Bonds still have a role to play in portfolio construction

Key points

- *The traditional role of bonds has been under pressure as rates have fallen to zero or into negative territory.*
- *However, bonds continue to offer downside protection and diversification against equity sell-offs.*
- *Investors need to be remain vigilant about liquidity in bond portfolios.*

Bonds will continue to offer diversification and downside protection despite the coronavirus pandemic extending the era of historic low yields into the foreseeable future, according to bond managers speaking at the Frontier conference.

Pendal Portfolio Manager, Amy Xie, said the performance of bonds in Europe and Japan was still negatively correlated during an equity market sell-off.

She said bonds could still rally even when central banks peg interest rates at zero because that setting may not stimulate a struggling economy.

"I still have no doubt that even at these very low yield levels, if you do get these sudden sharp drops in equity markets that negative correlation in fixed income does persist."

Jamieson Coote Bonds Executive Director and Chief Investment Officer, Charlie Jamieson, said Japanese and European bonds, where rates have dropped into negative territory, yielded positive returns when the currency was hedged back to Australian dollars.

"Japan is an interesting market – it definitely had the best liquidity in March and April when a lot of other markets were suffering from bouts of illiquidity."

Look out for liquidity issues

Liquidity became an issue during the depths of the COVID-19 crisis, with the major Australian banks refusing to bid back their own their own senior paper, Xie said.

"That illiquidity that you saw in corporate bond markets – basically illiquidity in anything that wasn't government bonds – was far worse than what was witnessed during the GFC," she said, citing tighter regulations that have driven contrarian investors from the market as a factor.

Investment grade credit has a role to play in portfolios, but investors need to be wary about sacrificing quality to get a better yield because those bonds may become illiquid under stress. Businesses are under increasing pressure as the COVID-19 crisis continues to play out, pressuring business models and potentially increasing defaults.

"My views is that rating agencies have always been behind," she said. "You only need to look at how markets are pricing those downgrades before the rating agencies ever get there."

Investors are also considering implementing protection against inflation over the medium term. Xie said the market is currently predicting medium term inflation of just 1.5%, which is well below the RBA's target inflation band of 2-3%.

"At 1.5% we don’t think it's cheap protection right now – below 1% it's probably worth it."

Meanwhile, Jamieson said there was significant demand for Australian sovereign bonds as the government looked to fund its major fiscal stimulus.

"It really is the Rolls-Royce of global bond markets – triple-A rated, a Westminster legal system, a Commonwealth nation. And now with a very big and broad market that's going to be north of a trillion dollars shortly in terms of government issuance and semi-government issuance outstanding, there are huge amounts of liquidity that can satisfy those much bigger investors."

Key questions the panellists answered

- *(7.05m) What role should Europe and Japan play for bond investors?*
- *(09.35m) Should investors consider having a standalone allocation to the Chinese bond market?*
- *(12.15m) Is it time that investors reconsidered the typical 50:50 split between Australian and international bonds?*
- *(16.55m) What is your view on investment grade credit, should we ignore the growing proportion of fallen angels given yields are so low on other assets?*
- *(19.15m) What is your view of green bond issuance and demand?*
- *(25.00m) How should investors be thinking about liquidity given the COVID-19 crisis?*