ERSTE Asset Management

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https://blog.en.erste-am.com/interest-rates-are-back/

Interest rates are back

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Our experience in recent years has been that of very low interest rates. There was no return to be made from the savings book, and bonds with a longer maturity were not very attractive from a yield perspective. For many years there was hardly any reasonable opportunity to invest in the bond market, so it comes as no surprise that this investment vehicle has almost been forgotten.

However, the tide has turned in recent months. After significantly higher inflation figures, the central banks have raised key interest rates several times, and at the same time bond yields have risen sharply.

This creates new opportunities for bond investors to add according interest rate products to their portfolios.

The leading central banks have increased key interest rates both repeatedly and significantly

Let’s first take a look at the central banks of the USA and the Eurozone. The tasks of central banks include stability and maintaining the purchasing power of the currency. In view of the rapidly rising inflation in almost all currency areas, quick and aggressive countermeasures by the central banks were of the utmost importance. One of the options in such a scenario is to raise key-lending rates, which indirectly leads to higher bond yields. This also makes loans more expensive, which should in turn lead to a cooling of consumption and the economy, and – as is the hope of central banks – also a decrease in inflation in the medium term. Key interest rates have risen significantly in recent months, with the US Federal Reserve leading the way and the European Central Bank following suit with some delay.

The longer-term view shows how aggressively the US Fed in particular has acted in recent months:

Chart: Key interest rates USA and Eurozone
Source: Refinitiv Datastream, long-term horizon, data as of 21 December 2022
Please note: Past performance is no reliable indicator for future developments.

This long-term representation clearly illustrates two aspects:

- The previous cycle of interest rate hikes occurred in 2006/07 (and was followed by the Great Financial Crisis)
- From the financial crisis onwards, key-lending rates fell to almost zero percent, with the US Federal Reserve raising rates in the meantime but later lowering them again
- The current key-lending rate increases in the USA occurred almost to the 2007 level, while the ECB started much later

Both the US Federal Reserve and the European Central Bank have indicated that further interest rate hikes are to be expected for the coming months.

Effects on the bond markets – the yield is back!

As you can see in the chart, the key-lending rates in the USA (i.e. the Fed Funds rate) are already at 4.5%. This alone should have driven up the attractiveness of bonds. The following questions arise for investors:

- What bonds or what bond segment can cover the currently very high inflation?
- How can I invest in this asset class simply and in a way that makes sense?

Not all bonds are equal – investors should know where to invest!

A bond is a promise by a debtor (issuer of the bond) to repay the capital raised in full at the end of the term and to service the promised interest on time. Issuers of bonds are

- states (government bonds)
- or companies (corporate bonds)

Option 1: government bonds

First, let us look at the yield of government bonds with high ratings, i.e. those from the USA and Germany.

Chart: 10Y government bond yield, USA and Germany
Source: Refinitiv Datastream, long-term horizon, data as of 27 December 2022
Please note: Past performance is no reliable indicator for future developments.

Shown in blue is the yield of the 10Y German government bond (i.e. 10Y to maturity). The yield was negative for several years but has soared significantly in recent months to currently 2.5%.

In comparison (red line), the yield of the 10Y US government bond, i.e. the US Treasury bond, is currently just under 4%. An increase in yields is good for investors who want to reinvest, but it also means losses for investors who have invested at lower yields.

With inflation above 10% in Austria (as of November 2022), the question that arises for government bonds is how a yield of 2% or 4% is supposed to offset an inflation rate of about 10%.

This question is more than justified. If inflation does not subside significantly in the coming years, government bonds are probably not the right investment to preserve the real purchasing power of an investor’s capital.

Option 2: corporate bonds

When companies issue a bond, they usually have to offer a higher yield than comparable government bonds. This yield premium is also referred to as spread and depends on the quality – i.e. the rating – of the respective company.

The rating is assessed and awarded by independent rating agencies. It is usually expressed in letters, where AAA (the so-called triple A) represents the best possible credit rating level. The lower the credit rating, the higher the probability of an issuer’s default – and the higher the interest rates the company has to pay for its bonds. For investors, this means that they have to carefully weigh the potential return and the risk of default for every investment.

The development of yields for different credit ratings clearly shows how high this compensation for the risk taken currently is:

Corporate bond yields by rating, Eurozone (BOFA – investment grade and high-yield) / 10Y, data as of 27 December 2022

Chart: Corporate bond yields, Eurozone (BOFA indices), various ratings
Source: Refinitiv Datastream, long-term horizon, data as of 27 December 2022
Please note: Past performance is no reliable indicator for future developments.

The chart shows the market segments BBB, BB, and B of corporate bonds from the Eurozone. The yields are currently in the range of about 4.5% to 7.5% and thus clearly above those of German government bonds.

The high-yield range (BB or B) is traded at a yield above that offered in the past ten years. At such high levels, a rate of return seems possible that can also cover inflation in the medium term.

Some bond segments have turned attractive again

The significant rise in yields is evident across all bond segments. For investors who are already invested, this has manifested itself in painful losses. However, for newcomers and of course also for existing investors, there are opportunities to buy or expand positions that have not existed in the past ten years.

As we have seen, however, not all bond segments are equally interesting. For those looking to earn a return that can at least cover inflation, corporate bonds can be quite interesting. But investing here is not so easy, because:

- Where do you find the right corporate bonds, and
- How can you spread your risk sufficiently?

A fixed-income fund could be the solution

There is always a certain degree of default risk associated with corporate bonds. Moreover, it is not easy for retail investors to find and buy such bonds. Corporate bonds often come with a high denomination, which makes it very difficult for retail investors to diversify across individual securities. And it is not advisable to put all your capital on just one issuer. Rather, it should be spread across many issuers from different sectors. The principle of risk diversification is particularly important when investing in corporate bonds.

A fixed-income (or bond) fund does just that for investors. The paid-in capital is used to purchase many bonds from companies from different countries, industries and/or rating segments. The greater the risk, the broader the diversification should be. In corporate bond funds, you will therefore often find considerably more than 100 different bonds.

Investors do not have to search for suitable bonds themselves and can invest in such a fund with small amounts as a one-off payment or in tranches, or even save monthly.

Conclusion

After yields have risen noticeably in recent months, investing in the bond market has become much more interesting again. However, if you want to cover inflation with your investment, you should take a closer look and also have to take certain risks.

This may be a good time to ask your bank about investment opportunities, e.g. in corporate bond funds.

Please note that an investment in assets also entails risks in addition to the opportunities described.

Johann Griener

Johann Griener has worked at Erste Asset Management in Sales Retail since 1 January 2001. In this function he supported for example the Sparkasse banks in Austria, with a current focus on Upper Austria. His scope of duties includes the servicing, training, training and education of Sparkasse employees who work in the securities field. This means creating and holding presentations in the local branches and in Erste Asset Management for the purpose of promoting sales of Erste Asset Management GmbH and Erste Immobilien KAG funds. He also supports the Sparkasse banks (Austria-wide) in their own investments (nostro business). In addition, Griener is developing numerous publications for internal and external use. The "1x1 of Investment Funds" that he wrote is found in all of the branch offices of Erste Bank and the Sparkasse banks as basic reading and an introduction for customers on how investment funds work.

Griener began his career in 1988 as an employee at the bank counter in a local Sparkasse bank. There he learned the banking business, from a savings book to loans to investment operations. After a few years at the Sparkasse, he decided to continue his studies at the Vienna University of Economics and Business, with a focus on "banks" and "securities". After completing his master's degree, he remained loyal to the Sparkasse sector and has been working at Erste Asset Management since.

His motto: "Only a day with laughter is a good day"