IMPERIUM CAPITAL

momentum

Global Matters Weekly

17 October 2022

Gilty Pleasures

– Alex Harvey, CFA — *Senior Portfolio Manager & Investment Strategist*

Three weeks ago, I had just landed in Morocco and with impeccable timing, as I worked out how to use Agadir airport's ATM, Sterling tanked on the back of the UK government's now well pored over 'mini-budget'. I found it mildly amusing that the ticker for the Sterling-Dirham currency pairing is GBPMAD. It certainly felt like it! Of course, this wasn't a bout of Dirham strength but a Sterling maelstrom resulting from the aforementioned budget, and the Pound was in freefall against every major currency. After reaching an intraday low of 1.035 dollars to the Pound on Monday 26th September (the lowest level ever plumbed and breaching the 1.054 set in February 1985[1]), the currency has bounced back, albeit limply, to over 1.12 dollars to the Pound today.

Readers will know that the last few weeks have also seen whipsawing prices for UK government bonds. As they are known, these' gilts' derive their name from the perceived security that accompanies their ownership. Indeed, the original certificates, issued by the newly founded Bank of England in 1694, had gilded edges to attest to their quality. In recent months however, security is not what gilts have been known for. Although we might be an island nation, the pricing of UK financial instruments is not immune – far from it - from global influence. Readers will know we have the highest inflation for 40 years and the heady rise in yields is both a market and policy response to that. Short end yields are largely a function of Bank of England policy rates, and expectations for said policy rates looking forward a couple of years; long bond yields should pay a 'term premium' over shorter bonds, which embodies several risk premia including both liquidity and longer-term inflation risk (and the volatility thereof). Supply and demand does the rest which can further distort yield curve shape.

The rise of Liability Driven Investing (LDI) in recent decades has seen UK pension funds increasingly use long dated 'swaps' – a financial derivative instrument which replicates the return profile of long dated gilts, but which is achieved without paying for them fully upfront. Where this is unfunded it creates leverage, and leverage creates risk, which has manifested in recent weeks in a gilt sell-off of epic proportions. Other commentators have exhausted the LDI analysis so I will not go there, but suffice to say that a massive repricing has taken place in gilts and also sterling corporate bonds, whilst there's more than a whiff of discount hanging across all UK assets right now (as there has been since the Brexit referendum vote in 2016).

> **A modicum of value has come back into the UK bond market**

The UK government's on/off messaging with respect to tax cuts and budgets, and the rapidly evolving political backdrop (Kwarteng out, Hunt in on Friday), has done little to calm the markets. The Bank of England has also now ended its emergency gilt purchase programme, but the Temporary Expanded Collateral Repo Facility (TECRF) remains in place until at least 10th November[2] which should support residual gilt trading for any pension plans that have not already sufficiently delevered.

Gilt yields continue to oscillate with an amplitude more fitting of an emerging market nation or the high yield corporate bond market, but then you only have to roll back twelve months and that's where both those markets were both trading[3]. The outcome of all this is that a modicum of value has come back into the UK bond market. It is far too early and difficult to see a point where gilt yields settle, but you have to go back to the Global Financial Crisis (GFC) to see yields on 'linkers' – UK inflation linked bonds – at the levels they are today, which are now positive across most tenors having been deeply negative for the best part of a decade (the 5yr linker yield first went negative in October 2009; it bottomed at -4.18% on 13th December last year; a week ago it was +1.3%). UK investment grade corporate bonds now yield over 7% which, bar a period of GFC capitulation, have not been higher for 25 years. For investment grade paper with limited default risk that looks attractive. Gilt yields can of course go higher from here, and corporate bonds would follow their lead, but for long term investors targeting real (post inflation) returns, there could be worse times to put your toe back into the Sterling bond market

*Sources: [1]keycurrency.co.uk, [2]Bank of England, [3]On 18th October 2021, the yield on the Bloomberg Global Yield index was 4.78%; on the JP Morgan EMBI Global index it was 4.9%. The 30yr gilt yield traded as high as 5.135% on 28th September 2022. *Unless stated all figures are from Bloomberg Finance, L.P*

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The Marketplace

- Global equities fell by 1.7% last week
- The International Monetary Fund released their latest round of economic projections leaving their 2022 global growth forecast at +3.2%, but downgrading 2023 to +2.7%
- Brent crude fell by 6.4% over the week to $91.6 a barrel
- Gold fell by 3.0% to $1644.47 per ounce

Market Focus

US

- US equities returned -1.5% last week
- The minutes from the Federal Open Market Committee meeting were released which reflected the growing debate on the Committee about the risks to over or under-doing the tightening cycle. There was also continued debate about the form of labour market softening that would be required to help return inflation to target
- Another upside Consumer Price Index (CPI) surprise ruined any chance of a near-term Fed policy pivot. Headline consumer prices rose by 0.4% over the month and 8.2% year-on-year. Core CPI was also stronger than expected, with the year-on-year measure up to 6.6%, its highest level since 1982

UK

- UK equities returned -2.0% last week
- The Bank of England ended its emergency support for bond markets on Friday
- UK Prime Minister Truss announced plans to hike corporation tax and removed Kwasi Kwarteng in favour of Jeremy Hunt
- UK unemployment rate fell to 3.5% vs 3.6% expected in the three months to August, the lowest level since 1974
- The UK will continue to be in the spotlight this week with CPI, Retail Price Index and Producer Price Index to be released on Wednesday

Europe

- European equities were flat last week
- European Central Bank (ECB) Chief Economist Lane said "the ECB's Governing Council is fully aware that further ground needs to be covered in the next several meetings to exit from the prevailing highly accommodative level of policy rates"

Asia/Rest of The World

- Global emerging market equities fell 3.8% over the week
- Japanese equities returned -0.5% last week
- The Japanese yen hit a fresh 32-year low versus the US dollar last week. The Bank of Japan Governor Haruhiko Kuroda indicated that he intends to stick to his policy of large-scale monetary easing, contrasting with other central banks
- Inflation has remained subdued in China amid persistent lockdowns and soft commodity prices. CPI advanced 2.8% year-on-year in September, pushed higher by food costs

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Asset Class/Region	Currency	Currency returns			
		Week ending 14 Oct. 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	-1.5%	0.0%	-24.2%	-18.4%
United Kingdom	GBP	-2.0%	-0.5%	-1.8%	1.4%
Continental Europe	EUR	0.0%	0.9%	-20.0%	-15.8%
Japan	JPY	-0.5%	3.4%	-2.3%	-1.9%
Asia Pacific (ex Japan)	USD	-3.8%	-1.7%	-27.6%	-28.8%
Australia	AUD	-0.1%	4.4%	-5.6%	-3.4%
Global	USD	-1.7%	0.0%	-25.5%	-21.7%
Emerging markets equities					
Emerging Europe	USD	-0.1%	5.0%	-78.9%	-81.5%
Emerging Asia	USD	-4.0%	-2.3%	-30.4%	-31.6%
Emerging Latin America	USD	-3.8%	3.3%	6.4%	2.7%
BRICs	USD	-4.7%	-2.8%	-29.6%	-34.9%
China	USD	-6.2%	-4.7%	-34.5%	-40.0%
MENA countries	USD	-2.7%	0.0%	-2.3%	-3.0%
South Africa	USD	-3.4%	-0.6%	-19.3%	-22.5%
India	USD	-0.5%	-0.7%	-9.4%	-13.5%
Global emerging markets	USD	-3.8%	-1.4%	-28.2%	-29.9%
Bonds					
US Treasuries	USD	-0.8%	-1.1%	-13.7%	-13.6%
US Treasuries (inflation protected)	USD	0.1%	0.6%	-13.9%	-12.8%
US Corporate (investment grade)	USD	-1.6%	-1.5%	-19.9%	-19.9%
US High Yield	USD	-1.1%	0.3%	-14.5%	-13.7%
UK Gilts	GBP	-2.0%	-5.9%	-30.2%	-29.0%
UK Corporate (investment grade)	GBP	-1.6%	-3.1%	-26.8%	-26.3%
Euro Government Bonds	EUR	-1.1%	-1.7%	-18.1%	-18.7%
Euro Corporate (investment grade)	EUR	-0.9%	-1.0%	-15.5%	-15.8%
Euro High Yield	EUR	-1.0%	-0.4%	-15.0%	-14.8%
Japanese Government	JPY	-0.6%	-0.3%	-4.1%	-4.1%
Australian Government	AUD	-0.9%	-0.4%	-11.2%	-11.7%
Global Government Bonds	USD	-1.3%	-1.9%	-21.8%	-22.5%
Global Bonds	USD	-1.4%	-1.8%	-21.9%	-22.6%
Global Convertible Bonds	USD	-2.7%	-0.7%	-24.6%	-27.2%
Emerging Market Bonds	USD	-2.3%	-2.0%	-32.1%	-32.3%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	-1.0%	-4.0%	-31.7%	-24.8%
Australian Property Securities	AUD	-1.8%	1.4%	-29.8%	-23.3%
Asia Property Securities	USD	-3.4%	-1.5%	-17.7%	-21.4%
Global Property Securities	USD	-1.8%	-3.2%	-31.0%	-27.6%
Currencies					
Euro	USD	-0.4%	-0.7%	-14.6%	-16.1%
UK Pound Sterling	USD	0.6%	0.3%	-17.5%	-18.4%
Japanese Yen	USD	-2.4%	-2.8%	-22.7%	-23.7%
Australian Dollar	USD	-2.7%	-3.4%	-14.6%	-16.2%
South African Rand	USD	-1.1%	-1.3%	-13.0%	-19.3%
Swiss Franc	USD	-1.2%	-2.2%	-9.4%	-8.1%
Chinese Yuan	USD	-1.1%	-1.1%	-11.6%	-10.5%
Commodities & Alternatives					
Commodities	USD	-3.2%	3.0%	17.9%	16.4%
Agricultural Commodities	USD	-0.1%	0.3%	7.1%	15.3%
Oil	USD	-6.4%	4.2%	17.8%	9.1%
Gold	USD	-3.0%	-1.0%	-10.1%	-8.5%
Hedge funds	USD	-0.2%	0.0%	-4.6%	-4.9%

Source: Bloomberg. Past performance is not indicative of future returns

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