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M&G Investments

Press release

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Difficult to avoid recession, but global bonds finally attractive

It will be difficult to avoid a global recession in 2023, and the recent surge in global bond yields is already reflecting the market's expectation of a significant economic downturn next year, according to Jim Leaviss, CIO of Public Fixed Investment at M&G Investments based in London. The good news for investors, however, is that all types of global bonds – government and corporate, high- and low-quality – are now looking attractive for investors, even with a recession looming.

Speaking at a presentation in Pretoria today, Leaviss, who has been called "the UK's best-known bond investor" and is responsible for overseeing some £141 billion in assets under management, said there was "very likely to be a recession", with central banks' aggressive interest rate hikes already having had a dramatic impact on global growth. He noted that almost every US recession since the 1970s had been preceded by a sharp spike in the oil price, which had resulted in a familiar pattern of broader rising inflation, steep interest rate hikes to suppress price pressures, and subsequent contractions in economic activity.

However, he said, there were reasons why this recession might not be as deep as previous downturns: among others, the global economy was now less energy-intensive than in the past; and governments were keen to use spending to boost their economies even as central banks were tightening monetary policy, which hadn't been the case for decades. The US, in particular, was likely to emerge in better condition than Europe and the UK due to its stronger underlying growth, more flexible economy and resilient labour market, among other factors.

Opportunity for "super-normal" returns from global bonds

Looking at current global bond market conditions, Leaviss said that following this year's sharp sell-off, both government and corporate bonds now offered opportunities for investors to earn "super-normal" returns. US dollar global investment-grade (IG) and high-yield (HY) corporate bonds were trading at their highest yields in 10 years: IG five-year bonds were yielding 4.8%, compared to only 2% just last year -- this was higher than during the Covid-19 pandemic, he pointed out. Meanwhile, HY corporate bonds (those with credit ratings of BB or lower) were offering around 9.0%.

"On the four occasions since 2012 when global corporate bonds yields were trading at similar levels, IG bonds returned between 7.5% and 12% over the subsequent one-year period, and HY bonds returned between 9% and 17%," he said. Investors finally had a good opportunity to add bonds to their portfolios for both income and diversification purposes after a long period of offering negative returns.

As for the risk of default in IG corporate bonds, M&G Investments credit research and historic default behaviour showed that this risk was "negligible", at less than 1%. In the riskier HY bond market, the cumulative five-year default rate was 15%, but the market was currently pricing in an exceptionally high 35% default rate, the most elevated level in 52 years and high even in the event of a serious recession.

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In M&G's view, the current HY bond yields should more than compensate investors for the default risk involved in a recession over the next year.

Another risk for bond holders, that of high inflation eroding bond returns, was indeed a worrying factor for investors over the shorter-term, Leaviss acknowledged. However, it was not likely to be a significant detractor for long. This was because inflation was expected to fall fairly quickly as a result of both high base effects, and the full impact of the most recent interest rate hikes and those yet to come. He was confident that investors who bought now and held their bonds over time would earn attractive returns.

In fact, M&G Investments had recently bought US dollar global IG and HY corporate bonds for their client portfolios, including those in South Africa, after having held none for a long period. However, they had not gone "all in" to buy up maximum bond exposure because of the still-existing risks and their desire to keep cash available for future opportunities.

"In our view, valuations are attractive on an historic basis across government, investment-grade and high-yield bonds, and we have started to take advantage of this," concluded Leaviss. "Investors can expect market volatility to remain elevated as markets continue to weigh the likelihood and severity of a recession ahead, and central banks respond to data and adjust their monetary tightening measures and outlook accordingly. It is a very news-driven market. Despite this uncertainty, we are confident that investors who buy now and patiently hold these assets are likely to reap the benefits of diversification and a steady income over time."

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