Asset Class Investment Strategies

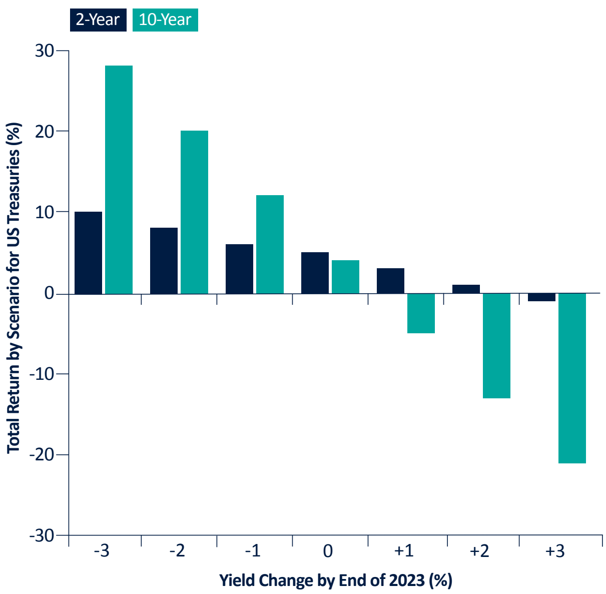
# Government Bonds

## Major Trends

**Better starting yields, particularly at the front end of the curve:** Nominal government bond yields are at their highest level in a decade. Absent an economic recession, they are expected to remain elevated due to the end of the 'Great Moderation'. Even in the event of a recession, we are unlikely to see a return to the near zero rates of the last decade. Shorter maturity bonds currently offer higher yields than long-dated bonds combined with far lower duration risk. As shown in Exhibit 1, interest rates would need to rise another 3% to lose money on a 2-year Treasury. This return profile partly explains our preference for lower duration fixed income.

### Exhibit 1

**Total return scenarios for 2-year and 10-year US Treasuries as of 31 January 2023**




***Source:*** *Bloomberg, JP Morgan*

**Flat forward curves:** 10-year bond yields are expected to remain close to their mid-February levels in the US and Germany, and rise only gradually in the UK over the next 10 years. More specifically, the 10-year yield in 10 years' time is expected to be 4.3% in the US vs. 3.8% as of 20 Feb 2023, 2.5% in Germany vs. 2.4% now, and 4.4% in the UK vs. 3.5% now (Exhibit 2).

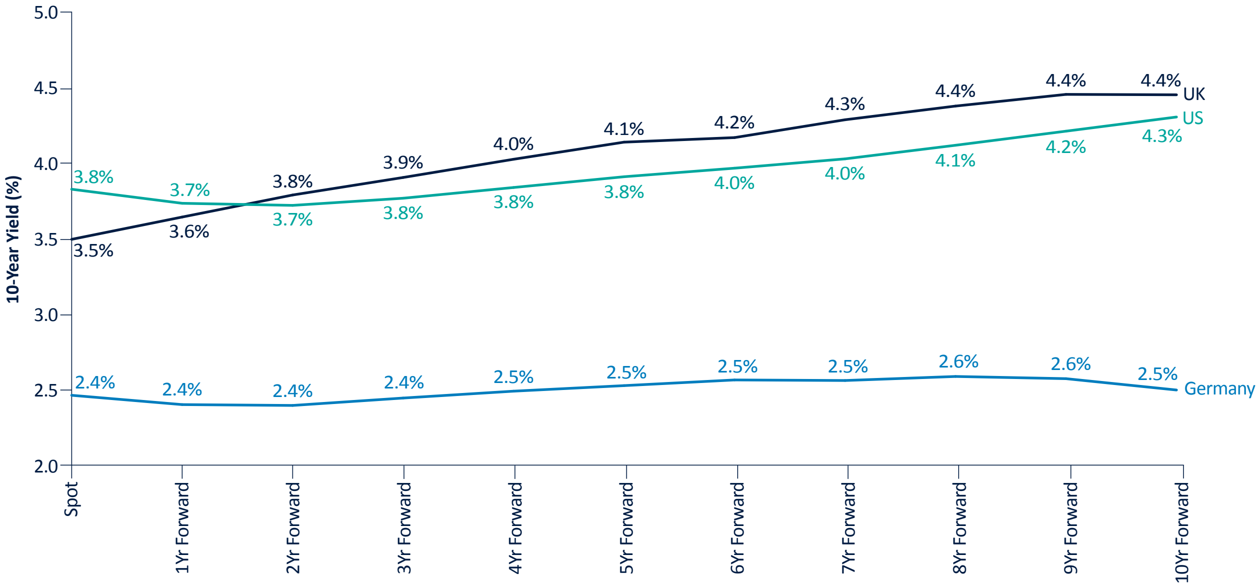
**DM central banks are continuing to shrink their balance sheets:** The net purchases of government bonds by the central banks of the US, Europe, UK and Japan are expected to decline by $1.5 trillion in 2023 relative to 2022. This withdrawal of purchases is well understood by the market, and as such should already be reflected in the price. However, it does mean that countries will once again be reliant on the private sector to fund any surprise budget deficits. As the UK's short-lived Truss administration discovered in 2022, the private sector is a more price-sensitive buyer than the central bank, which may lead to episodic volatility.

## Golden Rules

- Investors should gain interest rate exposure in the most cost-effective and tax-efficient manner possible. This is typically via passive ETFs or futures.
- Investors should typically own bonds denominated in their home currency, i.e., the currency in which their future liabilities are likely to be incurred.

## Exhibit 2

**10-year yields are not expected**




***Source:*** *Bloomberg*

## 2023 Strategic Priorities

With the yield curve the most inverted it has been in over 40 years, investors are overpaying for duration risk. As such, we continue to avoid long-dated government bonds in favour of holding more liquidity in short-dated bonds to deploy into opportunities created by volatility.

Empirical evidence shows that over the long term most assets benefit from a higher risk-free rate. As such, many financial assets including Absolute Return, Credit and Equities will have seen their expected long-term return increase as bond yields rose. Consequently, we do not feel it is necessary to allocate more to government bonds simply because yields have risen. However, in a scenario where central banks may eventually overtighten monetary policy to the extent that a recession becomes more likely, it would be advantageous to add to government bonds.

# Long-Term Expected Return

## Exhibit 3

**Based on our 10 year forecasts, we target the following long-term expected return for Fixed Income**

| | Fixed Income |
|---|---|
| **Risk-free Rate** | 3.5% |
| **Risk Premium** | — |
| **Illiquidity Premium** | — |
| **Manager Alpha** | — |
| **Total Return** | **3.5%** |

The starting yield on a 10-year US Treasury bond has historically provided a good estimate of future returns to a constant duration bond allocation over the next 10 years.

Hypothetical return expectations do not represent actual trading and are based on simulations with forward looking assumptions, which have inherent limitations. No representation is being made that any investor will or is likely to achieve returns similar to those shown. Such forecasts are not a reliable indicator of future performance.

Your capital is at risk and you may not get back the full amount invested.

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