Is there value in gilts and cash?

by Craig Inches

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In recent years, the prospects for gilts and other government bond markets have seemed somewhat dull, as the backdrop of historic low interest rates and quantitative easing meant the only sense of drama was how low yields could go. As a result, investors have viewed these assets as a dependable, risk-free, low-volatility, low yield asset. However, after 2022 – and notably for gilts, after the events in September – investors will be looking at these markets in a new light.

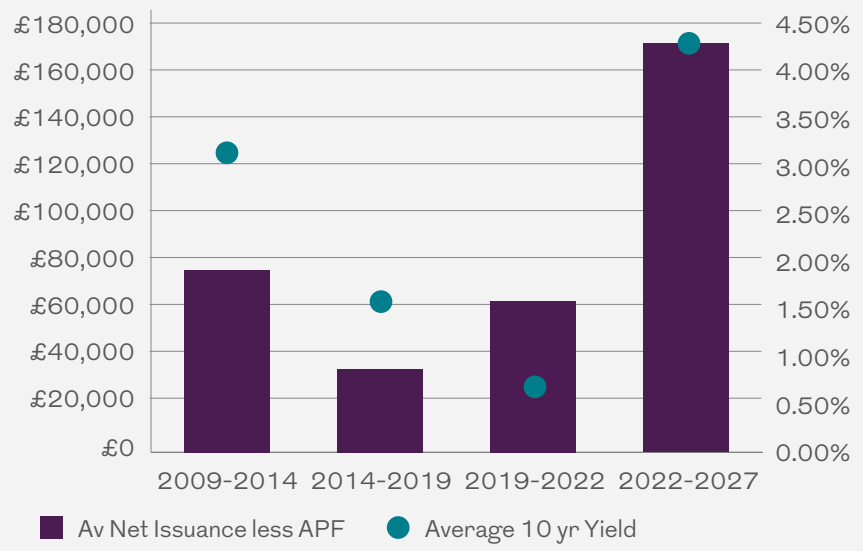
Of course, it had already been a challenging global environment, played out against a backdrop of persistently high inflation, war in Ukraine and escalating energy prices. For the UK though, the crunch came after then-Chancellor Kwasi Kwarteng's unfunded 'mini-budget' threw the gilt market into crisis. A fire sale followed, and gilt yields soared to levels not seen since the global financial crisis of 2008, while sterling fell to an all-time low. Only Bank of England (BoE) intervention – including committing to buy £65 billion of longer dated gilts – brought relief to the market, preventing a 'doom loop' that threatened the UK pension industry.

The clouds had already been gathering

While the mini-budget brought matters to a head, pressure had already been ratcheting up on the UK for some time. Although the BoE was the first major central bank to embark on a rate tightening cycle to combat inflation, its response overall proved painfully slow. As a consequence, the UK is expected to have persistently higher inflation – and for longer – than the rest of the G7 group. Domestic core inflation has picked up quite aggressively, partly due to weaker sterling feeding into core inflation. Back in 2021, the BoE considered UK inflation to be transitory – attributing it to higher food prices, higher energy prices (as a result of the Ukraine war) and ongoing but temporary supply chain challenges. But many of those supposedly transitory factors – deglobalisation, war, higher energy prices – look likely to remain with us for some time to come. Moreover, as core inflation keeps ticking up, that becomes problematic by leading to secondary wage effects feeding through.

The picture for gilt issuance doesn't look particularly pleasant either. Expectations are for net gilt issuance to increase from around £70 billion annually to anywhere between £160 - £200 billion per annum, but those estimates could be conservative. The sheer scale of net issuance will inevitably pull gilt yields higher – as it did in 2022 (see figure 1).

Figure 1: Gilt issuance and yields



Source: Bloomberg, ONS & Debt Management Office as at end October 2022.

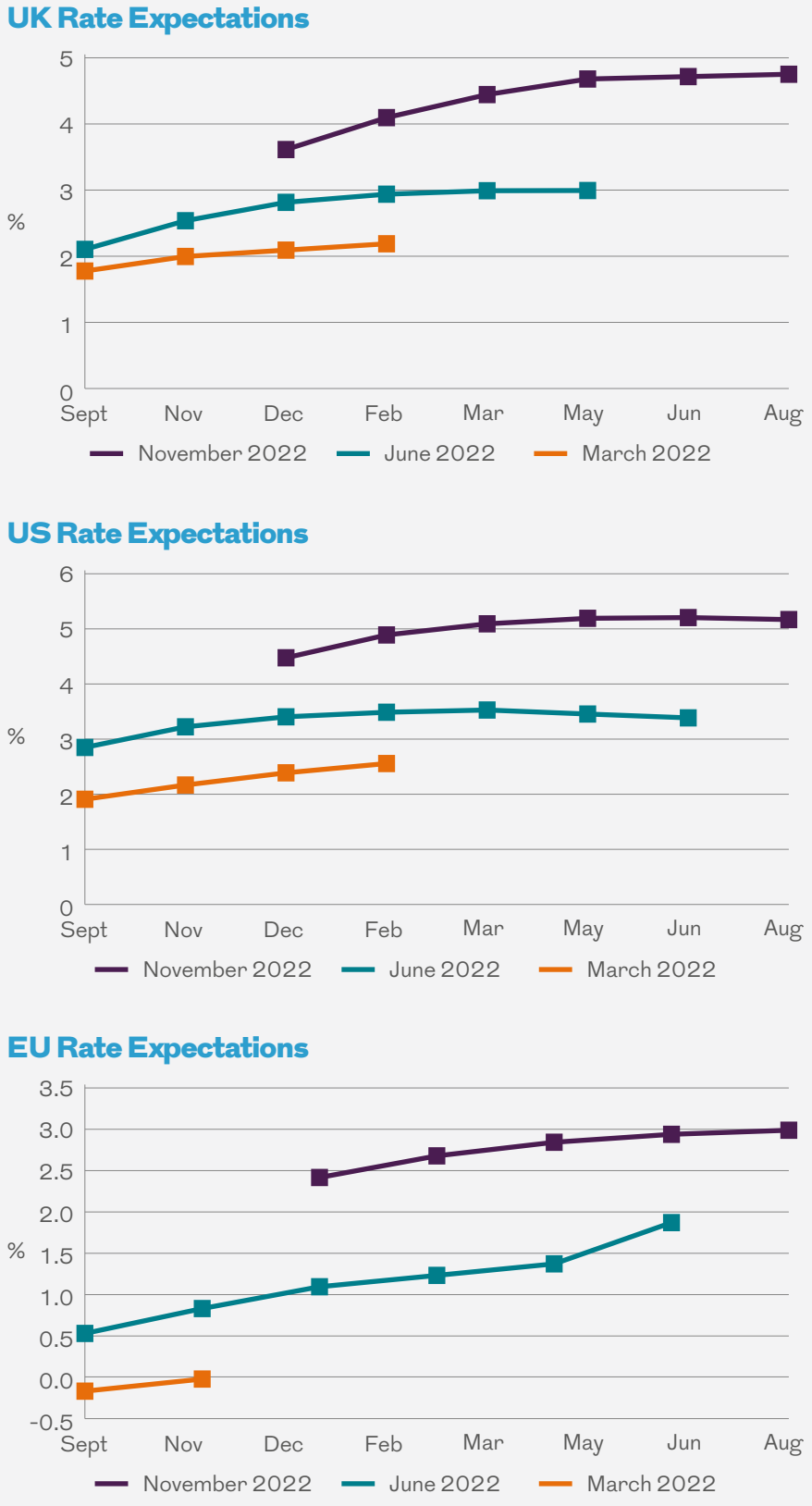
Central banks are under scrutiny

The BoE is not the only central bank under pressure. In the US, the Federal Reserve is trying to 'thread the needle' by engineering an environment where higher interest rates will dampen down the labour market, resulting in a mild recession at most. But should rate tightening lead to a deeper recession, we believe that the base effect plus declining demand would most probably push inflation back to the Fed's 2% target much quicker. This means that the US unemployment rate is potentially the most important metric to keep an eye on during 2023. As soon as the unemployment rate starts to go up, the Fed will be more inclined to ease off on rate hiking, as it should see a decline in second line wage effects, and therefore the demand side of the equation should also diminish.

Interest rate expectations have unsurprisingly shifted dramatically over the course of the year (figure 2). Between March and June, markets were expecting the BoE base rate to peak at around 2.0%. That peak forecast moved out to 6.0% in October, before settling back to nearer to 5.0% closer to the end of the year. Eurozone rates are expected to peak at 2.75% - 3.0%, while in the US, the peak is expected to be 4.75%.

At RLAM, our central case is that we expect UK rates to peak at 4.5% in the mid-part of 2023, before falling back to around 3.75% in 2024. That is based on the assumption we'll see inflation peaking in early 2023, then drifting back towards 2.0% by the end of 2024. However, a stickier labour market could see rates going much higher, perhaps closer to 6.0%, before settling at 4.0%. In this scenario, there's a high probability that gilt yields could at some point in 2023 move back up to 4.8% - 5%, where they were following the mini-budget. The more optimistic – and less likely – scenario is that the peak for interest rates is much lower, as a result of inflation cooling off faster during 2023, which would result in a much lower yield curve profile.

Figure 2: Market expectations have shifted – particularly for the UK



Source: RLAM and MPC, as at 3 November 2022.

Money markets now offer a return

Looking at cash markets, throughout 2022 we saw strong investor demand for liquidity and short term fixed income strategies, and we expect this to continue throughout 2023. Liquidity is a basic building block for every investor, and everyone has short-term cash requirements – requirements that were demonstrated during the market disruption in October. The drive for these products comes from investors looking for assets with low or no capital downside, and therefore wanting to be in the shortest duration product possible. There has also been considerable demand for cash vehicles from asset allocators who have wanted to shift their positioning and move in favour of offerings with little or no interest rate sensitivity and very low credit sensitivity.

Do these assets still have a place in portfolios?

From an investor perspective, 2022 was clearly one to forget. At the time of writing, it looks like investors in gilt funds will experience asset value falls of over 20% over the year. With headline yields rising from around 1% to 4% over the year, there is of course potential for further increases: but while a yield increase from 4% to 5% hurts, it is a lot less painful than the move from 1% to 4%. For those already holding the asset class, the risk of further short-term capital mark to market losses may be outweighed by the more attractive yields on offer for the medium and long-term investor.

For those considering adding to exposure to gilts, we believe that a 10-year yield of 4.5% to 5% would be an attractive entry point, and despite pension fund deleveraging, we would expect to see strong buying at that level. And if UK real yields approach the 1.5% to 2% which are currently seen in the likes of the US, Australia or Canada, (compared to the current UK level around zero), we believe this would also be an attractive proposition. And last but not least, money market and short term fixed interest funds yielding between 3.5% and 5% will look attractive to many investors given their risk profile and low volatility nature.

Gilts have a critical role to play as an asset class and within investor portfolios, and we expect this to continue in a higher-yielding environment. From a structural perspective, there will always be a strong demand for longer-dated gilts, particularly from pension schemes looking to own physical assets, as well as from overseas buyers who see the available yields as attractive on a relative basis.

For many years, we felt gilt fund investors were not being fully compensated for the duration risk they were exposed to, and equally haven't been paid relative to other global government bond markets. As a result, over the last few years we've seen investors diversifying that risk through the use of short duration and / or global rates strategies. But at the levels mentioned above, we are seeing investors considering the opportunities available within all-maturity rather than short-duration strategies, increasing the rate sensitivity of their investments as they feel they are being better-compensated for the economic landscape we now find ourselves in.

The key to remember is that while gilts should be default free, they will probably not be volatility free. Thus it is important to look at the long-term fundamental value of the asset class. We expect this higher volatility environment to remain in place for the foreseeable future, given we are in a world of no QE and high debt issuance. This presents numerous relative value opportunities for active managers to capitalise on and more importantly help to mitigate capital drawdown.

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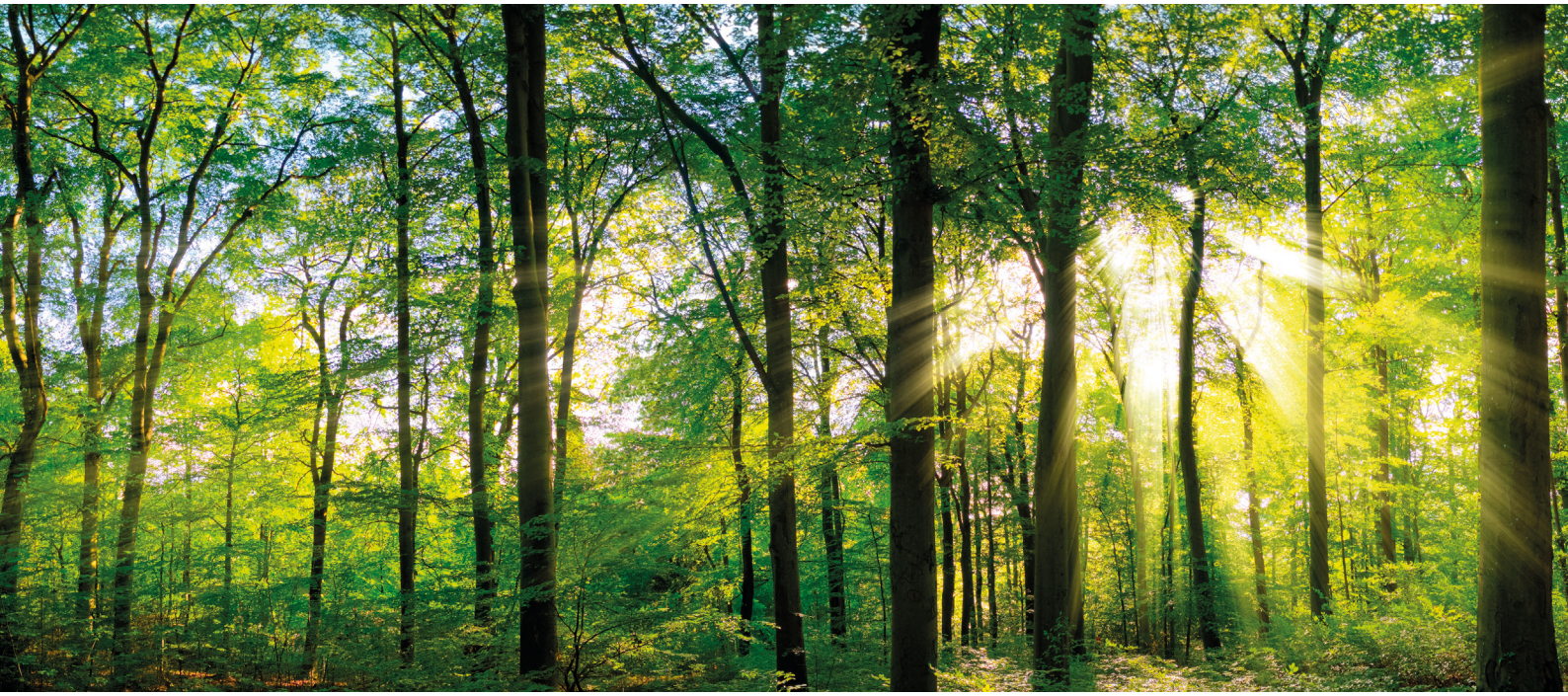

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