Silverdale
Fund Management

Bonds are Forever!

Understanding fixed income outlook and opportunities

By Sanjay Guglani

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Bonds are a crucial component of wealth preservation and creation strategies, emphasizing their timeless value in investment portfolios.

A Decade of Low Rates & Inflated Valuations, and the Fed Pivots

2023 was a watershed year in the world of investments. For 13 long years, effective interest dropped and the risk-free rate got decimated close to zero. The TINA[1] factor forced investors to embrace risks. Everyone became a venture capitalist! A startup projecting profits a decade out, discounted at near-zero rates, became a unicorn[2]. The party ended abruptly in 2022-2023 with the US Federal Reserve's aggressive rate hikes – the fastest ever[3] – to combat runaway inflation. This shift resulted in 2022 being one of the worst years for capital markets, with Government Securities experiencing their worst performance since 1788 and the bond yields sky-rocketing to multi-decade highs. In the last quarter of 2023, the Fed pivoted from rate hikes to potential rate cuts, sparking one of the best bond rallies since the 1980s. But it was only a trailer, with much more to come.

Record Inflows into bonds: Back to basics

2024 has already witnessed record US$ 274.8 billion inflows into bond funds (excluding another US$ 315.2 billion into money market funds[4]). Chartered Accountants understand that bonds prices and interest rates have an inverse relationship[5].

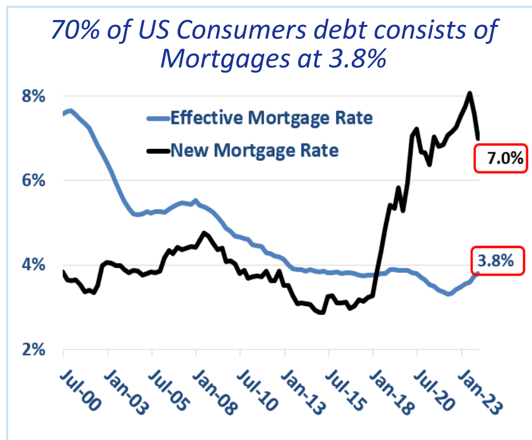
They know that bond yield is 'bond destiny'[6]. Yet, many get understandably spooked by falling bond prices due to increase in interest rates. *Hence, it is important to establish whether the interest rate can materially increase from here:*

Decoding Interest Rate & Inflation

The primary driver behind the Fed's interest rate hikes, has been its mandate to curb inflation. The key component of Core Inflation, contributing nearly 44%, is Shelter CPI. The Shelter CPI typically lags prevailing rental prices by 9-15 months. With prevailing rents already showing a downward trend, Shelter CPI, and consequently, overall inflation, is on a path of gradual, albeit bumpy, decline. The key reasons for the US economy still going so strong are:

[1] There Is No Alternative (TINA)
[2] A start-up valued at over US$ 1 billion
[3] 21-fold increase from 0.25% to 5.25%
[4] Source: BofA Research, EPFR Global, Jun'24
[5] Increase in interest rates by 1% results in the bond prices falling by 1% times the duration of the bond, ignoring convexity, and other factors.
[6] Bond yield is the return bond provides over the life time, including (a) coupon (interest on bonds) and (b) bond price appreciation / depreciation to its par value (pull to par).

- USA is predominantly a consumer economy, and US consumers are still strong, due to excessive savings from the Covid-era, resilient (though cooling) labor market, 13-consecutive months of positive wage hikes, while the weighted average mortgage rate for US household is still circa 3.8%.



- Even US corporates are robust, as USA is the only country where 81% of corporates borrow from the bond market typically for 5-year terms, as against borrowing from the banks. This means that corporates had locked in the low-interest rates that were prevalent five years ago.

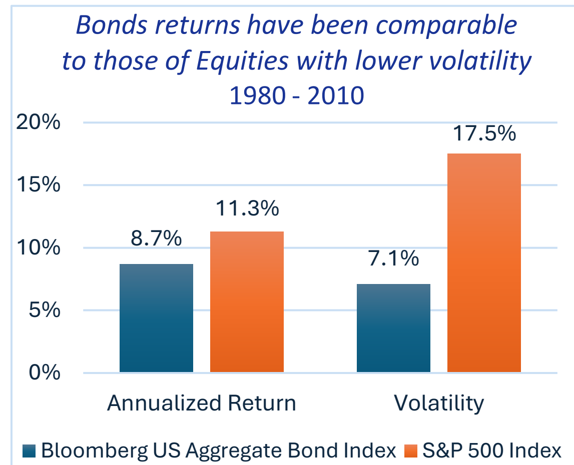
Cracks Beneath the Surface: Outlook

However, cracks are starting to show beneath the seemingly robust US economy, masked by a record $1.8 trillion budget deficit[7]. Credit and auto loan delinquencies for the bottom quartile of the population are already exceeding 2008 levels. The interest cost for the smallest 700 listed companies in the US has jumped by 50%, with bankruptcies in 2023 nearly equalling those of 2021 and 2022 combined.

Peak Interest Rates are Behind: Time to Invest is Now

The prevailing high-interest rates are starting to hurt the economy. Additionally, the real interest rate[8] in the US is above 2%, a level deemed to be unsustainable. Therefore, barring unforeseen events, the peak interest rates are likely to be behind us, implying that the mark-to-market losses induced by the rate hikes are a thing of the past. This presents a golden opportunity to invest into bonds.

Bonds offering equity-like return with half the adjunct risks



Over a long period of time, the difference between bond returns and equity returns is less than 3% p.a.[9] Except for the post-GFC era of circa 10 years, bonds have been an effective hedge against equity markets volatility. The equity-bond hedge broke primarily because of the artificially low interest rates, which are now being restored. Currently, the quality bond yields are higher than the equity earnings yield; thus, providing **equity like returns** with almost half of the adjunct volatility. Historically, 80% of the super-profits from bonds are made during the period between interest rate pause and cuts, not after the cuts - which is the current situation.

Cash could prove to be a 'Trap'

Currently, the interest rate curve is inverted[10] and it is easy to be allured to park the money in one year term deposits with bank. However, **this could be a strategic misstep**. Typically, the 2-year US treasury rates fall by 2% within 5 months of the start of interest rate cuts, inflicting huge opportunity cost of not locking in the current high yields for longer period. Based on the Fed rate hikes in 7 previous rate cycles, the short-term

[7] At 7.4% (un-adjusted), the US budget deficit is one of the highest since WWII

[8] Real interest rate is nominal interest rate less inflation

[9] Source: Bloomberg

[10] In normal market conditions, the longer the period, higher the interest rates; thus, a term deposit for 5 years provides higher interest rate than that provided by a term deposit for 3 years.

bond funds have delivered circa 3% higher return than that delivered by cash.

Leverage provides superior risk-adjusted returns

Savvy investors can further enhance their returns by using leverage. Today, an enhanced return 3-4 years fixed tenure US dollar bond fund can provide **8%-9% p.a. return**, that is, *doubling the money in circa 10 years.* In local EM currencies, the return could be higher by approximately 2%-3%, due to depreciation of currency (as in case of the Indian Rupee).

How Leverage Works

Illustration

Investor layout	: $100
Loan Taken	: $100
Total Investment	: $200
Interest earnings rate	: 6%
Interest paid on loan*	: 4%
Total interest earned	: 6% * 200 = $12
Interest paid on loan	: 4% * 100 = ($4)
Net income	: $12 - $4 = $8
Return on Investment	**= 8/100 = 8%**

((*) Post-Interest Rate Swap; Ignoring frictions & costs)

Innovative Strategy for Corporate Treasuries

Illustration of Fixed Tenure/Treasury Fund

Silverdäle FTF June 2028*

Target Returns	Approx **8.5% p.a**. (+/- 0.25%)
Tenure	June 2028
Leverage	Approx. 1.5x
Credit Rating	Circa 63% Investment Grade
No. of bonds	25-50
Dividend Plan	USD 7.00 per year

(*) Strictly for educational purposes only, numbers are indicative.

CAs managing corporate treasuries can unlock further value by using turn-key bespoke funds – by "loan-on-demand" facilities at very competitive rates. This strategy enables significant reduction in the amount of Cash & Cash equivalents, boosting ROI for the corporate treasury department. A bespoke treasury fund also enables creation of a bond portfolio **dynamically laddered to match the company's ever-changing funding needs**, further enhancing the treasury returns.

Executive Summary:

The key takeaways for fellow Chartered Accountants are:

1. **Bond yield is Destiny**
   In the short run, the direction of interest rates drives bond markets, but in the long run, it is the starting yield that really matters.
2. **Lock-in prevailing elevated yields**
   Don't miss the forest for the tree – the prevailing interest rates are high and should be 'locked-in'.
3. **Fixed Tenure Funds provide higher assurance of returns**
   Non-recourse leverage can render superior risk-adjusted returns.
4. **Bespoke Treasury Funds** significantly increase corporate treasury returns
   Through ***Liquidity, Leverage, and Laddering***
5. **Compelling Income and Potential Gains**
   At current yields, bonds offer a compelling combination of attractive income generation and potential capital appreciation.

Thus:
Bonds are an integral part of all wealth preservation and wealth creation strategies, that's why: **Bonds are Forever!**

Disclaimer: *This article is for informational purposes only and does not constitute financial advice. Please consult a qualified financial professional before making any investment decisions.*

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