Buy bonds or bye bye bonds?

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Rates and cash

The US economy, the world's largest, often hogs the headlines and garners the most attention of investors. As we head into 2025, this will be no different. Donald Trump's win in the US Presidential election – with the Republican party claiming a clean sweep of the Senate and Congress too – will shape world's financial markets for years to come resulting in clear winners and losers. This will undoubtedly lead to heightened uncertainty and volatility.

President-elect Trump ran a campaign promising to revitalise the US economy and make America great again, which translates to be a positive for US growth, negatively impact non-US growth, and likely lead to higher levels of global and US domestic inflation. While risk markets have so far traded positively on the prospect of looser regulation and fiscal stimulus, there may be potential downside risks ahead.

But first, let's look closer to home. The Labour party claimed a sizable majority in the UK General Election and, in late October, nearly four months on from its landslide victory, they delivered its first budget in nearly 15 years. Chancellor Rachel Reeves outlined the vision for the new government which bond markets did not receive well, with the Office of Budget Responsibility's forecasts of above target inflation and the sheer scale of additional government borrowing spooking investors.

'Bambi'-flation

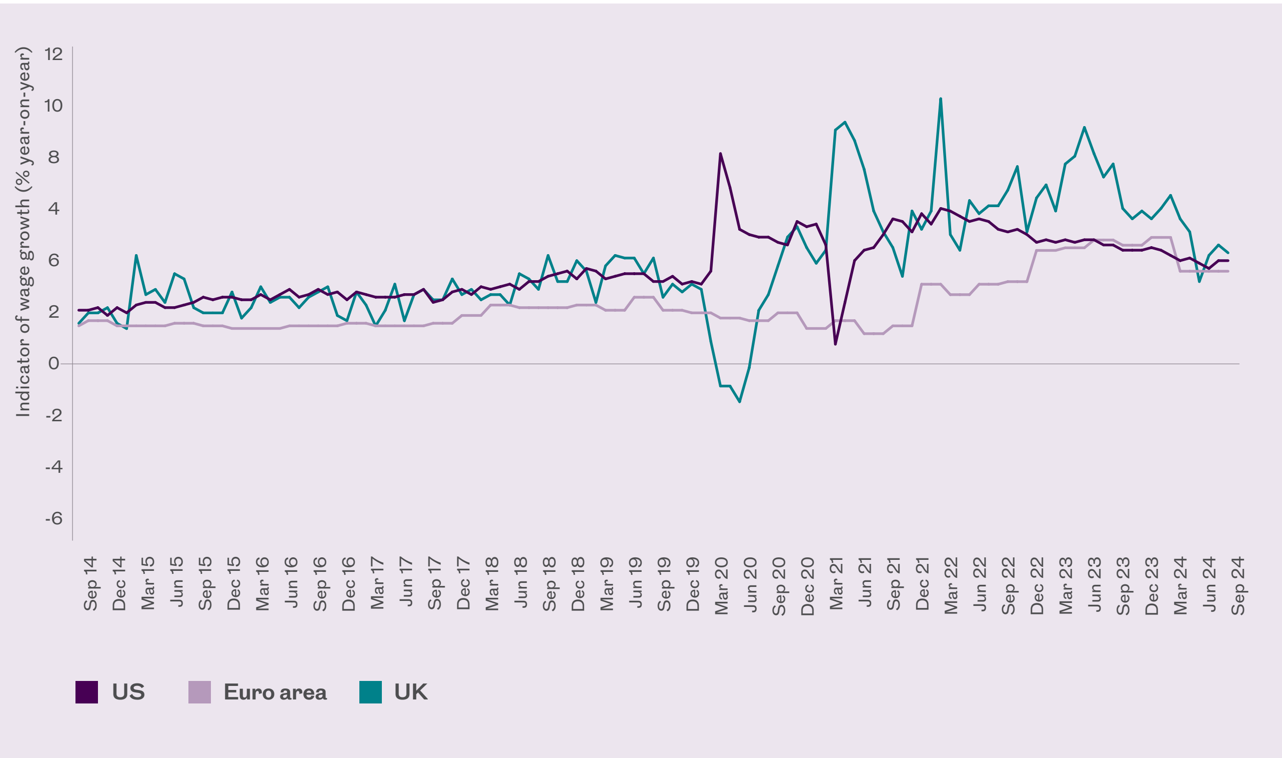
Stagflation is a combination of stagnant growth and high inflation. While we don't see the UK economy going into stagflation, we can see a scenario where growth doesn't excite and inflation remains sticky, so instead of 'stagflation', we see it more as 'bambi'-flation.

We need to start with the Bank of England (BoE): where market pricing is all but locked in for three or four interest rate cuts for 2025, while inflation is forecast to gradually achieve the BoE's 2% target over a three-year period. We see three rate cuts for 2025 and are comfortable with markets pricing in no more than four.

The overall picture is of a gradual loosening in the labour market which, on balance, supports the BoE's moderate approach to rate cuts. Next year, the BoE doesn't see wage growth potentially coming down, while unemployment has been revised lower, meaning there will less slack in the labour market. The BoE's central case calls for a drop in wages and unemployment, which leads us to ask: if you're looking for a pay rise, will you need to leave for another job?

What, then, does this mean for the UK government and its spending plans? With costs rising, where will the economy see productivity gains? If your pay rise next year is to come from moving jobs, that suggests that there might be upside risk to the BoE's employment figure forecasts. As a result, we would not be surprised to see unemployment rise – but this will likely be offset by a rise in public spending.

Wages declining



Source: Datastream. As at end of October 2024.

With costs and unemployment rising in the scenario above, we could find ourselves in a private sector recession – putting real pressure on consumers and potentially leading to services inflation cooling. Can the government really spend its way out of a private sector recession?

Whilst this isn't our central case, we do feel the Budget has heightened the risk of the UK economy falling into a recession in late 2025.

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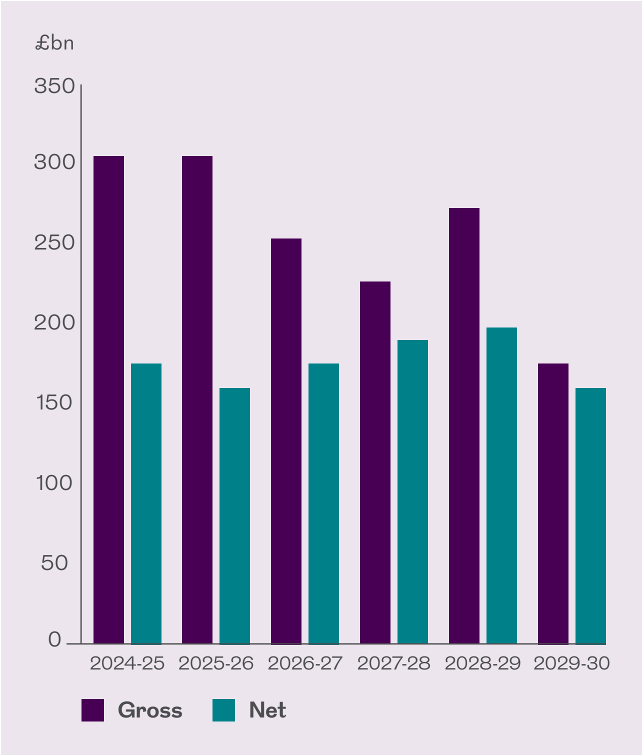
UK gilt issuance



Source: Office of Budget Responsibility. As at end of October 2024.

To Trump it all...

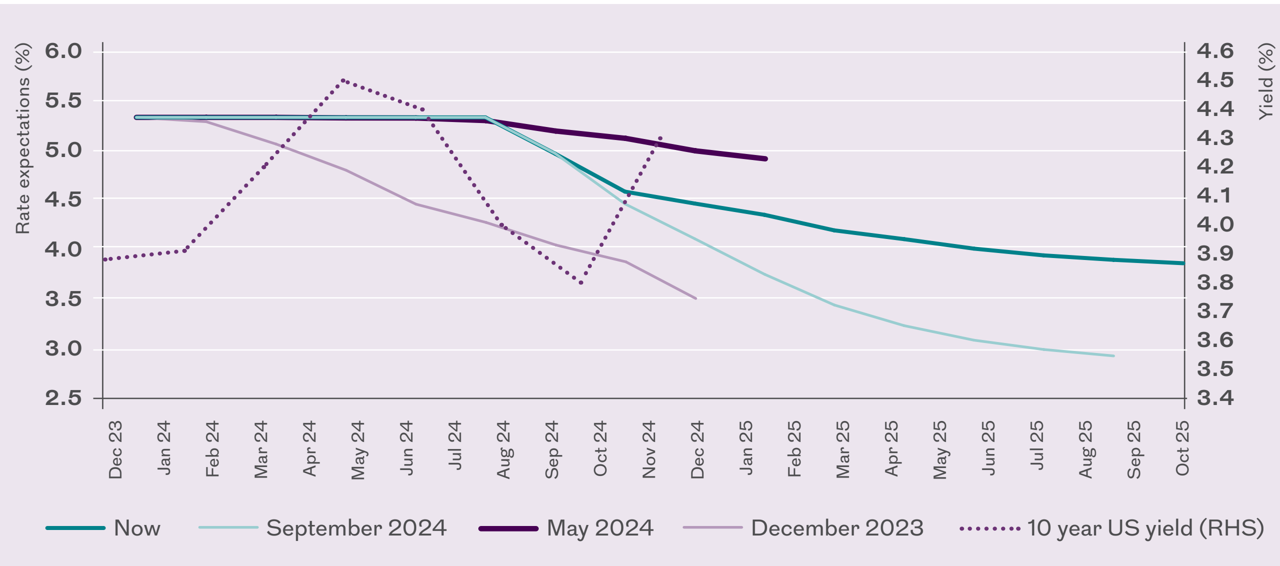
There is still so much to be determined with Trump. The Republicans won convincingly, giving Trump free rein to push his policies, with three main ones taking the centre stage during the campaign: tax cuts, tariffs and deportations. If history is any guide, a Trump presidency can over-promise but under-deliver, therefore trying to predict policies before they are announced seems futile.

We do know that the proposed tariffs if enacted, will hurt the EU, which in turn will hurt the UK as it is its largest trading partner. Tariffs hurt everyone, so the outlook for global growth has downside risk. Having said that, Trump will look to insulate the American consumer from the fallout. Will we see the US economy continue to show strength on the back of the spending power of the US consumer? This will be a key indicator for us going forward. Global growth will certainly struggle, but Trump will need more than rhetoric to protect the US economy and consumers.

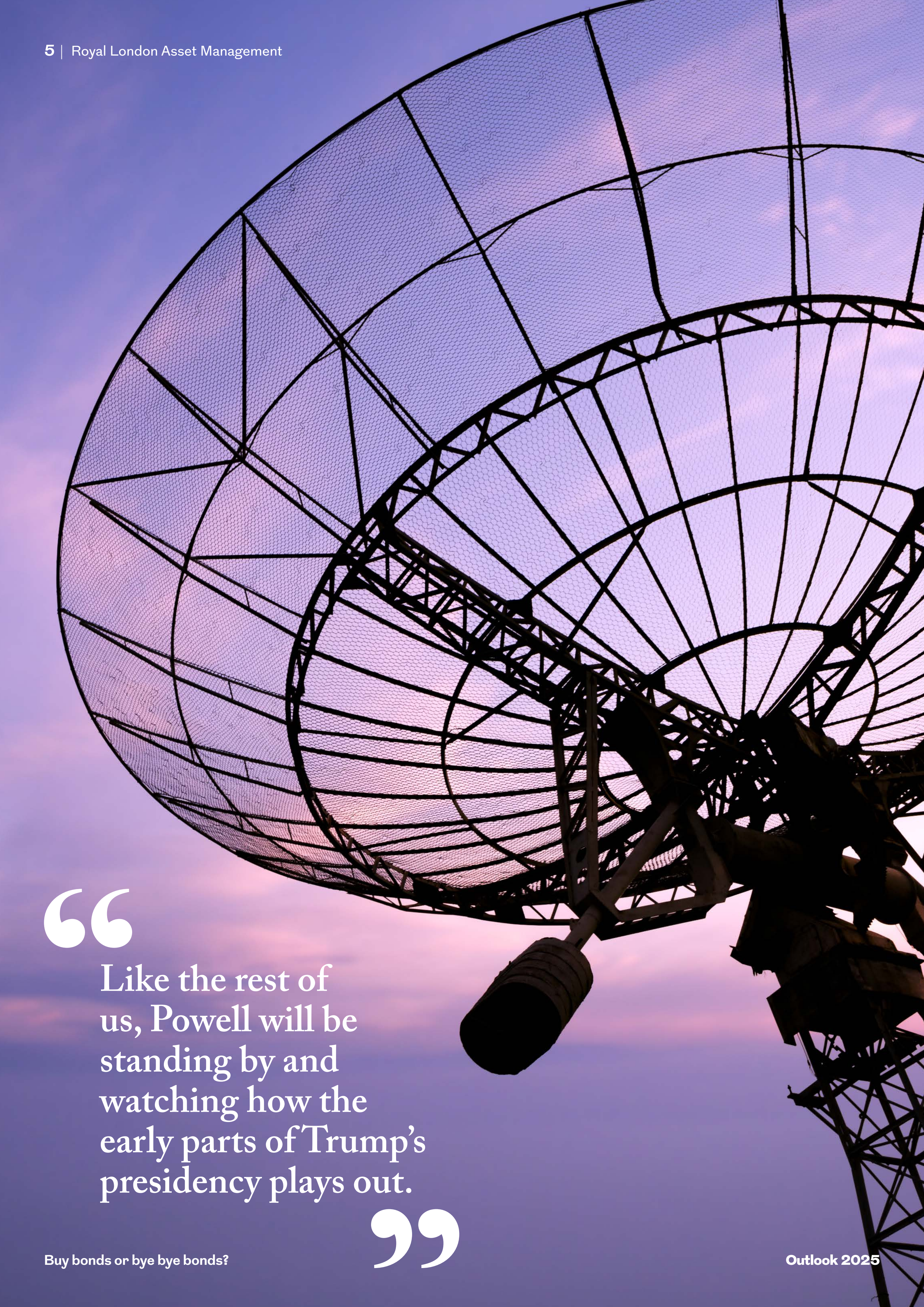
Financial markets, particularly in the US, reacted positively to Trump's victory – but this could have just as much been a reaction to a clear winner being declared early avoiding a long drawn-out process. We do expect to see a reversal of this initial euphoria, especially when the reality sets in that the Federal Reserve (Fed) may have to curtail its current rate cutting cycle. Fed Chairman Jerome Powell has more than once made it clear that the Fed is not on a preset course. So, like the rest of us, Powell will be standing by and watching how the early parts of Trump's presidency plays out. But if tariffs are imposed, which are inflationary, we could see the Fed potentially keeping rates higher for longer.

Given uncertainty, under a Trump presidency, predicting the course of action he will take is anyone's guess, but we believe it makes sense to assume less (or at least slower) rate cuts than an economy not implementing this combination of Trump's key policies.

US rate expectations



Source: Bloomberg. As at end of October 2024.



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However, with policy measures unlikely to come at once, and uncertainty about how far he will implement his proposed policies, the US monetary policy path may remain unclear for some time.

Another aspect of the Trump presidency to consider is if his targeting of migrants goes ahead and to what extent. The US economy is bolstered by migrants taking lower paid labour that might not be filled otherwise. This is also inflationary in nature and could therefore impact US economic growth. If enforced, we would definitely see 'Bambi' become a 'Stag' in the US.

What does this mean for markets?

All of the above will lead to steeper government bond yield curves in our view. Global central banks will be forced to keep a close eye on the slowing economic growth, which could be used to justify rate cuts. However, with inflation that may prove sticky and increased bond supply – to pay for new government spending measures on both sides of the Atlantic – we are likely to see deficits rise. We think this will increase term premia in markets.

European governments could also see an increase in defence spending, depending on how Trump handles Ukraine. It is possible that he may pull back or decrease US spending in Ukraine, forcing European governments to make up the shortfall.

Another element to keep an eye on is Germany's upcoming elections. Germany is in something of a quandary; their economic picture isn't terribly rosy, and it feels as if they may well be particularly exposed should Trump follow through on his tariff pledges and the associated hit to global trade.

However, they have historically been one of, if not the, most disciplined of economies when it comes to fiscal responsibility, and the debt brake notion is even enshrined in their constitution. So they are in a relatively more favourable starting position than most. If economic conditions deteriorate, then they may be more willing to countenance a less fiscally restrictive stance. The campaigning parties will likely factor this into their electioneering.

Cautious on the US, better value elsewhere

In the midst of all these uncertainties, where do we see opportunities? When seeking out value, we believe that long-dated UK and Australian government bonds look good, while the long end of the Japanese government bond yield curve when hedged back to sterling also looks very attractive.

We currently see little value in the US government bonds, which is our least favoured market, until the picture becomes a little clearer on just what Trump will look to do.

As yields rise, it may be beneficial to generally increase duration relative to the benchmarks. Looking at inflation, despite breakevens looking quite expensive at this point – with a lot of inflation priced in – real yields still look quite attractive as a hedge, perversely in the US. Finally, the combination of lower rates on slowing growth combined with excess supply and sticky inflation should see global yield curves steepen.

Our investment philosophy in rates markets is based on the belief that volatility is the friend of an active manager. While it is hard to be certain about a specific end point for bond yields in 2025, we do expect those macro factors and uncertainty around them to lead to some swings in yields which in turn provides opportunities to tactically add value.

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