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UNCERTAINTY SPREADS

REVIEW OF THE WEEK
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CENTRAL BANKERS IN THE US AND UK DECIDED INTEREST RATES SHOULDN'T GO HIGHER IN SEPTEMBER; BOND INVESTORS DISAGREED.

While the Bank of England (BoE) and US Federal Reserve (Fed) set interest rates that retail banks pay and receive on short-term loans and deposits from the central bank, it's the bond market that sets rates for the longer-term.

The UK Bank Rate and US Fed Funds Rate stayed flat in September as central bankers believed they had done enough, for now, on inflation. Yet the yield on 10-year government bonds on both sides of the Atlantic rose sharply since. The American benchmark bond jumped from 4.1% to 4.6% in September while its British counterpart now trades at 4.5%, compared with 4.2% a fortnight ago. These are big moves for government borrowing markets, which should be relatively stable and calm. These yields are essentially the bedrock for all longer-term interest rates in the economy – when a household or company wants a loan, a bank will take the long-term bond yield and then add a percentage on top to account for the risk of default and to make a profit. This means bond market moves are very consequential for economies.

So what has caused such wild changes in bond yields? It's hard to say for sure because market moves are the aggregation of millions of individual decisions. In a way, there is no one answer as people buy and sell for myriad reasons. However, it's helpful to understand what goes into pricing a government bond, as you can then decide what reasons make the most sense to you in context.

Long-term bond yields rise (and therefore their prices fall) when expectations for economic growth and inflation rise. That's because stronger GDP growth tends to improve people's confidence, encourage bondholders to sell and buy riskier assets with higher expected returns like stocks, and drives up demand for borrowing, increasing prevailing interest rates. Better economic growth also stokes inflationary pressures as spending increases and there's a good chance that the supply of goods and services won't rise instantly to accommodate it. Inflation is the bane of bonds because it destroys their real value – what you can actually buy with your money when it's returned at maturity – so estimated inflation over a bond's life is factored into its price. If inflation expectations rise, the bond's price will fall so that its yield increases to compensate for the greater erosion of value.

There is another, more ethereal factor in government bond prices. In the lingo, it's called the 'term premium'. It's fancy talk for the extra yield on a bond that can't be ascribed to expectations for inflation and economic growth. You can't calculate it directly, but you can infer it by subtracting the economic and inflation forecasts from a bond's yield and seeing what's left. The term premium is driven higher by increased supply of, and reduced demand for, bonds, along with increased uncertainty about how interest rates will move over the life of a bond. Of course, the reverse of these phenomena will push the term premium lower.

With signs of economic weakness increasing around the world and inflation generally falling, it seems to us that the reason for the sharp uptick in bond yields is heightened uncertainty about the future. This is shown by large jumps in the term premia of most advanced nations' debt. The rise in the term premia will of course also be a function of increased selling of bonds (both by governments directly in auctions and in the secondary market for existing bonds between investors) relative to demand from buyers.

We actually think that UK government bonds offer better value than at any time in the past decade, so we have recently started to increase our holdings of them. While both the Fed and the BoE have retained the option to increase rates further, we believe tightening has now substantially finished, with inflation in retreat. We think UK government bonds should also provide protection to diversified portfolios during any stock market drop due to recession, which we believe is more likely than not in the year to come.

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Caution warranted

We have expected a global recession for some time and have been found overly cautious. Instead of fading, global economic growth – particularly in the US – has been more resilient than expected. Despite this, we still believe a recession is more likely than not in the coming year.

A complacency seems to have descended on markets. The profits made by global stocks have been falling all year even as stock prices have risen. Corporate bankruptcies have reached a 13-year high, but US corporate bonds are still very expensive. Even if we're overly pessimistic in thinking that a recession is coming, it's hard for us to ignore a blasé mood that is permeating financial markets. The VIX index, which measures the volatility of US stocks, is near a three-year low. And the latest Bank of America Global Fund Manager Survey was the most optimistic in 18 months, with portfolio cash proportions falling to the lowest level in almost two years, equity investment rising and fully three-quarters of respondents expecting no recession or even no economic slowdown. This less than 18 months since the start of one of the sharpest hikes in global interest rates ever seen.

Since 1965, there have been five episodes where high inflation in both US wages and prices were tamed successfully by rate increases: all five were accompanied by recession. Now five is not a large sample, and it could be different this time. Yet if the peak impact of a rate change is felt after nine to 18 months, then it's important to note that 18 months ago the Fed Funds Rate was still 0.5% and nine months ago it was 4.0%. Today it's 5.5%.

Bank lending conditions have also tightened dramatically. Our analysis suggests that the reduction in availability of consumer finance would be consistent with a 10-percentage-point or higher contraction in retail sales by the end of the year. For as far back as the data goes, there's never been a 'soft landing' (where recession is avoided) after rates have surged and bank lending standards have tightened as well. Again, that doesn't mean it can't happen, but it's important information to note.

Meanwhile, the US consumer arguably faces a perfect storm later this year. Slowing growth in wages and employment combined with rising energy prices suggest that growth in real incomes will slow. After adjusting for inflation, the extra savings accumulated during the pandemic have now been depleted for all bar the richest 10% of households. And a couple of specific headwinds will kick in this month. Student loan repayments, which have been suspended since March 2020, are due to resume, subtracting an estimated 0.4 percentage points from disposable incomes. And tax relief related to severe storms in California earlier this year will expire. Most residents of the state – which accounts for one in every seven dollars of US GDP – have been able to delay personal and business tax payments originally due by April.

While long-term return potential keeps us invested, the short-term threats to risky assets aren't being adequately compensated, especially compared to the rather substantial returns available from relatively risk-free government bonds.

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you.

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