Are gilts in buying territory?

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The rate of inflation is still at elevated levels and expectations are that it will rise further in the UK before it reaches its peak. Despite this, we believe there will be fewer increases in interest rates than is priced into markets and there are now some selective buying opportunities among UK gilts.

Inflationary pressures have been building globally since economies reopened from 2020's lockdown measures, leading to supply chain crunches amid a resurgence in demand. But bond yields only really moved materially higher once we hit 2022.

The UK 10-year gilt yield increased by 80 basis points (bps) over the course of 2021, and were flat in the fourth quarter. In 2022, however, they rose by around 170bps to reach a mid-June peak of 2.65%, before falling to just around 2.0% currently.

The reason for this delayed reaction is twofold: central bank inflation denial and the war in Ukraine.

The failure to raise rates earlier than December 2021 looks to be a major policy error, with the BoE now facing the prospect of enacting further rate hikes against a backdrop of falling growth. History is against them on this front; the Bank of England has never before undertaken a rate hiking cycle at same time as growth is slowing sharply and a technical recession (two consecutive quarters of contraction) is possible. Indeed, this is the general rule around the world, with the exception of the US Federal Reserve's 1979 inflation-fighting bout under Paul Volcker.

Ultimately, we do not think the BoE will be able to pursue tightening to the extent the market is currently pricing in. Futures markets are currently pricing in 125 basis points of tightening from the current base rate of 1.75% up to 3.25% by early 2023.

While we think rates will go higher, we expect rates to peak below 3.0% due to a realisation that higher interest rates are likely to be a pretty ineffectual tool in this economic environment. Normally, higher rates would put the brakes on demand growth by increasing the cost of money, which in turn would reduce 'demand-pull' pressures (where demand is higher than supply, pulling up the cost of goods). However, current inflation is largely of the 'cost-push' variety (where a supply shock raises prices, leading to reduced demand) so addressing demand-side conditions will have limited impact.

Inflation is at its worst in non-discretionary items and those impacted by supply shocks, with soaring energy costs being the most notable example. While higher interest rates may help take some heat out of the labour market and lower the risk of a price-wage spiral, the BoE will be very wary of further undermining disposable income for many in society by making it even more difficult to afford the essentials. Further tightening would also risk damaging particular sectors of the economy such as retail and hospitality that have already been suffering as a result of Covid restrictions.

Our base case is that the BoE stops short of taking rates to 3.0% but accompanies further hikes with rhetoric which is aimed squarely at taming the risk of big second-order effects in terms of wage rises.

So what does this mean for our funds' positioning? Are UK gilts now a buy? We think they are, although not across the curve.

We have been structurally short duration versus the benchmark for a number of years, but the better value implied by rising gilt yields has led us to reduce the scale of this underweight to rates risk this year.

The UK 10-year yield is currently around 2.0%, and we expect it to stabilise in this range. While we plan to stay moderately short duration at current levels, we will aim to manage this quite actively rather than implement a more structural position. Were yields to rise to the 2.25% - 2.50% range, we would further reduce our duration short position. If, however, gilts rallied and the yield pushed back to 1.50% - 1.75%, we would increase the underweight to duration.

We will also be targeting parts of the yield curve that we think will prove most mispriced if, as we predict, there are fewer rate hikes coming than the market expects. The short end of the curve tends to be more policy sensitive, so we favour 2 to 3-year gilts where we expect yields to fall rate hikes are be priced out over time. By contrast, we are underweight the long-end as we think 30 year gilts still do not price likelihood of a sustained period of 2.0% - 2.5% inflation.