Quarterly Investment Outlook

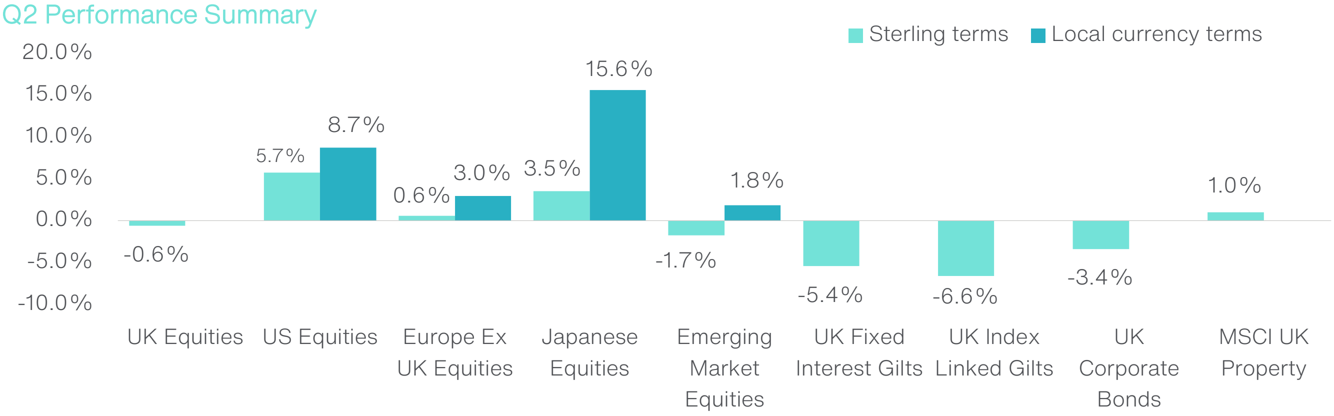
July 2023

Summary

- Bonds have done badly, especially gilts, and equities have done well, but there are early signs that this divergence is now starting to narrow.
- UK inflation has lagged the improvements in its global peers, blame sometimes attaching to high wage inflation. Though headline inflation is falling, concern over lingering high underlying inflation is still with us[1].
- After a strong sell-off in gilts through Q2, which took implied interest rate paths too high, yields have looked good value for those wanting to take hedging ratios higher or raise duration in sterling bond portfolios.
- We note how rising longer-dated yields in the 2021-3 period have almost entirely been driven by rising real yields. Implied inflation in bond markets has barely risen, even after several years of high inflation.
- We consider the implications if this implied bond market view is correct – good news on inflation, yes, but less good news for economies as these higher real yields would keep after-inflation borrowing costs far higher than in earlier years.
- Higher bond yields also pose challenges across the asset class spectrum since this lower risk investment is now clearly better remunerated than for many years. Relative rewards for risk-taking have fallen – equities and commercial property show bond-relative valuations as not very attractive.
- Credit is still something of a mixed story, with reasonably attractive yields (especially for the UK), but with spreads at best middling.
- We regard sterling's rise this year, supported by higher actual and anticipated interest rates, to have run its course. Portfolio positions now need to limit sterling exposures to strategic hedging needs only.

[1] See our new release, AA View: *Inflation Victory?*

Q2 Performance Summary



Source: FactSet, MSCI (Equities, Property), FTSE (Gilts), iBoxx (Credit)

Past performance is no guarantee of future results. Indices cannot be invested in directly. Unmanaged index returns assume reinvestment of all distributions and do not reflect fees or expenses

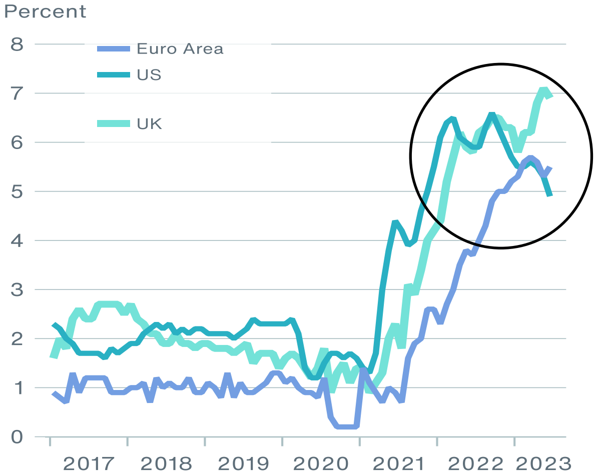
Bonds suffer, gilts especially

In a good quarter for stock markets, rising economic optimism in Japan turned its local market into a strong performer, though gains in sterling were less impressive. The US market's outperformance was the key factor in a period of generally rising global equities. For bonds, it was quite different. This was a particularly poor quarter for UK gilts, both fixed and index-linked, as upward revisions to expected policy interest rates pressured yields higher. Overseas yields rose too though UK pressures were stronger. Lately, upward pressures on gilts and other global bond yields seem to be waning, at a time when some reversal in equity market strength is also looking more likely. UK commercial property has steadied after big earlier falls, but few see an imminent recovery.

UK inflation behaving badly?

One of the dismaying features of UK inflation behaviour of late is the way it has diverged from trends in other major economies. The markets have been particularly concerned about the UK's high underlying or 'core' inflation measure (stripping out volatile items of energy and food). Even after a small decline in June, the contrast with other economies is striking (see chart). Though UK consumer price inflation is now clearly falling, concern remains strong about continued high underlying inflation, which puts pressure on the Bank of England to take interest rates higher still.

The UK's core inflation rate is lagging other economies



Source: Macrobond

Blame for high core inflation is sometimes attached to the UK's high wage inflation (see chart), a result of chronic labour shortages. Recent data points to some loosening in these conditions, but it will take a while for this to feed through into lower wage (and price) rises.

High UK wage inflation is a key issue (Median pay growth, %)

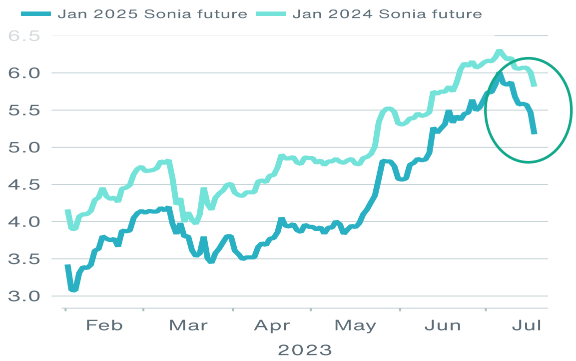
Source: ONS, Macrobond

Gilt yields look reasonable value

Selling pressure has mainly come from upward revisions to expected Bank of England interest rates. The latest inflation data has brought some respite (see next chart). Even though rate expectations had overshot and are now falling back, these market-implied rates for the next year or two are still a huge leap from the earlier decade-long period of near zero interest rates. Fortunately, there does not seem to be much of a UK-specific risk premium driving gilt yields in the way we saw last autumn. Gilt yield fluctuations are mainly based on changes in interest rate views.

Our view on yields reflects some cross currents. On the one hand, we have been seeing earlier rises in yields as an over-estimation of the likely path of the UK bank rate. This did suggest lower yields to come as those rate views corrected, helped by lower inflation. On the other hand, it is a reality that the demand-supply balance in the gilt market has turned adverse. Supply is large (this fiscal year's expected gross issuance of £238bn is a record high excluding the Covid fiscal year of 2020/21) and the demand response from pension funds and other natural buyers may not be large enough even though there is more overseas interest. Balancing these cross currents, we still think that yields are likely heading lower as inflation falls. This makes it good timing for those with discretion and wanting higher liability hedge ratios to take advantage.

UK rates – some relief, but these are still high interest rates (1 month SONIA futures, %)



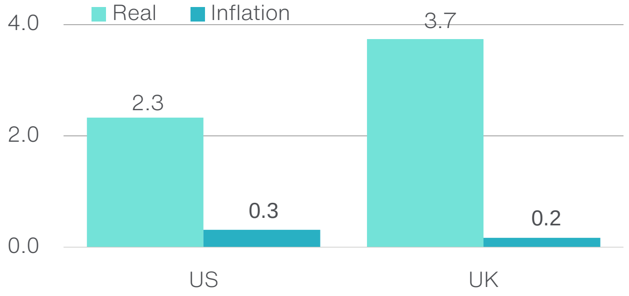
Source: ICE, Macrobond

Yield shifts globally are mainly 'real'

Yields have, of course, risen globally, even though the UK trend has been stronger. Even with persistent inflation for the best part of three years (2021-3), longer-term inflation implied by bond markets has not risen much, so that the rise in bond yields has been mainly about 'real' (i.e., after inflation) yields. This is true in the US and the UK (see chart below) and elsewhere too. Though this may be good news for inflation if correct, if most of the rise in real yields persists, as the yield curve is currently signaling, there is a less comfortable message. These higher real yields would imply a substantial increase in the real cost of financing borrowing. Compare this with the negative real rates that we saw in the 2010-21 period and the adverse change in the financing environment is clear for households, companies, and indeed governments, that have become much more indebted since the pandemic, like the UK.

Yield shifts since 2021 are almost all 'real'

(Changes in real yields vs 'breakeven inflation', 20-year par yields since January 1, 2021, %)



Source: US Federal Reserve, Bank of England, Macrobond

Credit - still a mixed story

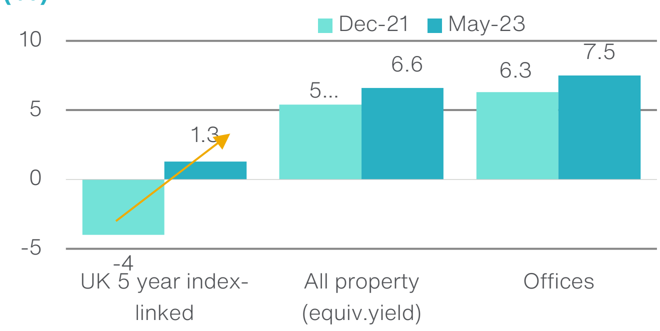
The big rise in yields has badly dented returns in investment grade credit given significant duration in these bonds. Equally, this means that current yields have turned more attractive for buyers (sterling corporate bonds now yield around 6%). Yields are also high enough to absorb some adverse trends in credit spreads and still preserve positive returns. Higher sub-investment grade yields (Yields on US high yield bonds are now over 8%) also appeal to the 'carry' investor, using funding in lower interest rate currencies (e.g., Japanese yen and Swiss francs).

The other half of the story is that for those investing to harvest the credit risk premium, the current reward for risk is middling, at best. If economic conditions worsen, which is still reasonable to expect, credit spreads will rise and excess returns over government bonds will disappear. To us, it still looks as though there is a risk that at some point, both investment grade and high yield bonds spreads could be rather higher, even if very adverse credit events look unlikely.

Bonds vs other asset classes?

A related question applies to the pricing of other asset classes vis a vis bonds. Government bonds are not risk-free, but other asset classes are typically riskier. This allows us a way to see how risk-taking is being rewarded across the spectrum. In fact, seen this way, the rewards for taking more risk away from bonds look relatively low today. Thanks to those big moves in bond yields, the equity risk premium – the anticipated reward for taking equity risk vs bonds are now at levels not seen since the early 2000's on most measures (Aon and other sources are roughly similar).

UK commercial property yields vs index-linked gilts (%)



Source: MSCI, Bank of England, Macrobond

For illiquid assets, like property, it is no different. The move in gilt yields has been big so that yield differentials with commercial property have fallen markedly even though property yields have risen (see chart). The relative reward of taking on illiquidity and property risk is clearly down versus a few years ago.

Sterling appreciation over

A weaker dollar and rising UK rates have lifted sterling this year, but we see this rise as over. As higher UK rates weaken the economic outlook, some give-back for the pound becomes more likely. Portfolios should now limit sterling positions to strategic hedging needs.

Definitions

MSCI UK Index – The MSCI United Kingdom Index is designed to measure the performance of the large and mid-cap segments of the UK equity market. With 80 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the UK.

MSCI USA Index - The MSCI USA Index is designed to measure the performance of the large and mid-cap segments of the US equity market. With 626 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US.

MSCI Europe Ex UK Index - The MSCI Europe ex UK Index captures large and mid-cap representation across 14 Developed Markets (DM) countries in Europe. With 344 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across European Developed Markets excluding the UK.

MSCI Japan Index - The MSCI Japan Index is designed to measure the performance of the large and mid-cap segments of the Japanese equity market. With 237 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

MSCI Emerging Markets Index - The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries. With 1,379 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

FTSE Actuaries UK Conventional Gilts All Stocks Index - The FTSE Actuaries UK Gilts Index Series is a broad-based family of indexes and related bonds data (e.g., duration) based on all eligible British Government Securities. The index consists of all securities from the conventional index family of the FTSE Actuaries UK Gilts Index Series, which includes all British Government Securities quoted on the London Stock Exchange.

British Government Index-Linked All Stocks - The FTSE Actuaries UK Gilts Index Series is a broad-based family of indexes and related bonds data (e.g., duration) based on all eligible British Government Securities. The index consists of all securities from the index-linked family of the FTSE Actuaries UK Gilts Index Series, which includes all British Government Securities quoted on the London Stock Exchange.

iBoxx Sterling Non-Gilts – The Markit iBoxx GBP index represents the investment-grade fixed income market

for GBP-denominated bonds. The iBoxx GBP Benchmark spans an array of sectors, including corporate, gilt, sovereign, sub-sovereign and collateralised (inclusive of covered) bonds, with a history dating back to December 1997

MSCI UK Monthly Property Index - MSCI's IPD UK Monthly Property Index measures unlevered total returns of directly held property Standing Investments from one open market valuation to the next. Standing Investments Indexes include completed and lettable properties only, often described as operating properties.

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