Vivek Prabhu: Why bonds are outshining equities – and what it means for investors

By Perpetual Asset Management
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Is TINA giving way to TARA? A decade of low rates meant there was often no alternative to

equities for many investors. But as rates rise, reasonable alternatives are starting to emerge. VIVEK PRABHU explains.

- Bond yields look better than equities for first time in a decade
- Defensive assets offer real alternative to equities
- Find out about Perpetual's Diversified Income Fund

DEFENSIVE assets like Australian credit and government bonds are offering a yield premium over equities for the first time in more than a decade, presenting an attractive opportunity for investors, says Perpetual's Vivek Prabhu.

A decade of low rates saw investors coin the acronym TINA – 'There Is No Alternative' – to explain why equities continued to rise.

But with the prospect of sustained high interest rates as central banks struggle to control inflation, a new acronym is on the rise – TARA: There Are Reasonable Alternatives.

"Ever since the GFC, there has been a running joke about cash offering 'return free risk', because you're getting almost zero in terms of yields and you were taking on some investment risk to do that," says Prabhu, Perpetual's head of fixed income.

"So, the term that was coined was the TINA trade.

"But now, there are real alternatives to equities – it really does change the equation."

More rate rises likely: RBA

New RBA governor Michelle Bullock addressed the challenge facing Australia in a recent speech, saying inflation was increasingly "homegrown and demand driven", suggesting a need for further monetary policy tightening.

"She was arguing that if inflation was simply the product of global supply disruptions or other price rises, then monetary policy has little influence.

"But as inflation is actually a result of strong domestic demand, then the RBA has some more work to do in terms of lifting interest rates," says Prabhu.

"For floating rate credit, that means the trajectory is looking even more positive."

Portfolio implications

Australians have a traditional love affair with equities and property and as a result can be underweight fixed income investments.

Total allocation to fixed income in superannuation is relatively low by global standards at 13 per cent, partly as a result of the defined contribution nature of super which encourages investment in long term growth.

But Prabhu says the yields on offer from credit are now comparable to returns available in higher risk assets.

The yield on 10-year Australian government bonds has been higher than the dividend yield on the ASX200 since September 2023. The last time this was true was July 2011.

The Perpetual Diversified Income Fund's running yield has exceeded the ASX200 dividend yield since December last year, while the RBA cash rate at 4.35 per cent is the highest it has been since November 2011.

"In floating rate credit especially, the return prospects for the coming year are quite strong," says Prabhu.

"The reason for that is as interest rates rise, the income generated on a floating rate portfolio rises as well, without that inverse relationship (between capital value and market yields) you have with fixed rate bonds.

"So, the capital is pretty stable and you're getting higher income generation – it's the best of both worlds."

Protection against economic downturn

Fixed income is also relatively attractive as the risk of a global economic downturn triggered by rising interest rates threatens earnings from equities.

Returns on a floating rate credit fund are a function of the RBA cash rate and movements in credit premiums, the additional returns investors receive over a risk-free investment.

Prabhu says credit premiums are back at long term historical averages after a trough post GFC, which means investors are getting better compensated for risk.

"Right now, both of those things are looking pretty healthy."

This provides an opportunity for investors to switch some of their equity holdings into fixed income to provide a buffer against market volatility, says Prabhu.

"You get a good return for low risk and retain the optionality to rotate back into growth assets should equities sell off," he says.

Have your cake – and eat it too

"Traditionally equities are high risk – and you expect a high risk premium. But for the first time in a decade, defensive assets like Australian credit and government bonds are offering a yield premium above equities," says Prabhu.

"As in investor, you're getting to have your cake and eat it too, because you're getting a good return for a defensive asset above what a riskier asset is offering."

About Perpetual's Credit and Fixed Income team

Perpetual offers a range of cash, credit and fixed-income solutions and are specialists in investing in quality debt.

We take a highly active approach to buying and selling credit and fixed income securities and invest extensively across industries, maturities and the capital structure.

Find out more about Perpetual's Credit and Fixed Income capabilities

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