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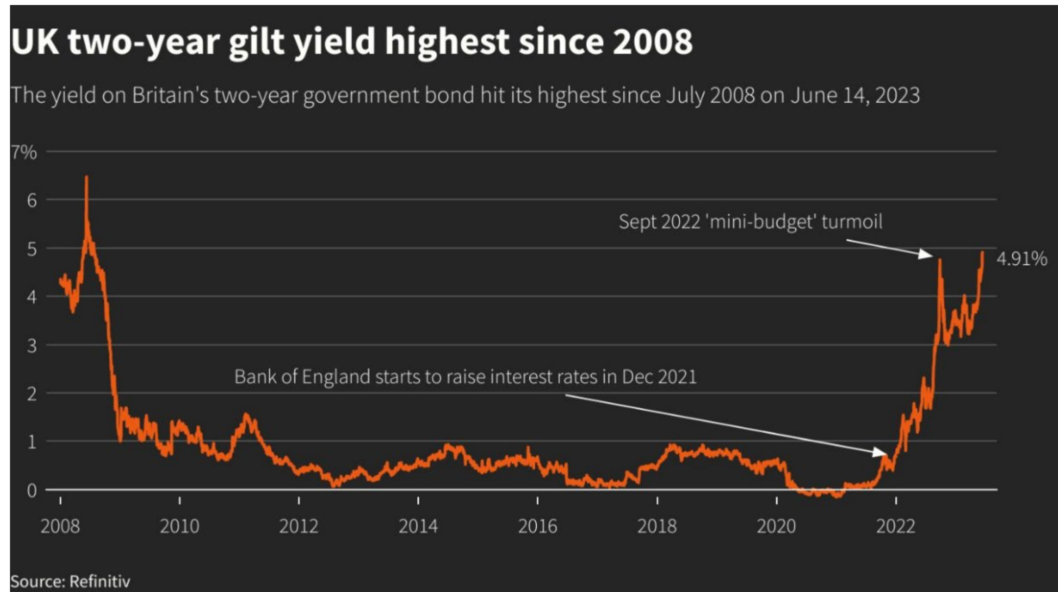
UK BOND YIELDS HIGHEST SINCE 2008

UK government bonds have seen the largest selloff since October's "mini budget" crisis, with 2-year gilts hitting a peak of 4.9% yesterday (highest since 2008):



THIS IS NOT A REPEAT OF OCTOBER MOVES

A big question is if this is a repeat to what we saw in October, which caused a Pension plan crisis, Bank of England (BoE) intervention and ultimately Liz Truss' resignation as PM.

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We do not think this is a repeat of that episode:

- Daily moves are smaller in magnitude.
- Daily moves are affecting, mostly, short dated paper (whereas September/October moves were concentrated in long dated gilts),which means that UK Pension plans are much more insulated.
- Last Autumn, there was a sudden and rapid increase in yields, leading to significant disruptions within the broader credit markets. In stark contrast, corporate and financial credit spreads have narrowed in tandem with global markets, as the interest rate cycle reassessment is not being driven by a breakdown in policymaking, fear, and uncertainty.

Ultimately, October moves were all about fiscal stability of UK Finances. This time round it is all about interest rates and inflation outlook (the move on Tuesday, for instance, was due to announcement that wages had risen at the fastest pace ever outside of COVID times. This prompted markets to raise BoE rate expectations).

UK INFLATION HIGHEST IN MAJOR WESTERN ECONOMIES

UK Consumer Price Index (CPI) was 8.7% in April (highest among major advanced economies), and BoE does not expect it to fall below its 2% target until 2025.

GILTS LOOKING ATTRACTIVE FROM INVESTMENT PERSPECTIVE

This gilt sell-off is starting to look overdone:

- UK 2-year gilts are yielding more than 1% now than at beginning of year (compared to US treasury yields, which are barely at same levels).
- UK 10-year yields are 2% higher than German equivalent (highest since 1997).
- UK 10-year yield spread over US is now higher than in October.

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The main message would not be that UK finances are in great shape (annual supply of bonds issued by UK Treasury is still around 240bn for 2023, and the BoE is no longer in Quantitative Easing (QE) mode), but they are not in the distressed state that current yields are suggesting.

BOE TO KEEP RAISING RATES

BoE is (famous last words!) going to raise rates by another 0.25% next week, and probably again in August.

OUR BOND PORTFOLIOS ARE REFLECTING OUR CAUTIOUS VIEW OF UK GROWTH

Based on market pricing, our perspective suggests that if the marginal propensity to consume (MPC) follows its current trajectory, it would have minimal impact on inflation sources like food prices and energy expenses. If anything, it might even worsen significant declines in interest rate-sensitive sectors such as housing and small businesses. Hence, we are keeping our exposure to these cyclical sectors extremely low.

Our UK portfolio duration has been kept relatively low and at this stage no changes are recommended.

Our UK Credit allocation is exclusively for key economic sectors such as major banks, insurance companies, utilities, telecom, and energy should be retained given the strength and resilience of the balance sheets.

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OUR UK EXPOSURE IN GLOBAL EQUITY PORTFOLIOS IS LOW, BUT UK STAR COULD STRUGGLE FOR A BIT MORE

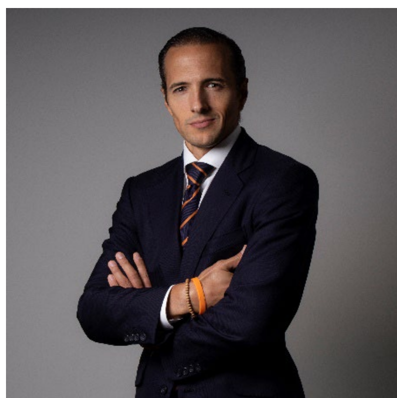
From a UK Equity viewpoint, the move up in UK yields has two main impacts:

- Currency: GBP has strengthened, which impacts the multinationals profits on a translation effect.
- Domestic interest rate-sensitives have suffered: as Cost of Debt assumptions have moved up and the housing market (and direct exposures) look especially vulnerable due to the mortgage market implications. This has fed into concerns that the UK consumer will have less disposable income.

We own just two UK Multinational Stocks in Global STAR (Diageo and GSK). These stocks will have had some share price headwinds from the GBP move up and the translation effect, but have certainly not had standout differentiated performance than other similar STAR stock in different geographies.

For UK STAR, this is less positive, which is also representative of the UK Market as a whole:

- Multinationals (like BAe Systems, Unilever, GSK, Reckitt, Diageo) are impacted by the profit translation effect with no FX offset for GBP based investors. The portfolio is quite heavy on defensive multinationals as this is one of the most longer-term attractive areas of the UK Stock Market.
- UK Domestic rate sensitives (like Lloyds and Persimmon) were hit hard last year and, so far, have been resilient as, although yields have moved higher, the expectation has been that an interest rate peak is within sight.



Kind Regards,

PAU MORILLA GINER
Chief Investment Officer

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