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Research Note

Category 1: For Public Release

To	**Investment Team**
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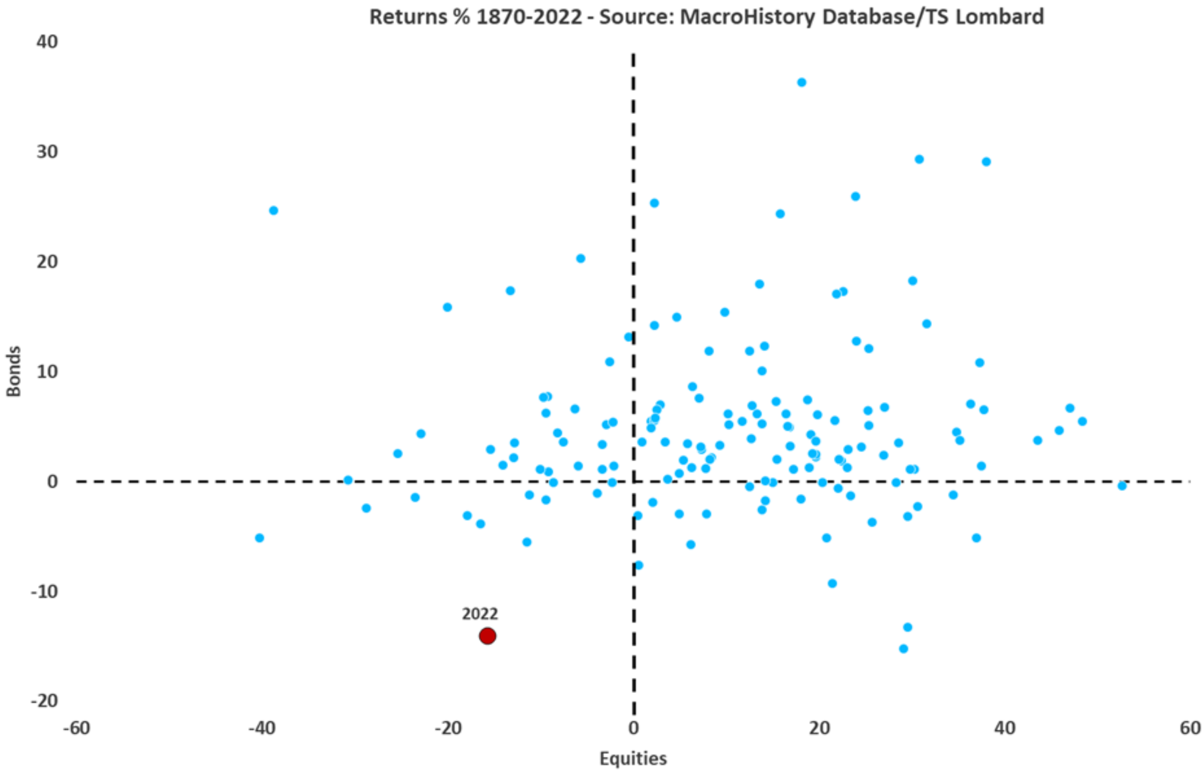
Date	**3rd February 2023**
Subject	**Bonds – Should We Buy Them?**

Bond investors took a hammering last year. Long dated gilts lost over 40%.

Chart 1 – Returns from UK Equities & Bonds in 2022

In fact, 2022 was a pretty lousy year all round with fixed interest and equities correlating downwards.

Chart 2 – Returns from UK Equities & Bonds: 1870-2022

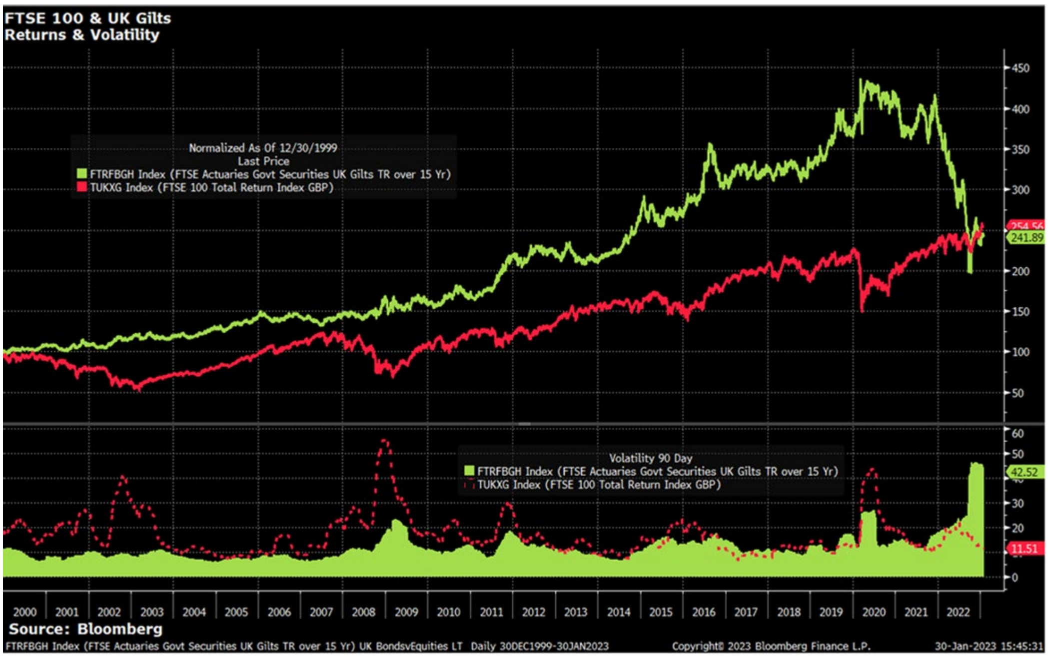


This probably heralds the end of a long-term trend whereby yields were declining and bond prices rising. Chart 3 below shows 20-year gilt yields in 1 and 2 standard deviation guidelines. In 2022, yields broke free of a 20-year trend.

Chart 3 – UK 20-year gilt yields

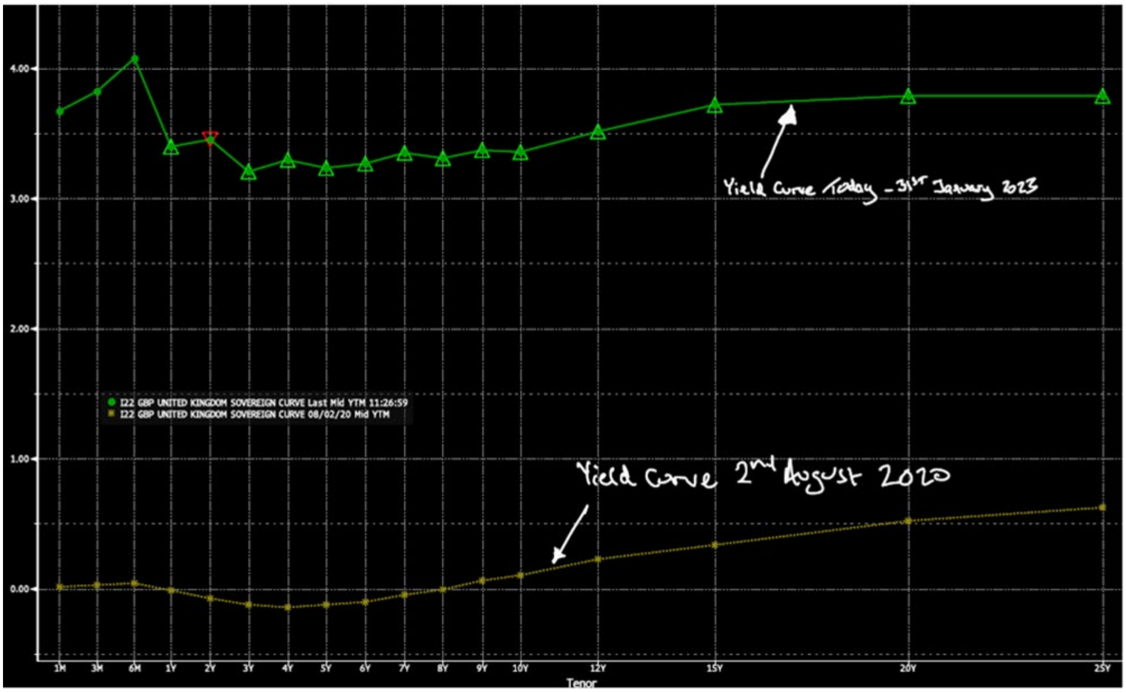
UK investors have for 2 decades been rewarded by holding gilts which had, up to 2022, delivered better returns than equities and at lower volatility. But a precipitous decline in bond prices through the last 12 months, and the robustness of shares which make up the majority of the UK stock market, prompted a remarkable reversal of fortune that saw equities become the best investment during this century – at least so far!

Chart 4 – Returns from long-dated UK gilts and FTSE 100 index



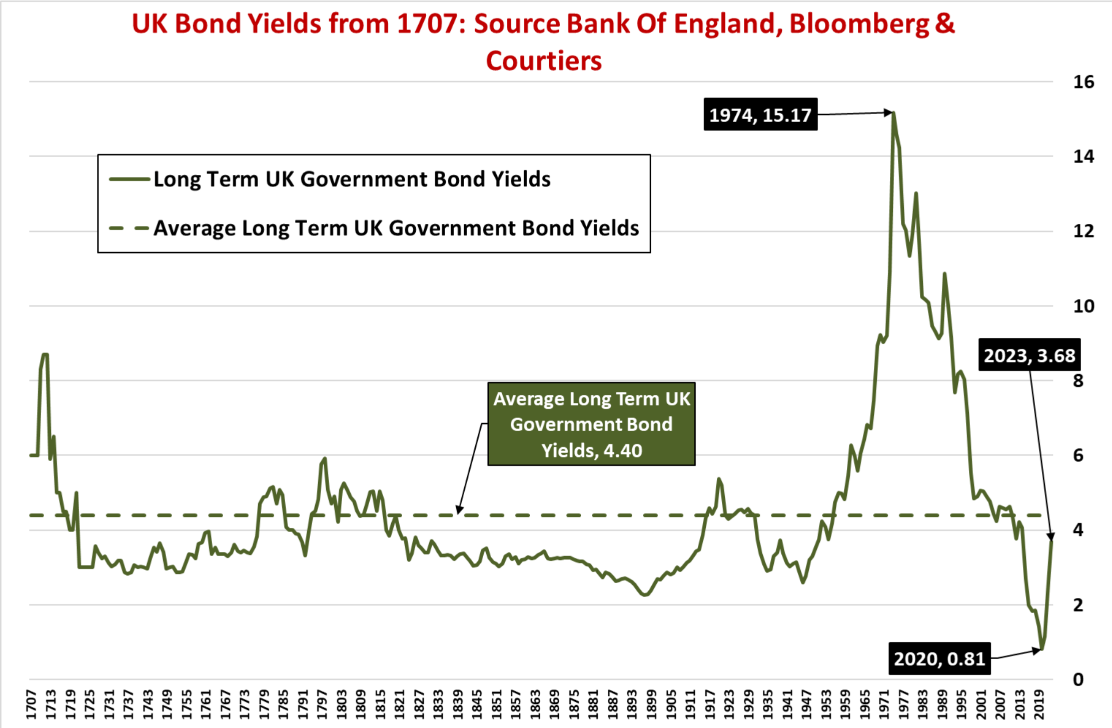
The peak-to-trough collapse in bond prices coincided, obviously, with the major shift in the yield curve. Chart 5 shows the extent of this movement by comparing the curve in August 2020 with the end of January.

Chart 5 – UK Sovereign yield curve



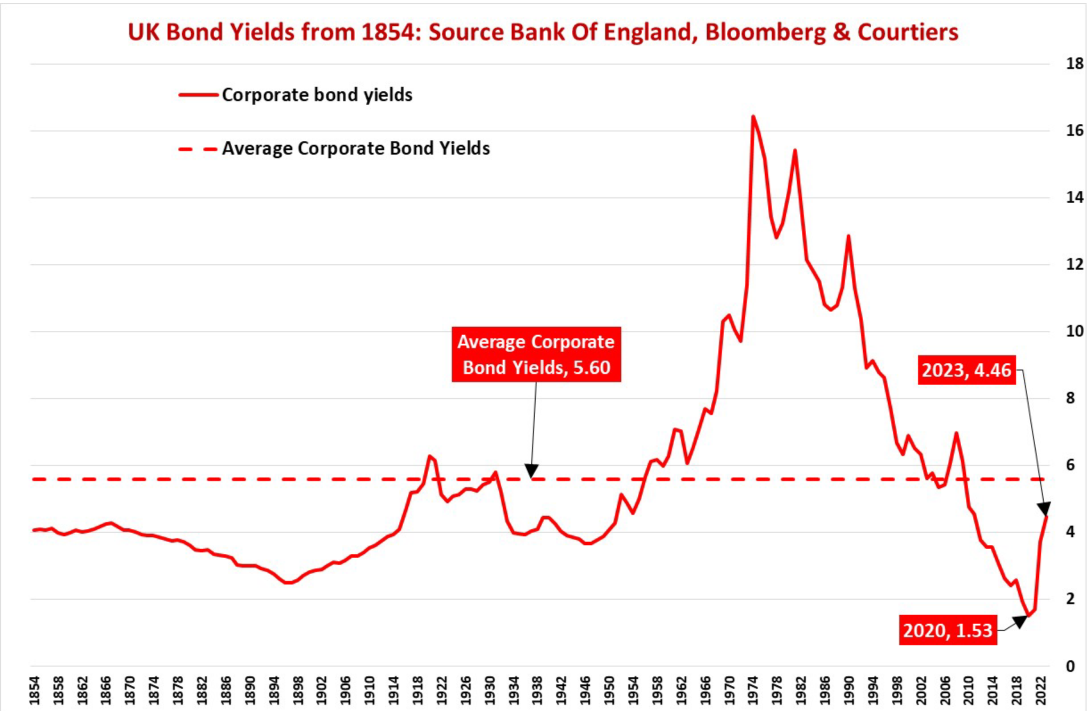
The low point in yields during the summer of 2020 marked a 300-year nadir.

Chart 6 – UK government yields since 1707



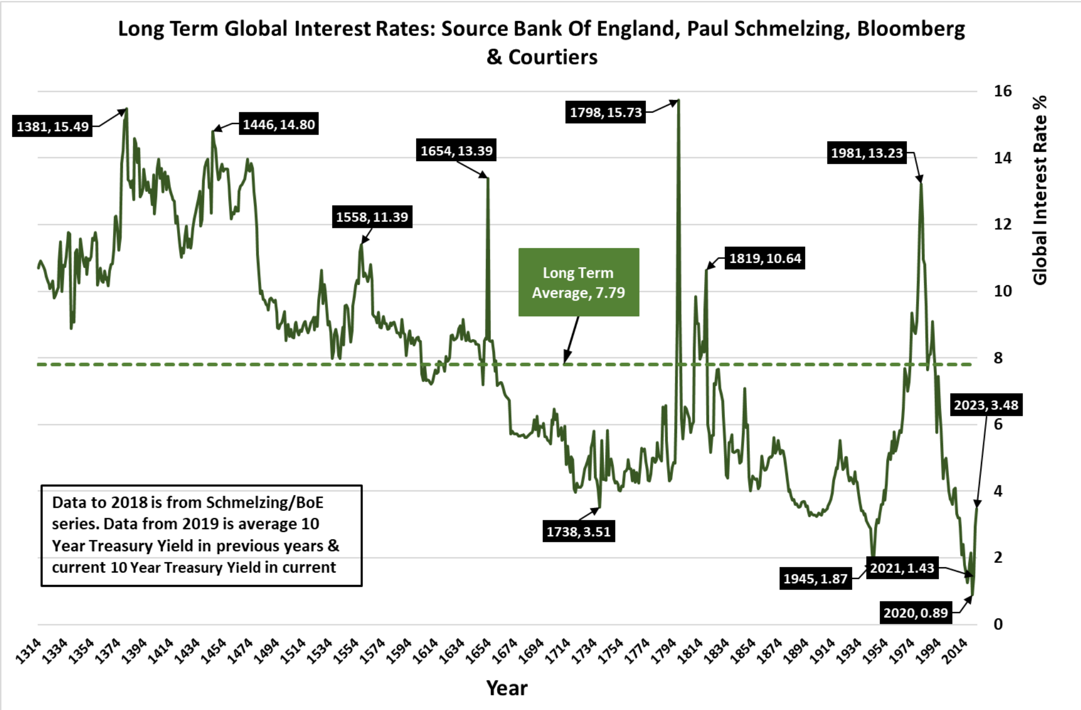
This low yield phenomenon was not exclusive to just government bonds. Corporate bonds joined the party and hit their own record lows.

Chart 7 – UK corporate bond yields from 1854



2020 was also a record low-point for global interest rates, which can be traced back even further than in the UK to 1314. Those involved in finance are generally too fond of referring to market movements as being many standard deviations from the mean, but as regard the low interest rates of 2020, based on 700 years of global data, and 300 years of UK data, they are a significant outlier.

Chart 8 - Global interest rates – last 700 years



Aside from some normalisation of rates taking place in the fixed interest market, inflation linked gilts also experienced a reversal in 2022 which began with 10 year issues paying a negative -3% (i.e. -3% per annum plus inflation). The yield turned positive late September but it has now slipped back to -0.3%.

Chart 9 - Index Linked Gilt Yields & Spread (implied inflation*)

** Implied inflation is market-based estimates of inflation over time, based on recent inflation activity*

Will rates test the 2020 low points again?

If you believe in mean reversion, then you will strongly argue that rates are unlikely to return to their all-time lows of 2020. But you would not need to rely on a statistical theory, some common sense would draw you to the same conclusion. For starters, the very low interest rate environment of the past 30 years represented a period which became known as "the great moderation", when reasonable growth seemed baked into the global economy and low inflation the norm. The re-emergence of inflation during 2022 has meant that bond holders have got their fingers burnt, and they will be less willing to risk significant losses for a second time.

Chart 10 – UK Inflation Since 1970

Another factor that kept interest rates low through the last decade is QE (Quantitative Easing). This started in 2009 under the then governor of the Bank of England Mervyn King when the Bank, having already slashed base rates post the global financial crisis, began buying gilts to ease long term interest rates. The bank engaged in another orgy of bond buying in 2020, which now seems pointless as there was little purpose in filling consumers pockets with cash when the economy was locked down. By 2022 the Bank of England had aquired £895 bn of UK government debt. It now owns 33.1% of debt in issue and with the UK debt management office owning 7.29% the government, directly and indirectly, owns over 40% of total gilt issuance. Although QE is a recent phenomenom in economics, its effectiveness is likely to follow a similar trend to antibiotics – overuse will render it less effective. The point here is that another dose of QE would not have the same effect on interest rates as it had in 2009.

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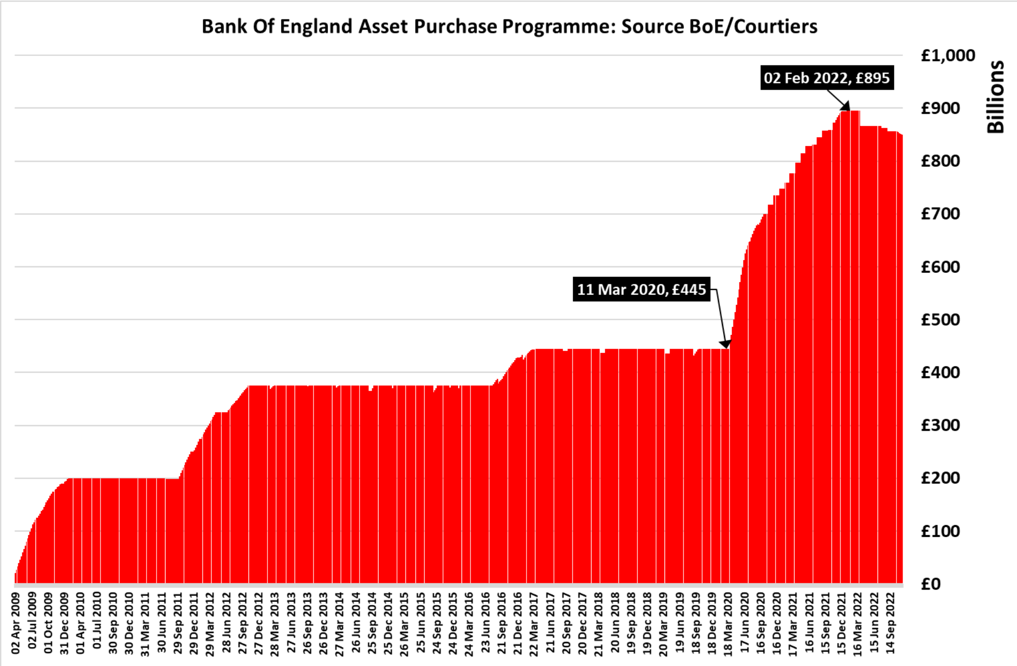
Chart 11 - Bank Of England QE (Quantitative Easing)/Asset Purchase Programme



Summary

We have lived through a remarkable couple of decades that have seen interest rates hit all-time lows. This occurred in an environment of globalisation, low inflation, pandemics, and lots of QE. It's unlikely that these factors will combine again to drive interest rates down to their previous lows and with major disruptions to global supply chains, geopolitical tensions and the domestication of manufacturing, inflation is likely to be higher over the next couple of decades than it has been over the previous couple. This suggests that the recent increase in bond yields is fully justified and is unlikely to be a temporary phenomenon. The risks for bonds are therefore still to the downside so we should be very careful with our acquisitions and not get carried away with stuffing too much duration into our funds.

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