



FEBRUARY 2024

# Interesting rates: What can bonds tell multi asset investors about the future?

## KEY TAKEAWAYS

- Changes in bond yields can have a significant impact on subsequent returns across asset classes.
- Monitoring and reacting to shifts in yields can therefore be an advantage for active multi asset strategies.
- Our research suggests a strong decline in yields (of 50bp or more) is the most favourable environment for returns across several asset classes.
- US small cap equities have historically been a notable beneficiary of a strong decline in yields: since 1988, on average it is the only time they have outperformed large caps.

**Bond markets don't just guide fixed income decision-making. They can help with investors' broader allocation decisions by offering insight into a range of different asset classes. With yields down sharply in recent months, which assets could be poised to benefit?**

There is a popular saying on Wall Street: bonds are smarter than equities. This stems from the fact that bond markets can tell us something about the future – since bond yields reflect market expectations for changes in interest rates, they also reflect market expectations about coming changes in economic conditions.

Bond markets have also historically shown predictive qualities. For example, an inverted US Treasury yield curve (where yields on short bonds are above those on longer bonds) has historically been a strong predictor of a coming US recession and thereby often negative equity returns.

As a result, multi asset managers closely monitor bond market dynamics to help guide their asset allocation decisions. With central banks on the cusp



**Andreas De Maria Campos**  
Team Lead Active Allocation  
Retail – Multi Asset



**Sebastian Lukas**  
Associate Portfolio  
Manager – Multi Asset



**Henri Foray**  
Associate Portfolio  
Manager – Multi Asset



## INTERESTING RATES: WHAT CAN BONDS TELL MULTI ASSET INVESTORS ABOUT THE FUTURE?

of a monetary policy regime change, what are bonds telling us about the future today?

### What does a new yield regime mean for investors?

After a prolonged rise in response to inflation-fighting interest rate hikes across 2022 and 2023, bond yields in recent months have declined sharply as investors have begun to price in rate cuts, particularly from the US Federal Reserve.

The drop in 10-year US Treasury (UST) yields, for example, has been remarkable not just in the context of the recent past, but historically. The -102bp change in yields (from just under 5% to under 4%) between 31 October 2023 and 31 January 2024 was in the largest 2% of rolling three-month yield declines observed since the year 1790.<sup>1</sup>

To understand what dramatic shifts in yield regimes can mean for investors, we looked at average three-month excess returns across asset classes in response to different three-month changes in 10-year UST yields.

Exhibit 1 shows historical average excess returns across four distinct yield regimes:

1. Strong yield decline (three-month decline larger than -50bp)
2. Slight yield decline (three-month decline between -50bp and 0bp)
3. Slight yield increase (three-month increase between 0bp and +50bp)
4. Strong yield increase (three-month increase larger than +50bp)

With the recent 102bp fall in UST yields mentioned above, the current environment sits comfortably in the "strong yield decline" category.

As Exhibit 1 shows, in general, a strong decline in yields is more favourable to average excess returns across several asset classes than any other environment.

Returns for developed market equities after a strong decline in yields are roughly double what they are after a strong increase in yields, for example (1.9% versus 1.0%). Emerging market equities have also performed far better following a strong decline in yields than under any other regime, and the same goes for US high yield bonds.

If we extend the horizon to six and 12 months following a strong yield decline, we see strengthening average excess returns across those asset classes (see Exhibit 2).

### Exhibit 1: Asset classes respond differently to yield regimes

Average three-month excess return of asset classes following different 10-year UST yield changes

% of observations	3m change of US 10yr yield	DM equities	EM equities	US small vs large caps	US value vs growth	US Treasuries	US high yield	Gold
	Yield change regime	average excess return (next 3m)						
17%	Falling > 50bp	1,9%	5,5%	1,3%	-1,7%	0,5%	2,5%	1,8%
35%	Falling < 50bp	1,0%	1,1%	-0,6%	-0,3%	0,6%	0,9%	0,5%
35%	Rising < 50bp	1,5%	1,5%	-0,5%	-0,1%	0,4%	0,8%	0,0%
13%	Rising > 50bp	1,0%	1,6%	-0,2%	-0,2%	0,5%	1,0%	0,3%
	<b>all times</b>	<b>1,4%</b>	<b>2,1%</b>	<b>-0,2%</b>	<b>-0,4%</b>	<b>0,5%</b>	<b>1,2%</b>	<b>0,5%</b>

Source: Bloomberg, AllianzGI, 31 January 2024. Yield regimes based on rolling three-month time periods January 1988 to January 2024. Past performance, or any prediction, projection or forecast, is not indicative of future performance. DM Equity is represented by MSCI World, EM Equity by MSCI Emerging Markets, US Small vs Large Cap by Russell 2000 vs S&P 500, US Value vs Growth by Russell 1000 Value vs Russell 1000 Growth, US Treasuries by Bloomberg US Treasury Total Return, US High Yield by Bloomberg US Corporate High Yield and Gold by Gold US Dollar Spot.

**Exhibit 2: Excess returns strengthen following a strong yield decline**

Yield change regime Falling > 50bp	DM equities	EM equities	US small vs large caps	US value vs growth	US Treasuries	US high yield	Gold
Horizon	average excess return						
Next 3m	1,9%	5,5%	1,3%	-1,7%	0,5%	2,5%	1,8%
Next 6m	4,1%	10,7%	2,0%	-1,6%	0,6%	5,6%	2,0%
Next 12m	6,2%	16,2%	2,8%	-2,3%	2,2%	8,3%	2,8%

Source: Bloomberg, AllianzGI, 31 January 2024. Yield regimes based on rolling three-month time periods January 1988 to January 2024. Past performance, or any prediction, projection or forecast, is not indicative of future performance. DM Equity is represented by MSCI World, EM Equity by MSCI Emerging Markets, US Small vs Large Cap by Russell 2000 vs S&P 500, US Value vs Growth by Russell 1000 Value vs Russell 1000 Growth, US Treasuries by Bloomberg US Treasury Total Return, US High Yield by Bloomberg US Corporate High Yield and Gold by Gold US Dollar Spot.

**US small cap vs. large cap equities**

The above analysis also reveals a relationship between yield regimes and relative performance between sectors, with the most notable being US small cap versus US large cap equities.

As Exhibit 1 shows, small caps outperformed large caps by 1.3% on average in the three months following a strong decline in yields, but underperformed large caps under all other regimes. And as Exhibit 3 shows, that relationship holds and the performance gap grows wider over the subsequent six and 12 months.

Although average performance figures provide a concise way to summarise a vast amount of data, it is crucial to also look at individual data points to gain a deeper understanding.

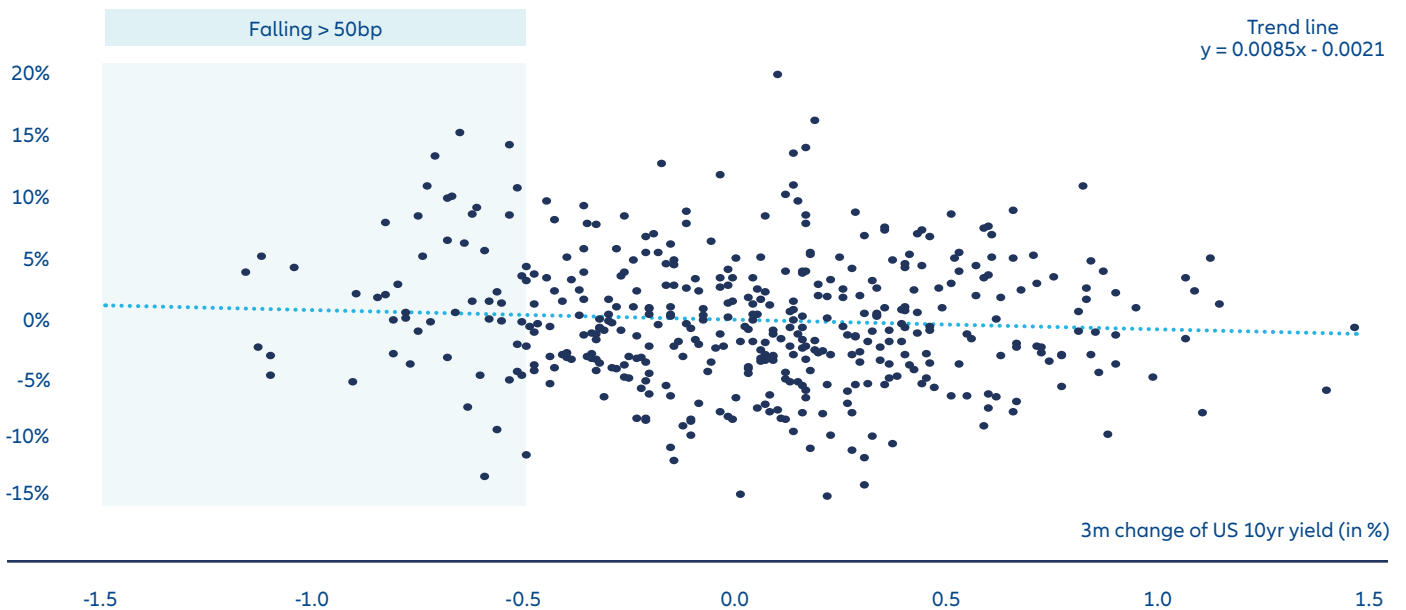
**Exhibit 3: Falling yields favour US small cap equities**

% of observations	3m change of US 10yr yield	US small vs large cap		
		forward average excess return		
		3m	6m	12m
17%	Falling > 50bp	1,3%	2,0%	2,8%
35%	Falling < 50bp	-0,6%	-1,0%	-1,9%
35%	Rising < 50bp	-0,5%	-0,4%	-1,6%
13%	Rising > 50bp	-0,2%	-2,8%	-4,6%
	<b>all times</b>	<b>-0,2%</b>	<b>-0,5%</b>	<b>-1,4%</b>

Source: Bloomberg, AllianzGI, 31 January 2024. Yield regimes based on rolling three-month time periods January 1988 to January 2024. US Small vs Large Cap represented by Russell 2000 vs S&P 500. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

**Exhibit 4: Substantial small cap outperformance predominantly occurs after drop in yields**

Outperformance US small vs large caps (next 3m)



Source: Bloomberg, AllianzGI, 31 January 2024. Yield regimes based on rolling three-month time periods January 1988 to January 2024. US Small vs Large Cap represented by Russell 2000 vs S&P 500. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

Exhibit 4 illustrates every individual data point going into the previous analysis, and two observations emerge. First, after a strong rise in yields the number of data points showing outperformance by US small caps (dots above the x-axis) decreases. Second, instances of substantial outperformance by US small caps (ie, more than 5%) are

predominantly observed following periods of falling or only moderately increasing yields.

**Absolute yield levels also matter**

Clearly, changes in yield levels exert a strong influence on asset pricing and the performance of different

asset classes. However, the absolute yield level at the time of the change also plays a significant role.

As Exhibit 5 shows, a strong decline in yields typically produces US small cap outperformance no matter the absolute yield level. However, the average outperformance was most pronounced when the yield

**Exhibit 5: Falling yields boost US small caps most amid high absolute yields**

		Level of US 10yr yields		
		"Low yields (1st tertile)" < 3%	"Normal yields (2nd tertile)" 3%-5.4%	"High yields (3rd tertile)" > 5.4%
<b>3m change in US 10yr yields</b>	Falling > 50bp	0,1%	0,6%	2,4%
	Falling < 50bp	-0,7%	0,5%	-1,6%
	Rising < 50bp	0,4%	-0,6%	-1,3%
	Rising > 50bp	-0,9%	2,4%	-2,8%

Source: Bloomberg, AllianzGI, 31 January 2024. Yield regimes based on rolling three-month time periods January 1988 to January 2024. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

decline occurred in the context of a high absolute yield level (average 2.4% outperformance when the absolute yield was above 5.4%). Equally noteworthy is the finding that during high yield environments, US small caps consistently underperformed large caps except when yields had strongly declined.

One plausible explanation for this phenomenon could lie in the higher economic exposure of small cap stocks to interest rates compared to large caps, owing to higher net debt-to-EBITDA<sup>2</sup> ratios. Since 2000, the average net debt-to-EBITDA ratio was 2.6x for the S&P500 index (large caps) but 4.0x for the Russell 2000 index (small caps). This illustrates how higher yield levels can increase challenges in meeting interest rate obligations for small caps, and why falling yields are generally welcomed by capital market participants.

Importantly in the context of today's conditions, a strong decline in yields given a "normal" absolute yield level of 3-5.4% has historically produced an average outperformance of 0.6% for US small caps over large caps in the subsequent three-month period (highlighted yellow in Exhibit 5).

Still, it is important to recognise that while yield levels and movements play a significant role in determining the relative performance of US small caps versus large caps, there are numerous other indicators that warrant analysis. Additional factors include, but are not limited to, valuation, earnings expectations, and sector compositions including their respective prospects in the business cycle.

### Multi asset flexibility an advantage

Bond markets can offer valuable insights into the anticipated and relative performance of different asset classes, and by extension multi asset allocation decisions. While declining yields typically support returns in various asset classes, there are certain asset classes and relative trades – such as small caps versus large caps – which particularly tend to thrive under such conditions.

Anticipating shifts in yield levels can therefore be an advantage for active multi asset strategies. Given their wide range of available instruments and asset classes, and highly flexible mandates, such strategies can adjust exposures according to the prevailing yield regime and target classes that, on average, benefit during the prevailing environment.

2. EBITDA, or earnings before interest, taxes, depreciation, and amortisation, is a measure of corporate profitability. By accounting for depreciation and amortisation, it aims to better represent the underlying profitability of a company's operations.

**Investing involves risk.** The value of an investment and the income from it will fluctuate and investors may not get back the principal invested. Past performance is not indicative of future performance. This is a marketing communication. It is for informational purposes only. This document does not constitute investment advice or a recommendation to buy, sell or hold any security and shall not be deemed an offer to sell or a solicitation of an offer to buy any security. The views and opinions expressed herein, which are subject to change without notice, are those of the issuer or its affiliated companies at the time of publication. Certain data used are derived from various sources believed to be reliable, but the accuracy or completeness of the data is not guaranteed and no liability is assumed for any direct or consequential losses arising from their use. The duplication, publication, extraction or transmission of the contents, irrespective of the form, is not permitted. This material has not been reviewed by any regulatory authorities. In mainland China, it is for Qualified Domestic Institutional Investors scheme pursuant to applicable rules and regulations and is for information purpose only. This document does not constitute a public offer by virtue of Act Number 26.831 of the Argentine Republic and General Resolution No. 622/2013 of the NSC. This communication's sole purpose is to inform and does not under any circumstance constitute promotion or publicity of Allianz Global Investors products and/or services in Colombia or to Colombian residents pursuant to part 4 of Decree 2555 of 2010. This communication does not in any way aim to directly or indirectly initiate the purchase of a product or the provision of a service offered by Allianz Global Investors. Via reception of his document, each resident in Colombia acknowledges and accepts to have contacted Allianz Global Investors via their own initiative and that the communication under no circumstances does not arise from any promotional or marketing activities carried out by Allianz Global Investors. Colombian residents accept that accessing any type of social network page of Allianz Global Investors is done under their own responsibility and initiative and are aware that they may access specific information on the products and services of Allianz Global Investors. This communication is strictly private and confidential and may not be reproduced, except for the case of explicit permission by Allianz Global Investors. This communication does not constitute a public offer of securities in Colombia pursuant to the public offer regulation set forth in Decree 2555 of 2010. This communication and the information provided herein should not be considered a solicitation or an offer by Allianz Global Investors or its affiliates to provide any financial products in Brazil, Panama, Peru, and Uruguay. In Australia, this material is presented by Allianz Global Investors Asia Pacific Limited ("AllianzGI AP") and is intended for the use of investment consultants and other institutional/professional investors only, and is not directed to the public or individual retail investors. AllianzGI AP is not licensed to provide financial services to retail clients in Australia. AllianzGI AP is exempt from the requirement to hold an Australian Foreign Financial Service License under the Corporations Act 2001 (Cth) pursuant to ASIC Class Order (CO 03/1103) with respect to the provision of financial services to wholesale clients only. AllianzGI AP is licensed and regulated by Hong Kong Securities and Futures Commission under Hong Kong laws, which differ from Australian laws. This document is being distributed by the following Allianz Global Investors companies: Allianz Global Investors GmbH, an investment company in Germany, authorized by the German Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin); Allianz Global Investors (Schweiz) AG; Allianz Global Investors UK Limited, authorized and regulated by the Financial Conduct Authority; in HK, by Allianz Global Investors Asia Pacific Ltd., licensed by the Hong Kong Securities and Futures Commission; in Singapore, by Allianz Global Investors Singapore Ltd., regulated by the Monetary Authority of Singapore [Company Registration No. 199907169Z]; in Japan, by Allianz Global Investors Japan Co., Ltd., registered in Japan as a Financial Instruments Business Operator [Registered No. The Director of Kanto Local Finance Bureau (Financial Instruments Business Operator), No. 424], Member of Japan Investment Advisers Association, the Investment Trust Association, Japan and Type II Financial Instruments Firms Association; in Taiwan, by Allianz Global Investors Taiwan Ltd., licensed by Financial Supervisory Commission in Taiwan; and in Indonesia, by PT. Allianz Global Investors Asset Management Indonesia licensed by Indonesia Financial Services Authority (OJK).