Rathbones
Look forward

Review of the week

1 March 2021

Bond vigilantes

When bond markets move, governments and stock markets take note. A swift rise in yields has rattled equities and focused attention on countries' swollen debt piles.

Bond markets were the centre of attention last week as benchmark government yields jerked yet higher after weeks of steady increases.

The 10-year US Treasury yield broke through 1.55%, having started the week at 1.34%. It's the highest level since the pandemic hit the West last February. For most of 2020 the yield traded between 0.60% and 0.80%. While the actual change may seem small, it's the relative that matters: the borrowing cost has roughly doubled in a short space of time.

The US Treasury market is the most watched because it is considered the benchmark cost of borrowing for the world. The dollar is the world's reserve currency - the go-to currency for crossborder transactions and valuing global assets - which means that the US benchmark yield is the bedrock for valuing virtually every other asset in the world. In the parlance, the US treasury yield is the 'risk-free' rate because it's assumed that it has no default risk (if it does default, you have much bigger problems than mispricing your investment). You take that risk-free rate and then add to it to account for other risks, like the chance of your investment going bust or currency fluctuations eating into your returns. That gives you a 'discount rate', which you can use to determine whether the price you're paying for an asset and the returns you're expecting are in line with its risks.

Because of all that, when the US treasury yield rises the price of an investment must fall unless it offers a higher return or it is at less risk of going bankrupt than it was before the yield move. So it's no surprise that stock markets had a tough week. Some stocks bucked this general downward trend, but they tended to be those businesses that should do better when lockdowns end (the chances of them offering higher returns has increased, offsetting the effect of higher yields). Companies whose returns are likely to remain the same regardless of reopening - particularly high-flying US technology stocks - took a hit.

Government bond yields are rising because of steadily growing concerns about inflation. When inflation starts rising, returns need to keep pace otherwise the value of investors' capital is eaten away. As we said last week, while we're expecting inflation to spike midyear, we believe this is simply a short-term inevitability caused by a pandemic-induced price slump and a sudden recovery. In short, the impending bout of inflation will be akin to an elephant passing through a snake: an interesting curiosity for people to talk about but it will sort itself out before you know it.

Any further increases in government bond yields will keep stock markets on their toes, however. Also, it will be important to listen closely to the US Federal Reserve (Fed). America's central bank is ensuring that short-term government yields stay extremely low by purchasing large amounts of those bonds. But they are not yet applying the same weight of purchases on longer-term debt (including the 10-year). Bond investors want to see them in control of the longer-term debt markets, especially as the huge sums the US government has spent on pandemic support has dramatically increased longer-term borrowing. With the Senate preparing to debate a $1.9 trillion support package passed by the House of Representatives last week, even more debt is coming down the pipe. The Fed may be forced into action.

Budget week

The US government bond market tends to drag other nations' sovereign debt around with it - the UK is no exception. The UK government 10-year bond yield finished last week at 0.82%, having started at 0.70%. That's its highest level since December 2019. Just what Chancellor Rishi Sunak wants ahead of this week's Budget Day: a taste of the power of bond markets.

It's pretty self-explanatory, but it always helps to remind ourselves: government bond yields set the cost of public borrowing. This means that the government has to keep a close eye on bond markets. When yields rise it makes any

future bond issues more expensive to service. They may even start rising because investors are nervous about a government's fiscal plans.

From the start, Mr Sunak has been nervous about the amount of borrowing the UK government has had to take on to pay for all the pandemic support. The huge amounts of money definitely cushioned our economy from what would have been an even greater cataclysm, yet, by virtue of his job, he has been more keenly aware than most about how it needs to be paid for. While interest rates remain low, it makes sense for the government to borrow money, as long as it's invested in things that offer a greater return. That can be investing in better roads and rail that make our economy more efficient or by supporting people to ensure their skills aren't destroyed by a multi-year slump that leaves large sections of society out of work. However, at some point, the spending has to be reined in. Not too quickly, otherwise it could turf the country back into a recession, but not so late as to make managing our debt pile insurmountable.

Mr Sunak's first tentative step in trying to right the ledgers is expected to be raising corporation tax from 19% to somewhere between 20% and 25%. Companies will grumble about this - few enjoy paying taxes - yet it makes sense. The UK has the lowest rate for businesses among the G7 major developed nations, and this tax will be levied against those businesses that are profitable. Companies that have struggled should be sheltered from the change somewhat by the ability to use huge losses in 2020 to reduce future tax bills. Higher taxes do mean lower profits for investors, however, so this measure would likely hit stock prices in the short term.

According to the FT, each percentage point rise in this tax will raise £3.3 billion, a pretty paltry sum compared with the £270 billion odd of public debt that the government has accumulated since April last year. Mr Sunak will need to do plenty more if he's going to get the nation's finances back on an even keel. Yet as long as interest rates remain low, he can afford to be patient. And he has plausible cover from the Bank of England, which is widely believed to be ready to step in and buy gilts if UK yields start to balloon. Similarly, the Fed has vowed to keep its interest rates buttoned down as well. We look forward to Mr Sunak's Budget, and we will be releasing an update on the economic and investment implications on Thursday morning.

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