Daily: Higher long-end yields do not undermine quality bonds

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From the studio

Podcast: Signal over Noise with Ulrike Hoffmann-Burchardi, on Apple or Spotify (6 mins)Video: Market Playbook | James Cheo on fixed income (5 mins)Video: The AI Show | China tech earnings update and what's next (3 mins)

Thought of the day

Long-term government bond yields have risen sharply in recent days. The 30-year US Treasury yield climbed above 5.31%, its highest level since 2007, and the 30-year German Bund yield reached 3.75% for the first time since 2011. The 30-year UK gilt yield is also near its May peak of 5.85%, which was the highest since 1998.

The latest moves came after the US government’s 30-year Treasury bond auction last week produced its highest yield since 2001 . Corporate bond supply is also elevated, with major tech companies increasingly issuing long-dated debt to fund their AI infrastructure buildout. Investor concerns about persistent inflation and government deficits have also kept longer-maturity bonds under pressure.

But the front end of the yield curve has stayed relatively anchored, and we do not think the rise in long-term yields invalidates the case for quality fixed income. Rather, we believe it reinforces the need for selectivity. With the long end of the curve more exposed to fiscal concerns, inflation uncertainty, and lower liquidity, we continue to see short- and medium-maturity quality bonds as attractive.

Starting yields have historically been a good indication of total returns. Elevated starting yields give investors a stronger income base than was available for much of the previous decade, and we believe today’s yields provide a meaningful cushion against further rate increases before investors would experience a potential loss. In our preferred short- to medium-maturity segment, our analysis indicates that US Treasury yields in the two- and five-year tenors would need to rise by around 100 to 230 basis points from current levels for falling bond prices to cancel out income returns. This helps explain why we continue to favor quality bonds at the short and intermediate parts of the curve.

Yields should decline as markets reassess central bank policy expectations. Current market pricing for central bank rate increases still looks too aggressive to us, and we believe quality bonds would benefit if incoming data led markets to scale back expectations for tighter policy. In the US, for example, recent inflation and labor market data have weakened the near-term case for a Federal Reserve rate hike, and our base case is for the disinflation trend to continue in the months ahead. In Europe, we expect limited further tightening, with policymakers likely mindful of economic growth risks.

Corporate fundamentals remain healthy. The corporate credit market has remained resilient, with spreads close to cycle lows and yield-seeking investors continuing to add exposure during bouts of volatility. But we think the resilience is not only a function of demand, as corporate balance sheets generally remain in good shape despite higher borrowing costs and an uncertain economic backdrop.

The market has also benefited from improved average credit quality across indices and lower index duration, which have helped limit sensitivity to market volatility. Still, we believe rising performance dispersion across sectors and issuers reinforces the case for selectivity.

So, we continue to favor quality short- and medium-maturity fixed income, although we see scope to extend duration in the Eurozone. For investors seeking more diversified income approaches, select exposure to emerging market and high yield credit can also be considered, alongside equity income and yield-generating structured investment strategies.

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