RATHBONES

INTERESTING TIMES FOR BONDS

REVIEW OF THE WEEK

NORMALLY STAID BOND MARKETS SEEM HIGHLY STRUNG LATELY, BUT THERE ARE REASONS TO HOPE FOR SOME LOOSENING UP

In one of the more striking signs of our investment times, government bonds – normally the most dependable and staid part of the markets – have gone crazy. Just when it seemed like some calm was returning, a string of robust economic data has rekindled inflation and interest-rate fears that have shaken markets for over a year now.

The yields that bond investors earn for lending to governments and companies have soared over that time as central bankers have been combatting persistently high inflation with aggressive interest rate increases. Bond prices move in the opposite direction because bond coupon payments are fixed, meaning their prices rise or fall to bring yields in line with prevailing rates.

At the end of last week, the yield on America's benchmark 10-year Treasury extended a two-month climb to top 4% for the first time since early March. The yield on the 2-year Treasury note hit its highest level since 2007, before the global financial crisis.

These latest moves happened after another in a long string of strong US jobs reports on Friday. Though this latest catalyst for inflation worries came from the other side of the Atlantic, 10-year UK gilt yields hit a 15-year high above 4.6% as UK bonds fell in sympathy. There are a couple of main reasons for that – first of all UK inflation is staying higher for longer than its developed market peers, while bond markets are also global in nature and tend to be led by what happens in the US.

Stubbornly high inflation has recently led to speculation that the Bank of England (BoE) and its peers at other major central banks may need to lift their 2% inflation targets to something more suitable to this new normal. But BoE Governor Andrew Bailey soundly rejected the idea, warning that doing so could damage the credibility of central banks and "unpick expectations." Bailey, speaking at a conference in Aix-en-Provence this past weekend, said that though the BoE can be flexible about the timing for bringing inflation back to target it's "absolutely critical that that flexibility isn't confused with people thinking we are not pursing 2% anymore."

Reasons not to worry

While the risks have by no means vanished, as we noted in our recent quarterly **Investment Update** we believe on balance that it's reasonable to expect headline inflation to fall to the low single digits in the months ahead. The key factors that caused inflation to spike in the first place – a pandemic-related surge in goods prices, big increases in food and energy prices caused by the invasion of Ukraine and strong rises in services prices linked to very tight labour markets – do appear to be unwinding.

You can read more detail on this in the quarterly **update**, but in a nutshell, a host of measures indicate that the disruption to global goods markets is now all but over and the shock to global energy and food markets caused by the invasion of Ukraine is now fading. Services is the area where there's been the least progress on inflation, and the risk of further persistence here shouldn't be dismissed. Yet even in this area there are tentative signs that pressures will soon ebb.

A far-sighted perspective

The BoE may be adamant that it will keep on hiking until inflation is subdued, but many more of its hikes lie behind us than ahead. Increasing investor nervousness about how the UK economy will hold up further into the future has kept longer-dated 10-year gilt yields from rising as much as shorter-dated yields. As our head of fixed income **Bryn Jones explains in his latest blog**, longer-dated bonds are likely to at least stabilise and may even make significant gains after the BoE finishes raising rates. They tend to perform particularly well soon after the last rate rise, as economic growth slows, inflation drops and investors price in lower rates in coming years.

Also keep an eye out for our next edition of *Investment Insights* coming out this week, where we'll be discussing more on why we see a light at the end of the tunnel for gilts after a pretty horrendous couple of years.

Loosening up

Although the 209,000 new jobs added to non-farm payrolls was lower than the consensus forecast of economists for the first time since March last year, and some of the gains in previous months were revised slightly lower, it was still a strong enough increase to spook investors worried about persistent inflationary pressures.

In particular, it was notable that builders, architects and engineers, real-estate agents, vehicle manufacturers and other businesses typically sensitive to higher borrowing costs have increased employment during the opening months of 2023.

Wage growth, supported by tight labour markets in the US and UK, has helped feed the persistent strength of services inflation. But Friday's US payrolls notwithstanding, there is evidence that the labour market has begun to loosen. Unemployment rates have risen from last year's multi-decade lows, while in the UK the rate of unfilled job vacancies has fallen. Surveys show that firms have reined in their hiring plans, even as it has become easier to find qualified candidates. The labour market is likely to loosen even further in time, with the massive pandemic-related government and central bank support now firmly in the rear-view mirror. This is likely to cause wage growth to fall. We've already seen this beginning to happen in the US, even if it hasn't taken place as quickly as central bankers would have liked.

Taking all this into account, we continue to be positioned cautiously. This doesn't mean throwing the baby out with the bathwater, and we still think it makes sense to be invested in equity markets. We're also seeing opportunities in the beleaguered bond markets as an end to rate increases comes into sight.

If you would like to hear more about what's going on in the global economy and how it affects the way we invest, please join us for our next Investment Insights webinar on Tuesday 11 July at 12.30pm. You can register **here**.

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.