aegon asset management

BondTalk

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AEGON INSIGHTS

# Fixed Income: the asset class for everyone

*I have been preaching about the 'year for fixed income' since end of 2022 now. If you allocated to bonds back then, chances are, you enjoyed a nice total return in each of the past few years. Yet the appeal of both the income as well as the total return component of bonds remain as robust as it has been for a long while.*

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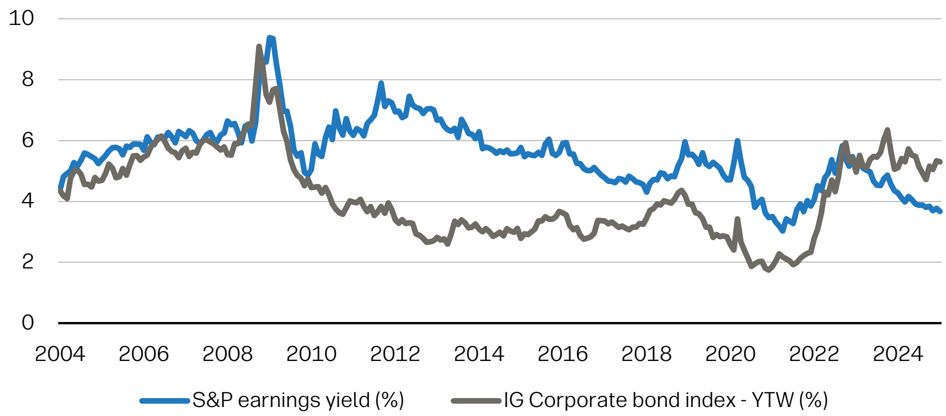
Fixed income is by far my favourite asset class – and not by virtue of my vocation. In my opinion it offers something for everyone. It can be your source of income, it can be a powerful total return play, and it can be anything in between. Hence, I have started to refer to it as **'the asset class for everyone'**. High starting yields make a strong case for positive total returns near term, historically tight credit spreads present a challenge. However through an active approach to bond investing, it has never been more pertinent to be able to extract these yields.

## Why everyone needs bonds

Over the past 24 months the chart below has become my number one go-to chart, and it still holds true! After a decade of being starved out of income alternatives, the average investor can still de-risk their portfolio and allocate back to any flavor of bonds they wish, while picking up more yield along the way. This is by far the clearest explanation why bonds are so attractive right now.

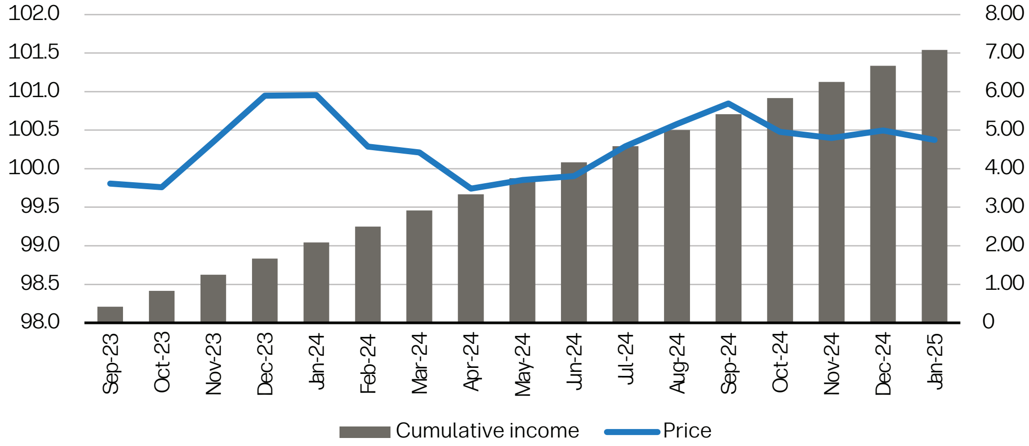
**Chart 1: Bond yield vs Earnings yield**




Source: Bloomberg as at 31 December 2024

In practice, this means that as long as yields remain around current levels, an investor could buy short-dated government bond debt with very little capital risk and guarantee a solid income stream that can be periodically rolled over.

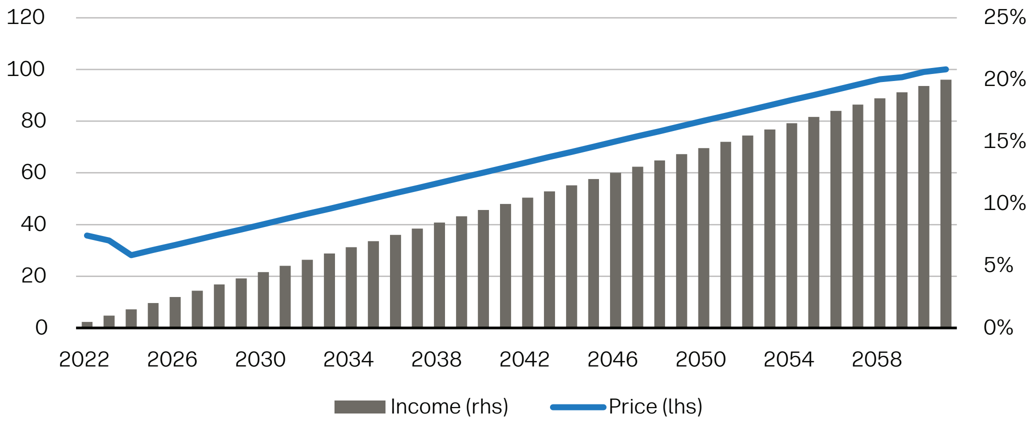
**Chart 2: US Treasury 5% 2025**




Source: Bloomberg as at 31 December 2024

But it is not just income. Bonds can provide a virtually guaranteed capital upside total return too. If you were to buy the UK Treasury 0.5% 2061 government bond today at around a price of £28, you would be guaranteed (by the UK government) to get back the par value of the bond (£100) in 2061, while also getting paid a 0.5% coupon every year for the next 36 years. Assuming reinvestment at current market rates, this is more than five-fold total return for the investment period.

**Chart 3: UK Treasury 0.5% 2061**




Source: Bloomberg as at 31 December 2024

## Government bonds

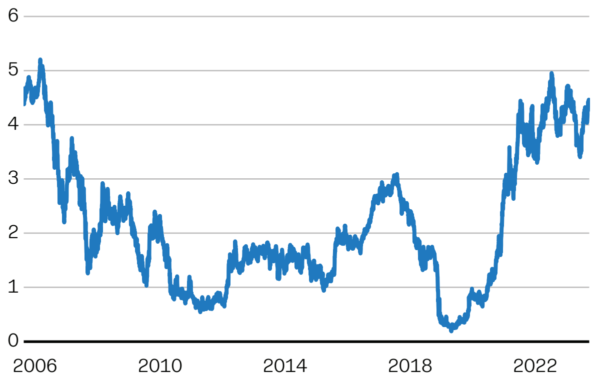
Government bonds have been a stable source of returns lately, much to the delight of many risk averse investors who have been paying fees on cash accounts.

A generic government bond index[1] had a total return of 0.58% and 4.05% in 2024 and 2023 respectively, and the starting outlook for 2025 is equally appealing with a Yield to Worst (YTW) of 4.45% as of January 1st 2025*. Looking at my favourite bond breakeven calculator, if an investor were to buy the 5 year United States Treasury (UST) today, they would be faced with a very interesting return profile probability on a 12 month horizon. If yields were to remain unchanged or rallied up to 100bps, the twelve month total return on investment would be in the range of 4.4% to 8%. Moreover, this investment would only start to be loss making if yields increased by over 100bps during the same time horizon.

> ***But it is not only income. Bonds can provide a virtually guaranteed capital upside total return too.***

*Source: Aegon Asset Management as at 1 January 2025.
1 Bloomberg US Corporate 1-3 Yr Index, LF99TRUU

### Chart 4: Yield on US five year government bond




**One-year breakeven calculator**

↑ Yield rises > **5.5%** – negative total return

↔ Yield remains at **4.4%** – total return of **4.4%**

↓ Yield drops to **3.5%** – total return > **8%**

Source: Bloomberg as at 31 December 2024

Note, I used the same logic to illustrate an investment case at the beginning of last year too. If you bought the 'then-on-the-run' five year US treasury bond, you would have had a total return of inside 3% for the year. Not a disaster.

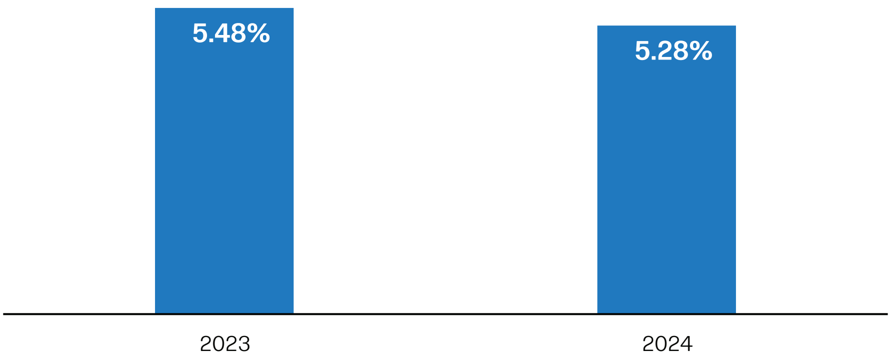
I understand that there is some lingering anxiety with respect to bond yield levels and their direction of travel. The yield on the 10 year US Treasuries increased more than 120bps since the middle of September of last year, mainly driven by a strong economic activity in the USA. I would again argue that the higher the starting yields, the better the risk/return outlook is for all things fixed income, as illustrated in the above 'calculator' (chart 4).

But if an investor wished to be extra conservative, they can easily pick a US government bond with a 4.5% coupon that matures in May 2027 and lock in a 4.3% yield per year**.

## Investment grade credit

Global investment grade (IG) returns in the past 2 years have been 8.5% in 2023 and 2.1% in 2024. Owing to the high starting yield levels, income has by far been a very solid part of that, providing 5.4% and 5.1% respectively. This makes for an interesting point: conservative bond investors do not need to look down the rating spectrum to generate income. One option is to buy high quality corporate bonds and hedge out the interest rate risk, another is to just look deeper in the higher quality corporate bond spectrum. IG credit index of 1-3 years to maturity[1] is much less exposed to generic level of rates and has had a stellar one year return, providing a 5.5% return.

### Chart 5: Short dated IG total return

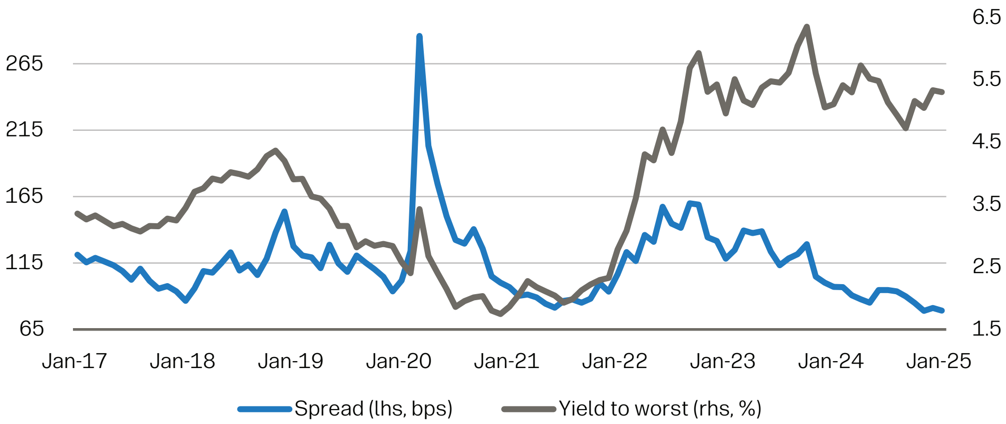



Source: Bloomberg as at 31 December 2024

**Source: Aegon Asset Management as at 22 January 2025.

The challenges in generic investment grade bonds, much like that in lower quality corporate bonds, stem from the very tight spread levels. This creates a bit of an anomaly; on one hand, index yields are at historic highs, making the total return argument of the asset class, at least in the near term, very compelling. On the other, spreads present an asymmetric risk reward function here which only seems to be a matter of time.

**Chart 6: Investment grade - yield vs spread**



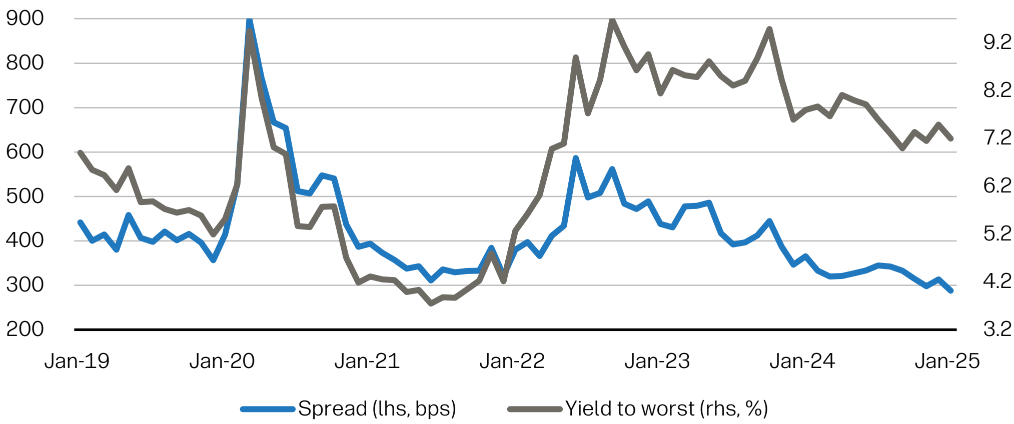

Source: Bloomberg as at 31 December 2024

This is the elephant in the room. Investors who choose to access the attractive yields in the market via passive or less active bond strategies are exposing themselves to a hard time but fairly inevitable sharp repricing.

## High yield credit

High yield returns have been even stronger at 13.5% and 8.2% in the past two years.[2] Traditionally an income asset class and an even larger proportion of the returns is explained by distributions. The dilemma that investors face, not dissimilar to that in investment grade credit, is the overall tight level of credit spreads. Historically, credit spread levels would be of a bigger concern to a speculative grade investor than a higher quality one given the asset class' higher exposure to default risk. Personal unsecured credit defaults are rising at a post global financial crisis (GFC) record pace across many developed economies, which should be enough to warrant caution. However, the high all-in starting yield provides a significant amount of protection against yield widening and a total return loss. In addition, much of the riskier credit that typically enters the public wholesale market has now been shifted to private lenders, keeping the default ratios contained. This increases the risk of an asymmetric move to high yield credit spreads, but at the same time, it reduces the likelihood of a gradual repricing wider along the way. The probability of entering a tail event has probably reduced somewhat, but the expected move in spreads if we land in one has probably increased.

**Chart 7: High yield index - yield vs spread**




Source: Bloomberg as at 31 December 2024

2 Bloomberg US Corporate High Yield Bond Index, LF98TRUU

## Where are we today vs a year ago?

US government bond yields oscillating between 4% and 5% are at historically attractive levels. Risks to the upside for bond yields stem from ongoing economic strength or resurgence of inflation. Risks to the downside, on the other hand, can see investors enjoy a double digit total return from this asset class alone.

What is similar versus a year ago – starting yields continue to appear very attractive. This is typically a reliable predictor of forward 12 month total returns. Therefore, the investment case for the asset class is as strong as ever, at least in the short term.

What has changed – credit spreads are extremely tight, increasing the risks for corporate bonds even in a non-recessionary environment. We do not foresee a specific catalyst, nor do we anticipate any large growth shocks. But we also know that corporate bonds are a mean reverting asset class, simply because there has to be a certain level of default risk premium in spreads. There can be prolonged periods of time where spreads offer very little default compensation, but it never lasts forever. And the tighter the spreads are, the larger and more abrupt the repricing usually is.

Trying to time it is a fools' game. But focusing on a high quality, defensive stream of income while positioning for an asymmetric move wider seems a sensible way of earning a good level of carry while minimizing exposure to generic market beta.

## Recap

Bonds' growing appeal over the past 24 months has been unstoppable. Not often have investors been able to diversify their holdings with less risky but more yielding alternatives and they jumped on the opportunity which usually is short lived.

We start 2025 pretty much where we were a year ago – a fixed income market that has something for almost everyone. Along the way, the conversation that I have with investors has moved from 'whether it is time to buy fixed income' to 'what types of outcomes do I want to achieve from my bond allocation'. The asset class has the potential to offer something for everyone.

**"** ***The asset class has the potential to offer something for everyone.***

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