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As rates rise, is it time for bonds?

The Bank of England hiked the base rate this week by half a percentage point to 5% in a stepping up of efforts to tackle rampant inflation. It was the 13th increase in a row.

While the hike in interest rates will have come as little surprise to most following this week's high inflation figures – albeit to the consternation of many mortgage holders who will see their monthly mortgage payments rise sharply – the decision to increase by half a percentage point rather than a quarter percentage point has moved the dial more dramatically than some expected.

But could this mean that we are coming towards the end of the sequence of rates hikes and furthermore, could there be a silver lining in the opportunities offered by the bond market?

The effect of the many recent base rate increases on the economy tends to lag the data, in that it takes some time for the real effects to be felt. For some experts, the expectation is that previous rate rises will soon begin to catch up the economy – in particular, as growing numbers of fixed rate mortgage deals come to an end – and that therefore we are now nearing the end of the regular rises.

Liontrust's Sustainable Investment Fixed Income team believes this is the case. As fund manager Aitken Ross points out: "Central bank base interest rates typically affect the economy in a lagged manner and we think the market is underestimating the cumulative contractionary pressures that will kick in soon."

According to the BoE, the proportion of fixed-rate mortgages has increased from around 30% in 2010 to around 85% presently.

Ross adds: "Homeowners on fixed-rate mortgages will have been protected against the impact of higher rates, but this will change as they refinance their fixed deals over the coming months and years. This will be a headwind for underlying economic growth.

"With the economic growth outlook looking anaemic and inflation likely to belatedly fall back towards the Bank of England's 2% target next year, we think the case for further rate hikes is limited."

There is growing talk of the UK heading into recession, and if this were to happen then the rate of inflation would be likely to fall as a result of a decrease in consumer demand for goods and services and a fall-off in economic activity.

This could also be good news for bonds, Currently, yields on investment grade sterling corporate bonds are back to levels not seen since before the global financial crisis in 2007, as the chart below shows.

We believe our funds are well positioned to capitalise on the opportunities the asset class now offers.

Not only could a fall in inflation help bonds become even more attractive but according to Ross, corporates are currently in good shape to withstand a possible recession, underpinning the attractiveness of bonds because yields should not rise much further while expected defaults are low.

Ross says: "The bond market is currently very focused on short-term trends in macroeconomic data – such as inflation prints – as it attempts to call the peak in base rates, so we expect more volatility over the course of this year as sentiment fluctuates.

"However, we think long-term investors should view this short-term noise as a mispricing opportunity; with base rates close to peaking, we think current UK government bond yields of 4.4% (10 year bonds) are very attractive."

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