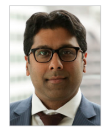
The Rates Perspective: Can Bonds Provide Shelter for Stormy Weather Ahead?

Can bonds still act as defensive assets amid growing concerns over government-debt sustainability?

Insight from sub-adviser, Wellington Management



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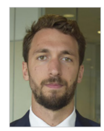

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Investment Director

We started the year expecting rates to remain elevated and increased divergence across bond markets, as investors and policymakers reacted to increasingly local growth/inflation dynamics. Markets have pondered the possibility of rates staying higher for longer on several occasions since the inflation shock of 2021–2022, only to look for signals of any easing to prompt market rallies, such as in the last quarter of 2023 and last summer. The question, then, is this: Will this time prove to be any different? And what can a bond allocation offer in a broader portfolio?

Vigilantes Are Back, Capital Flows Could Follow

There has been no shortage of exogenous shocks in the first half of this year. The Trump administration's approach to tariffs escalated progressively. Further escalation ensued after the April 2 announcement, upending decades of trade policy, until a temporary reprieve was announced. In this context, longer-dated bonds, rather than equity markets, acted as the disciplinarian, forcing the administration to rethink its approach. This could mark the return of the so-called bond vigilantes—buyers who use their buying and selling power to influence policies—with fixed-income markets imposing a degree of restraint on governments whose fiscal outlook is increasingly deteriorating. Even if some of the tariffs are walked back through trade deals, there's an increased probability of more economic nationalism and repatriation of capital. We could start to see capital outflows from US financial assets into global fixed income, which should imply higher risk premia[1] and higher long-term bond yields for the US. In the rest of the world, this could be a strong technical factor to support non-US financial assets, with European, Japanese, and Chinese fixed income potentially benefiting from US outflows.

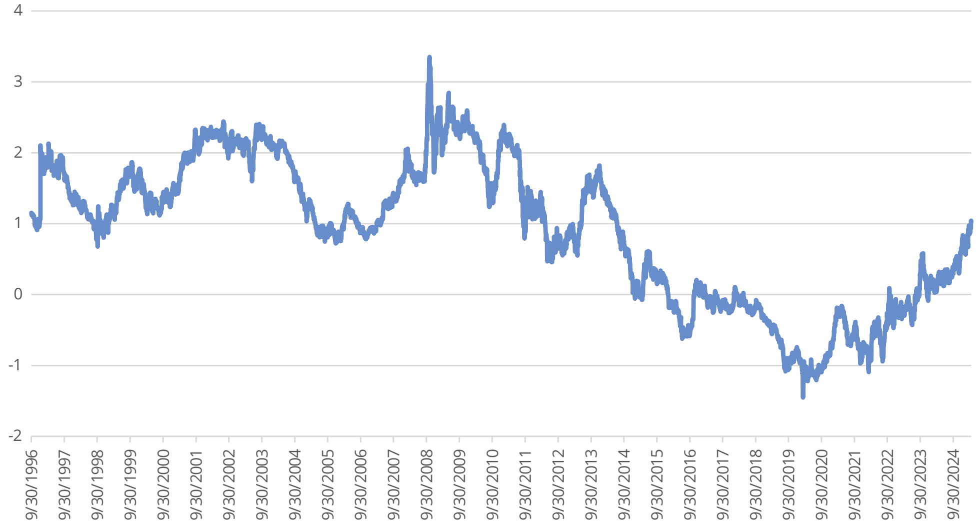
Storing Up Trouble

We continue to expect heightened volatility in rates markets around longer-dated maturities. Yield curves[2] across developed markets have now normalized, but could see further steepening due to persistent inflation and high government spending. Growing concerns about debt sustainability could lead to higher term premia[3] across developed markets, especially the US—a dynamic illustrated by **FIGURE 1**, which shows that, at the time of writing, the average term premium across developed markets had risen above 1.0% for the first time in 11 years.

Key Points

- Local factors are driving bond markets; inflation and fiscal issues are impacting markets, especially in the US, Europe, and Japan.
- Bond vigilantes have returned, pressuring governments and potentially prompting potential capital shifts from US to global bonds.
- US bonds may still maintain their defensive status, but investors are diversifying beyond US Treasuries amid rising volatility.

FIGURE 1
Term Premia Are Starting to Rise Across Developed Markets (%)



As of 5/22/25. Data Sources: Morgan Stanley and Wellington Management.

The euro area is a good example of this tension. The European Central Bank appears biased to continue its rate-cutting cycle, while the sustained increase in defense spending—especially in Germany—and deteriorating fiscal outlooks in some countries (notably France) could push long-term bond yields higher. Equally, the Japanese yield curve has steepened significantly in the last year with 30-year bonds reaching yield levels not seen this century, even if monetary policy remains stubbornly loose. Contrary to other markets, we expect to see a flattening of the Japanese curve should the Bank of Japan opt to hike policy rates, in response to a potential trade deal with the US and persistent, domestically generated inflation.

Finding the Right Defensive Asset

In times of macroeconomic turbulence, rates should act as an anchor that rallies as riskier assets depreciate. Investors have been skeptical of bonds' total return and their correlation to equities since the annus horribilis of 2022. Recent market turmoil suggests that bonds have generally regained their historical role, providing portfolios with income and downside mitigation. However, identifying where this anchor can be found could be changing. Over the course of April, global investors implicitly challenged the notion of the US Treasury market as the main diversifier asset in times of exogenous shocks. Moody's recent downgrade to the US credit rating (due to concerns about growing national debt) may further cement the view that alternative assets, such as European, Australian and Japanese government debt (as well as select currencies) can deliver the required diversification within a broader portfolio. Diversification does not ensure a profit or protect against a loss in a declining market.

In summary, bonds are demonstrating once again that they can be a defensive asset during heightened volatility, but an active approach may be warranted as local conditions increasingly trump the global cycle in driving market returns.

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Talk to your financial professional to learn more about fixed-income opportunities.

[1] Risk premia is the investment return an asset is expected to yield in excess of the risk-free rate of return.

[2] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

[3] The term premium is the amount by which the yield on a long-term bond is greater than the yield on shorter-term bonds. This premium reflects the amount investors expect to be compensated for lending for longer periods.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • US Treasury securities are backed by the full faith and credit of the US government as to the timely payment of principal and interest. • Foreign investments may be more volatile and less liquid than US investments and are subject to the risk of currency fluctuations and adverse political, economic and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets.