This Interview was conducted on 15 March 2024. Content updated on 26 April 2024.

All back to bonds?

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While 2023 arguably marked the comeback of bonds, there's no guarantee this trend will continue in 2024. And as the latest Natixis research points out, uncertainties over growth prospects and inflation levels, and hence over the timing and scale of central bank rate cuts in 2024, are prompting bond investors to exercise caution.

So, how should we be looking at bond segments? Are investor interests in green bonds justified? Is it the right time to lengthen duration in portfolios? And can inflation fall back below the 2% mark set by central banks?

According to the 2024 Natixis Global Fund Selector Outlook Survey, green bonds continue to hold an interest for selectors in almost all regions. Overall, 84% say they will maintain (50%) or increase (34%) their allocations. Do you share their optimism – and where do you see the headwinds and tailwinds for this asset class in Europe?

We share the optimism of fund selectors regarding green bonds for three reasons. First, there's strong investor demand. There's growing environmental awareness and regulation in favour of sustainable investments which is driving the demand for green bonds.

Second, there's a massive amount of funding needed for the green transition. The world economy requires significant resources to achieve its climate goals, making green bonds a crucial financial tool. Something in the region of $4 trillion a year for clean energy is required to reach carbon neutrality by 2050.

Third, the new European Green Bond standard which is coming in 2025 will provide greater transparency and clarity to the market.

And while the global outlook is positive, challenges exist alongside opportunities. For example, green bond investors may also suffer from macroeconomic uncertainties. If rates continued to rise or we had stronger than expected inflation, this would impact bond valuations – including green bonds.

A second concern may be greenwashing risk. Concerns about the true green nature of some labelled bonds may create investors hesitancy until the implementation of stronger regulations arrive to thwart greenwashing.

But EU initiatives such as the NextGenerationEU programme provide green bonds with a public support. The sustainable bond markets is increasingly diversified and innovative, evolving with a broader base of issuers and more options to invest, such as Sustainability-Linked Bonds. And when it comes to performance, studies suggest that green bonds could offer similar or better risk-adjusted returns compared to their conventional counterparts.[1]

So overall, despite the headwinds, we think that the long-term outlook for green bonds in Europe remains positive.

Would you agree that bonds are unequivocally back in 2024?

Yes. And I think the renewed interest in the bonds asset class in 2024 is not limited to green bonds but encompasses all types of bonds. This is for three reasons.

First, the search for yield has revitalized the bond market after a prolonged period of historically low interest rates. The US 10-year Treasury yield has climbed from a low of 0.5% mid-2020 to its current level of 4.7%[2], making bonds significantly more attractive to investors.

Second, the current global economic landscape, which has been marked by slowing growth and decreasing inflation rates for several months, provides an impetus for central banks around the world to initiate rate-cut cycles, even if in recent months there has been a little more caution especially in the United States. Once the cycle has started, and we are confident that the ECB intends to start in June, the impact on bonds should be positive..

Third, at the beginning of the year bond investors were worried about supply risk. We think that supplies, especially in the US, will increase massively in 2024 compared to last year.

But these concerns have been allayed as the market has responded favourably to the very heavy supply since the beginning of the year. And this resilience bodes well for the future performance of bonds, enhancing their attractiveness as an investment option. So overall the combination of macroeconomic factors and market dynamics underscore the compelling case for the resurgence of bonds in 2024, likely during the second half of the year.

Given that Interest rates remain the top portfolio risk for fund selectors, is it too early to add duration to portfolios?

Investors need to keep in mind that two components drive the return of fixed income portfolios: the price return, which is linked to the move of interest rates, and the carry. The carry component has been left aside for many years as rates were maintained at a very low level by central banks. It should not be neglected.

With rates much higher now than in the previous decades, investors get compensated for a lot more running interest rates risk. Central bankers have pivoted away from the hawkish narratives and inflation is progressively normalizing back towards the 2% level.

Increasing the duration of an allocation is often done in response to expectations of declining policy rates, and central banks have started to communicate that way, with much more caution on the Fed side. Investors should therefore begin to increase their allocation to fixed income, at least in the eurozone.

We believe that the first cut of the ECB will happen in June. The Fed, because of a more resilient economy, less rapid disinflation, and a tight labour market, will act later.
For the Fed, we have less than two cuts priced by the market, which is roughly in line with our scenario. We think that the front end of the US curve with 2-year bonds yielding around 5% is attractive.

Only when we get more clarity about the first Fed cut we will move along the curve.

Fewer fund selectors (22%) think inflation will hit the 2% targets set by central banks any time in 2024, while more than half (54%) are resigned to the fact that that higher inflation is the new normal – a sentiment most strongly felt by those in the UK (62%) and EMEA (61%). Does this persistent high rates and high inflation environment threaten to delay the financing of the energy and environmental transition?

Most central bankers believe inflation will stay above the 2% target in 2024. ECB projections for this year show 2.3% for the headline inflation and 2.6% for the core inflation. There is a high chance that most respondents of the survey are right.

The shift in inflation regime is much more subtle. One should look at 2% as the new floor. And the bias is in the prevailing tendency to break above it rather than drop below it. Most metrics followed by the Fed are now below 3% and should be around 2.5%. However, the latest figures show the fragility of these forecasts. We think inflation that's sticky around 2.5% is very different from inflation that's sticky at 5%, especially for fixed income.

And we think it should not be problematic for financing the green transition at this level.

Moreover, most projects are done with a long-term view. We think the support from governments will fill the gap for any profitability issues in those projects. And we therefore remain confident that it won't affect the financing of the transition.

What else do you think should be top of mind for investors when considering the fixed income portion of their portfolio this year?

Well, if inflation proved stickier the Fed would have to give up its soft landing economic scenario and would keep its Fed Funds rate beyond 5% for longer, albeit with the risk of a financial accident. In this case, the first move for the market will be an increase in rates, which has already been seen in part since the beginning of the year. Risky assets would be penalized by keeping real rates high for too long. However, in this type of scenario, Treasury bills and bonds would eventually perform due to a preference for quality assets but also in anticipation of more accommodative monetary policies.

(1) https://www.climatebonds.net/policy/policy-areas/improving-risk-return-profile + Over the six years from 2016 to 2021, euro-denominated green bonds at an aggregated level outperformed their non-green equivalents by 52 basis points on an annualized basis.
Source: https://www.gsam.com/responsible-investing/en-INT/professional/insights/articles/how-green-bonds-fit-in-a-fixed-income-portfolio
(2) As of 26 April 2024

Additional notes

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