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20 YEARS ANNIVERSARY

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MARKET COMMENTARY

UK inflation and the Bond Market.

Since the start of 2023 as an investment committee, we have agonised over bond duration. Put simply this means whether we own the more interest rate sensitive longer dated bonds, that will reflect the longer-term market view on interest rates; or instead own the less sensitive shorter dated bonds that reflect the Bank of England rates and are much less likely to move in price.

Like most of the market, we have been expecting inflation to fall over the course of the year and for the fixed income market to stabilise. This would see a peak in the Bank of England base rate and then at some stage expectations rise for a fall in interest rates. Given the terrible performance of fixed income last year, and the impact this had on lower risk portfolios, this would be welcome news. This would also favour longer duration in fixed income.

During the difficult year for bonds in 2022 we began adding to fixed income and duration in the Spring, this was all good until the Liz Truss Governments Mini Budget and the Liability-Driven Investment (LDI) disaster in September that sent bond prices, and especially longer duration bond prices, plummeting. This served as timely reminder that duration does add to risk and not all risks can be foreseen.

We have kept duration lower since the autumn, less so because of the impact from the mini budget, but more so because we felt expectations on inflation were too universal and too positive. Whilst the base effect, lower gas, lower oil and lower wheat prices, as well as fewer supply chain issues will all feed through, this will be countered to some extent by higher wages, the pass through of higher corporate taxes and increased economic redundancy as security becomes an issue. We simply felt the market was too optimistic.

Since the start of the year, we have seen bonds rally and then fall back twice, with peaks in at the end of January and mid-March. Since the start of May, bonds have been falling and finally crossed the 4% yield on UK ten year, once again making them more attractive. The catalyst for the fall today (24th May) has been the UK inflation number falling to 8.7%, itself a great fall from over 10% but not as much as the market had hoped for. Not only are yields more attractive, but expectations on inflation and future rates are now more realistic.

At these levels, we see adding to duration as less of a risk, but this will be done incrementally, and we will look to update investors on our actions in due course.

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