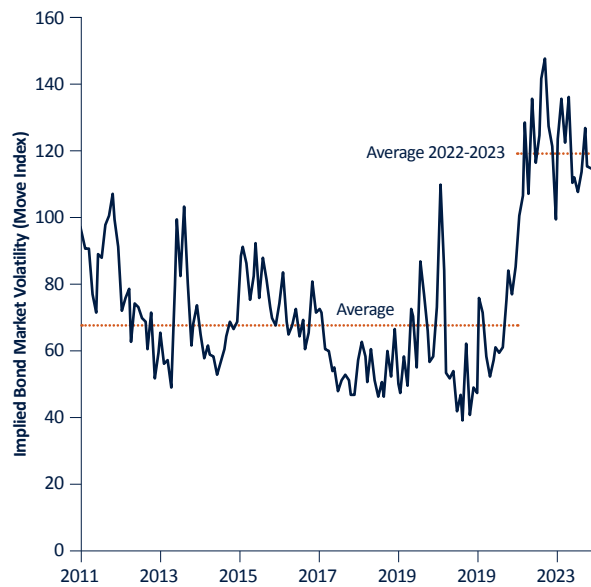


# Government Bonds

## Major Trends

**Heightened yield volatility:** Nominal government bond yields were unusually volatile in 2023, particularly at the longer end of the curve. As shown in Exhibit 1 The MOVE Index, which uses options pricing to establish market-implied bond volatility, has been structurally higher over the last two years compared to the prior decade. We expect this elevated volatility to persist.

**Exhibit 1**  
Bond volatility has been structurally higher

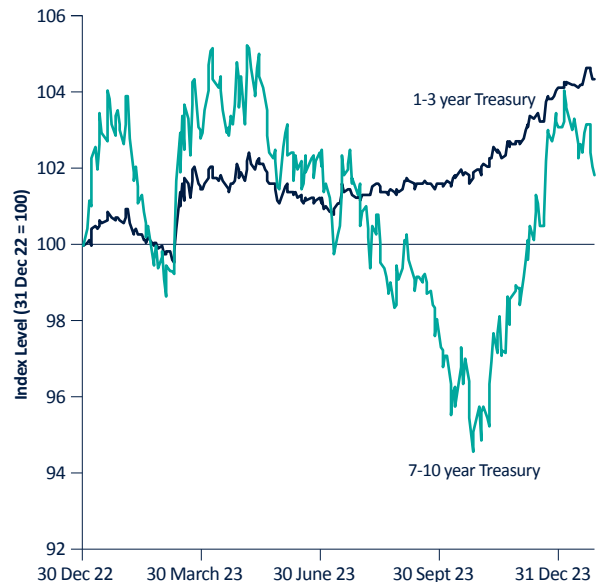


*Note: The MOVE index is similar to the VIX in equity markets. It is a yield-curve weighted index of the normalised implied volatility on 1-month Treasury options*  
Source: Bloomberg

**Longer duration magnifies the volatility:** As shown in Exhibit 2, the 1-3 year Treasury Index accrued interest and rose steadily over 2023. In contrast, the 7-10 year Index suffered a -10% peak-to-trough decline and remains volatile in early 2024.

**Flat forward curves:** The 10-year bond yield is priced to remain close to the end-of-January levels in the US and Germany and rise only gradually in the UK over the next 3-5 years. Over the next decade the yield is discounted to rise steadily towards 5% in the US and UK, and 2.8% in Germany (Exhibit 3).

**Exhibit 2**  
The 1-3 year Treasury Index rose steadily in 2023 without the volatility of the longer-duration assets



Source: Bloomberg

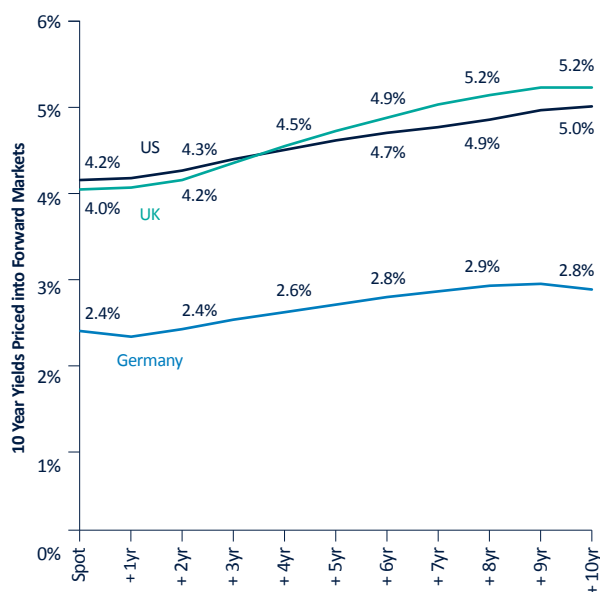
**Very large issuance net of central bank purchases expected in 2024:** The large deficits being run by several developed market countries will result in the highest issuance of government bonds in a decade, net of redemptions and central bank purchases. Morgan Stanley estimates that across the G7, the amount of new supply to be funded by the private sector in 2024 will amount to \$2.45 trillion, up from \$1.68 trillion in 2023, a 45% increase in net issuance year-on-year.

**Higher correlation of bonds and equity:** The correlation between US equity and government bond returns changed from negative to positive in mid-2021. Since then, the monthly realised correlation of the daily returns has remained positive, reducing the diversification benefits of bonds. Economists at the Bank of International Settlements argue that this should increase the term premium on bonds, since investors should require additional compensation for the now less diversified risk in government bonds.<sup>1</sup>

<sup>1</sup> BIS Quarterly Review, Dec 2023

# Government Bonds *continued*

**Exhibit 3**  
10-year yields expected to rise gradually from current levels over next 3-5 years



Source: Bloomberg (data as of 25 January)

## 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., that currency in which their future liabilities are likely to be incurred.

## 2024 Strategic Priorities

Yield curves remain inverted and the term premium is close to zero compared to a long-term average of c. 2%. This suggests that investors are currently overpaying for duration risk.

However, with the central bank hiking cycle coming to an end, we will look to add duration

if the yield curve steepens via rising long-end rates. For example, if the 10-year US Treasury or UK Gilt yields were to rise to c. 4.5%, or the German Bund to 2.5%, we would consider adding duration to portfolios. Such a move would be contingent on our economic outlook at the time, and an assessment of the relative attractiveness of alternative uses for the capital (e.g., liquid Absolute Return managers).

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 have seen their expected long-term return increase as bond yields increased. Consequently, we would not automatically 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 4**  
Based on our 10-year forecasts, we target the following long-term expected return for Fixed Income

	Fixed Income
Risk-free Rate	4.0%
Risk Premium	0.3%
Illiquidity Premium	—
Manager Alpha	—
<b>Total Return</b>	<b>4.3%</b>

The expected return for Government Bonds in USD represent the average of the 10yr Treasury yield forward curve over the next 10 years (1Y10Y, 2Y10Y, etc). This suggests modest term premium over cash.

**Hypothetical return expectations are based on simulations with forward-looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.**