volatility. Certain structures may allow investors to express the view that market yields may trade in a pre-defined range, potentially using elevated volatility to enhance income versus equivalent bonds while incorporating capital preservation features. However, investors should be willing and able to bear the unique risks of investing in options, while also mindful that in a highly data-dependent monetary policy environment, the risks of yields overshooting may have adverse impacts on certain types of structured solution. Separately, a multi-asset income portfolio spanning multiple asset classes and regions could offer another means of generating sustainable, recurring income throughout the business cycle.

So, while yield and rate expectations are shifting, bonds remain a key source of portfolio income. We expect returns to be driven primarily by the high level of outright starting yields, which should provide a degree of resilience amid continued volatility. Investors looking to diversify their sources of income can also consider diversified fixed income approaches, structured strategies, and multi-asset income portfolios.

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