.6th Floor
Candlewick House
120 Cannon Street
London
EC4N 6AS

Telephone: 020 7426 5960

KING&SHAXSON
ethical investing

Fixed Income – November 2016

We all know UK Interest rates are at a low of 0.25%, even lower are money market rates and on Friday (25th November 2016) one month money was as low as 0.11% at the DMO UK Government Treasury Bill Auction. Against this background we would expect fixed income markets to be roaring higher.

However expectations are beginning to change and we have seen sharp falls in fixed income markets over the last few months, not just here but in the US and Europe, despite the fact that things are very different in each region. In the US, under a new president, there are strong expectations the government will embark on fiscal expansion and borrow to build some much needed infrastructure projects.

The US economy has been the first to exit the global financial crisis and the market unanimously expects interest rates to rise in the US in December, the only question is whether by 0.25 or 0.50%. As a result the yield curve in the US (the difference between short term money and then bonds at various maturities out to 30 years) has steepened and is now 0.25% to 2.32% for 10 years and 2.98% for 30 years. (source Bloomberg)

The situation in the Eurozone economy outside of Germany remains dead in the water and the ECB is still aggressively engaged in quantitative easing. Elections that could change national leadership take place in both Germany and France next year, uncertainty is rife. Brexit talks may begin with one set of key leaders and end with another.

In the UK the Brexit vote led to an interest cut that divided opinion. We felt the UK economy was stronger than expected before the vote and that although Brexit will slow the UK economy with the uncertainty it causes, it is also far from fatal. The UK is the world's 5th largest economy and at the moment no-one knows or *will know* how things will progress. We are suffering endless drivel from journalists and the numerous noisy officials who are not involved, but focused on the final settlement that is still possibly years away, which is so important to all sides that we feel it will be neither be hard or soft, but pragmatic.

What is fact and that can be banked on is that weaker sterling will lead to higher inflation next year, and like the US we are seeing the UK yield curve normalise out to 30 years. The current curve is 0.199% to 1.3925% for 10 years and 2.058% for 30 years. Three months ago this was 0.236%, 0.5636% and 1.2683% (source Bloomberg), so short term interest rates have fallen but long term interest rates have risen sharply. This has impacted bond prices.

This rise in yields has led to some sharp falls in bond prices, but this was something that we saw coming and we responded in two ways.

Some time ago we used the weakness to add more index linked exposure to portfolios, either via direct bonds in the Personal portfolios (Network Rail 1.75% Index Linked 2027 and Yorkshire Water) or via an index linked fund in the model portfolios.

In the personal portfolios (where we only make direct fixed income investments) we also reduced duration. Back in August we sold two long dated social housing bonds, the Circle Anglia 5.2% 2044 then at £152.37 per £100 and the Places for People 5.875% 2031 at £134.21 per £100, these bonds have since fallen sharply in price (by 12% and 8.4%) to £133.97 and £122,92 respectively.

We replaced these with a smaller investment (about half of our intended investment) in a lower duration Places for People bond, the 2.875% 2026 and this fell from 101.20 to 95.79, or just 5.35% outweighing costs and the lower rate of interest.

At the time we only added half of the allocated amount, mainly in case an unexpected event drove fixed income higher (we have had enough of these events this year), but have held back on making any further investments.

We still expect there to be further uncertainly. How the markets will react to the (highly expected) rise in US rates, and how the US Federal Reserve plots interest rate rises next year will be a key factor in the direction of fixed income.

Likewise the change in politics in the US will lead to some global economic changes, right now no one knows exactly what will happen. A looming referendum in Italy, then next year elections in Germany where we believe Angela Merkel will remain Chancellor, but we do have fears that her coalition partners will be the weak link. We anticipate a new French president, but the run off may well be between the right and the far right.

Finally we see the global economy continuing to recover despite all the noise, especially in the US, the UK and emerging markets. At the same time we do not expect the oil price to rise much more. OPEC is not as powerful as it was, even if they ever manage to agree as the US and shale is now the swing producers of oil, not Saudi Arabia, we for that reason do not see oil prices derailing any recovery.

Therefore the need for lower interest rates and even QE has declined and we remain cautious on the outlook for bonds.