

THE BIG **BAD** BOND MARKET

Dr Dan Appleby

CHIEF INVESTMENT OFFICER
BLACKFINCH ASSET MANAGEMENT & VENTURES



01

THE BIG BAD BOND MARKET

It was only back in 2022 that investors were worried about inflation spiralling out of control. This was a year in which the Consumer Price Index (CPI) spiked to 11.1% in the UK, far above the Bank of England's 2% target. For bond investors, inflation erodes the spending power of fixed interest payments and redemption values. Investors then demand higher yields, pushing bond prices down, which is exactly what happened during this inflation shock.

11.1%

CPI SPIKED TO 11.1% IN THE UK

Inflation was broadly a global issue at the time, and central banks responded with sharp interest rate rises in an attempt to bring it back down. It worked, to a degree, but not to the point at which central banks could claim they had tamed inflation. Indeed, inflation is rising again, and it is a global issue once more. The Federal Reserve (Fed), under new chairman Kevin Warsh, raised its key interest rate by 0.25 percentage points in September in response to persistent price pressures.

2%

THE BANK OF ENGLAND'S
2% TARGET

Rising energy prices are a major reason for renewed inflation pressure, echoing 2022, when Russia's invasion of Ukraine disrupted energy supplies. Today, energy shipments through the Strait of Hormuz remain restricted as the conflict between Iran and the US continues. But inflation is only one reason for yields to rise. Fiscal policy, economic growth, and the ongoing investment in artificial intelligence are also influencing the market.

When it comes to fiscal policy, Liz Truss has the bond market to thank for why her prime ministerial role was cut short. UK government bond yields spiked after her now infamous 'Mini Budget' was viewed to be unfunded tax cuts. Although this is an over-simplification of what really happened, the power of the bond market ultimately led to a prime minister handing in their resignation. More recently, the US Treasury has increased purchases of its own bonds through its buyback programme as it tries to cap interest rates.

Hence the bond market can be a powerful force for anyone that needs it for financing, which is generally most governments given they spend more than they generate in tax revenue. This was captured by James Carville, Bill Clinton's political strategist, who said, "But now I want to come back as the bond market. You can intimidate everybody."

For investors, though, an intimidating bond market can also be a useful one. After years of very low interest rates, bonds can once again provide meaningful income. The task is to capture that opportunity while managing the risks through a diversified portfolio.

02

INFLATION AND INTEREST RATES

3.1%

UK ANNUAL CPI INFLATION ROSE
TO 3.1% IN AUGUST

At the start of the year, market prices suggested the Bank of England's base rate would fall to around 3.3% by December, implying almost two quarter-point cuts. By late September, that expectation had shifted to around 4.1%, above the current rate of 3.75%, with an increase expected as early as November. The reversal largely reflects rising energy costs following the outbreak of war in the Middle East.

We are beginning to see the effects of this war in the inflation data. UK annual CPI inflation rose to 3.1% in August, from 2.9% in July, with petrol and diesel prices making the largest contribution to the increase. Goods inflation, which includes fuel, rose from 2.2% to 2.7%. As Figure 1 shows, the picture is more settled elsewhere. Core inflation, which excludes energy, food, alcohol and tobacco, remained at 2.6% for a fourth consecutive month. Services inflation was also unchanged from July, at 3.4%.

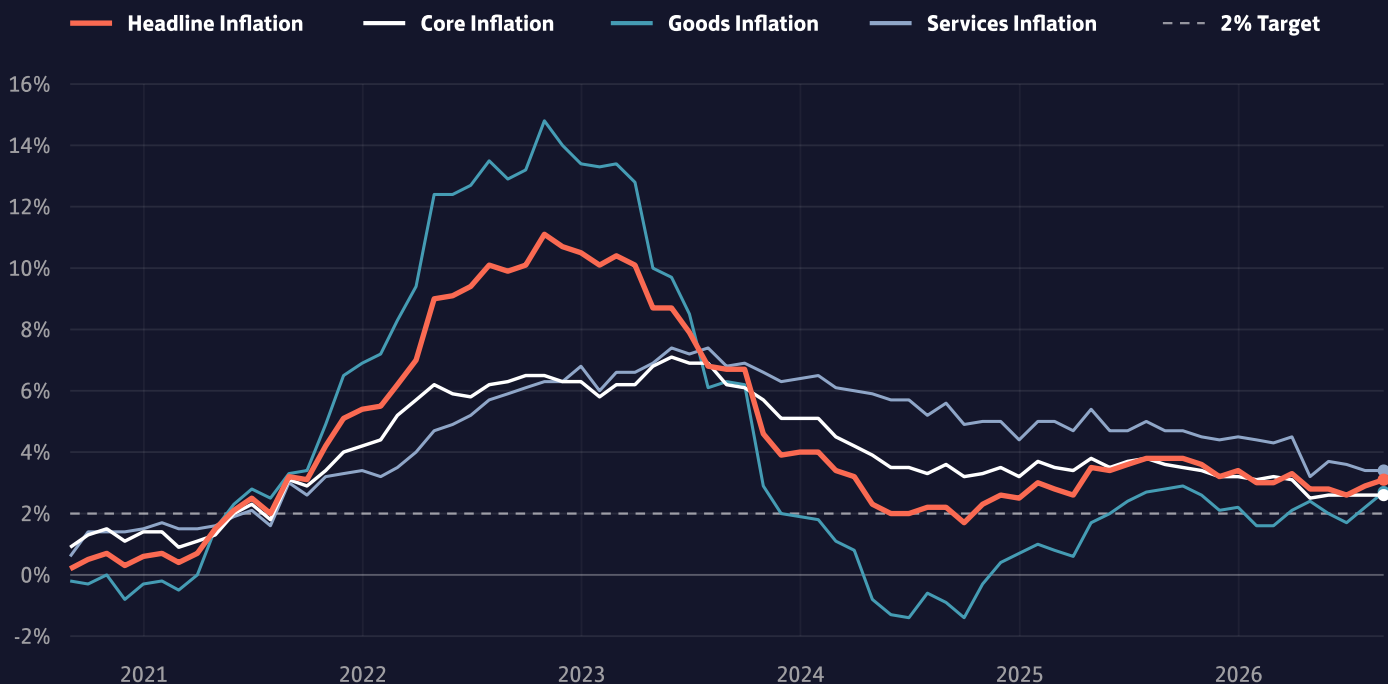


FIGURE 1: UK annual CPI inflation and selected components. The dashed line shows the Bank of England's 2% target for headline inflation.

SOURCE: BLOOMBERG

So far, this looks different from the broad surge in inflation heading into 2022. Core and services inflation are well below their peaks, although slower inflation still means prices are rising. And while there are similarities between now and then, mostly due to war-driven increases in energy costs, there are also significant differences. For instance, there was a huge demand impulse post-Covid when economies opened and consumers had reasons to spend right at a time when supply chains were still recovering from lockdowns. Today's energy shock is serious and inflation resides above target, although the wider economic backdrop is different.

But if it is energy prices driving inflation higher, why would central banks raise interest rates at all? Higher rates cannot reopen the Strait of Hormuz or directly increase supplies of petrol and diesel. Yet in this situation, there is always a concern that an initial energy shock could spread into a more persistent rise in wages and other prices. If households and businesses expect high inflation to persist, they may seek larger wage increases or raise prices further, making inflation harder to bring down. And if a central bank does nothing in response, it brings into question their credibility over being able to control inflation at all.

Thus, if a central bank does nothing when headline inflation rises, markets may begin to lose confidence in its ability to control inflation, which in turn can add to inflationary forces. This is why central banks watch inflation expectations so closely, using surveys as well as financial market prices. If inflation expectations become 'unanchored', the market is sending a signal that it is losing confidence in its central bank achieving its 2% inflation target. Investors may also demand higher bond yields in response. Raising rates can help restrain spending and maintain confidence that inflation will be brought under control, but it comes at a cost to growth.

“

Raising rates can help restrain spending and maintain confidence that inflation will be brought under control, but it comes at a cost to growth.

03

WHAT IS DRIVING BOND YIELDS HIGHER

US government bonds, known as Treasuries, sit at the centre of global bond markets. Treasury yields provide a benchmark for borrowing costs around the world, so their influence extends far beyond the US. The closely watched 10-year Treasury yield rose from around 4.2% at the start of the year to 5.2% in late September, as Figure 2 shows.

To understand that rise, it helps to distinguish between nominal and real yields. The nominal yield is the quoted return before allowing for inflation. The real yield shown here comes from US inflation-linked government bonds and represents a yield above US inflation. The gap between the two is known as 'breakeven inflation' and is often used as a guide to the average annual inflation rate investors expect over the next ten years and is one way for a central bank to measure inflation expectations.

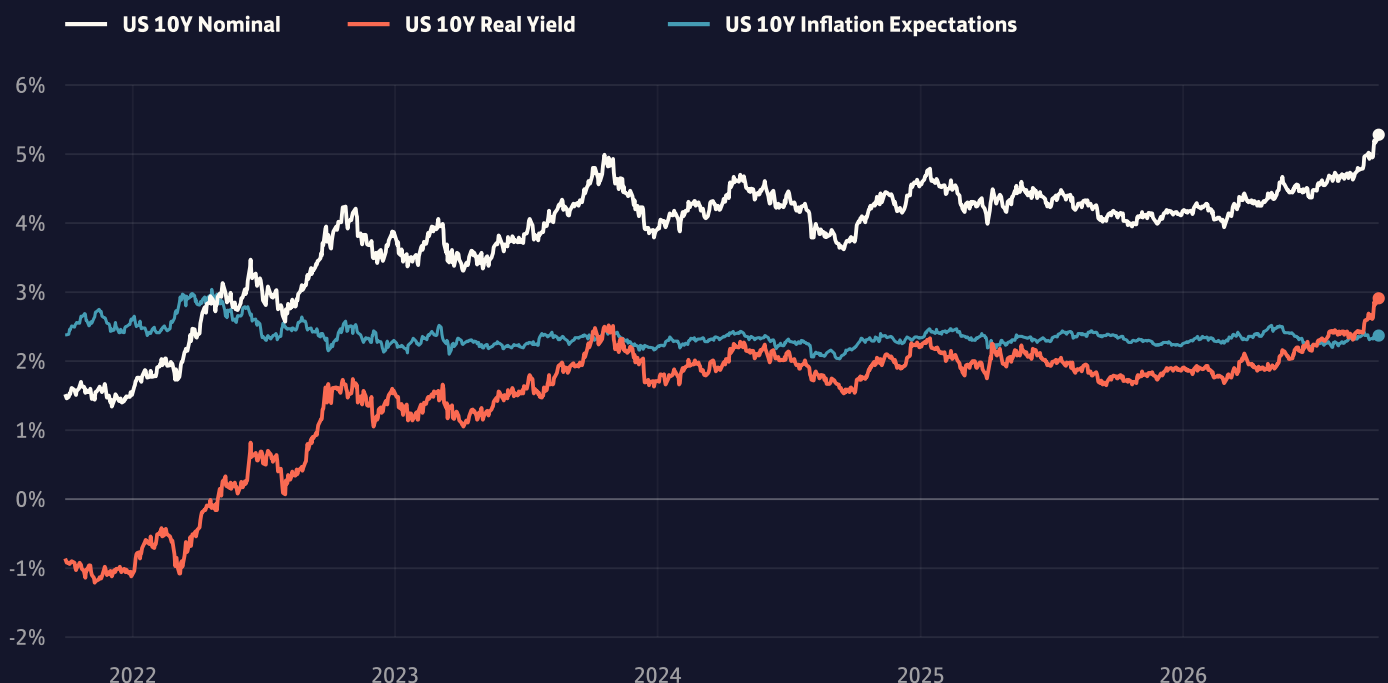


FIGURE 2: US 10-year Treasury showing the nominal and real yields alongside the embedded inflation expectation.

SOURCE: BLOOMBERG

Most of this year's increase in the nominal yield has come from the real yield, while breakeven inflation has remained relatively steady at around 2.3%. That is reassuring for the Fed as this measure offers little evidence that investors have lost confidence in its ability to contain inflation over the longer term.

Why might real yields be rising? Resilient economic growth and the surge in AI investment are plausible contributors. And against this growth backdrop, corporate earnings have risen and stock markets have rallied higher in response. So with stronger potential returns elsewhere, investors are simply demanding higher yields to hold bonds. It is therefore unsurprising that bond yields and share prices are rising together.

However, interest rates cannot rise indefinitely without financial strain emerging somewhere. It becomes increasingly difficult for overly indebted governments to refinance debt, while higher rates also weigh on the valuations of other asset classes. Eventually investors would simply buy government bonds if they could generate enough of a return and not bother with the riskier stock market. The key question is just what interest rate a government bond needs to offer to put the brakes on a rising stock market. There is also the risk of a further rise in inflation, particularly if disruption in the Strait of Hormuz persists. That could keep interest rates higher for longer and put further pressure on bond prices.

“

However, interest rates cannot rise indefinitely without financial strain emerging somewhere.

04

BUILDING A PORTFOLIO WITH HIGHER INTEREST RATES

Looking back across the period after the 2008 financial crisis, central banks kept interest rates close to zero, or even negative in some economies, in an attempt to stimulate economic growth. They also used quantitative easing (QE), buying bonds to help lower longer-term borrowing costs. Moreover, disinflation was the problem, rather than inflation of today, meaning central banks would now struggle to resort to zero interest rates and QE. And if governments want to spend ever more then the bond market will demand higher interest rates to compensate for this inflationary force.

But for investors buying bonds in a portfolio, this is generally a good thing. Yields are attractive again and meaningful income can be generated across the bond maturity spectrum. The 10-year US inflation-linked government bond, for example, offers a real yield close to 3%, compared with around minus 1% in early 2022. If we do see recessionary risks emerge, central banks have significant room to cut interest rates – if inflation allows – given they are well above zero. Yet this is not a base case for this quarter due to significant spending from both governments and the big technology companies competing in the AI race.

Bonds therefore offer more downside protection for when economic growth does slow, and a stronger starting point for income than they did during the years of near-zero rates post-2008. We must still watch inflation closely and diversify across borrowers and maturities. The bond market may continue to intimidate politicians, but for patient investors it can also offer opportunity.

3%

A REAL YIELD CLOSE TO 3%



The bond market may continue to intimidate politicians, but for patient investors it can also offer opportunity.

Dr Dan Appleby

CHIEF INVESTMENT OFFICER
BLACKFINCH ASSET MANAGEMENT & VENTURES