Wealth Management

LGT Snapshot

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Rising gilt yields: Not always a reason to panic

Rachel Reeves has been called upon to address what many have described as a crisis in the gilt market, as yields rise to levels not seen since the global financial crisis. Investors should take some comfort knowing this is not just happening in the UK —government bond yields are rising globally, which has spilled over into equity and currency markets.

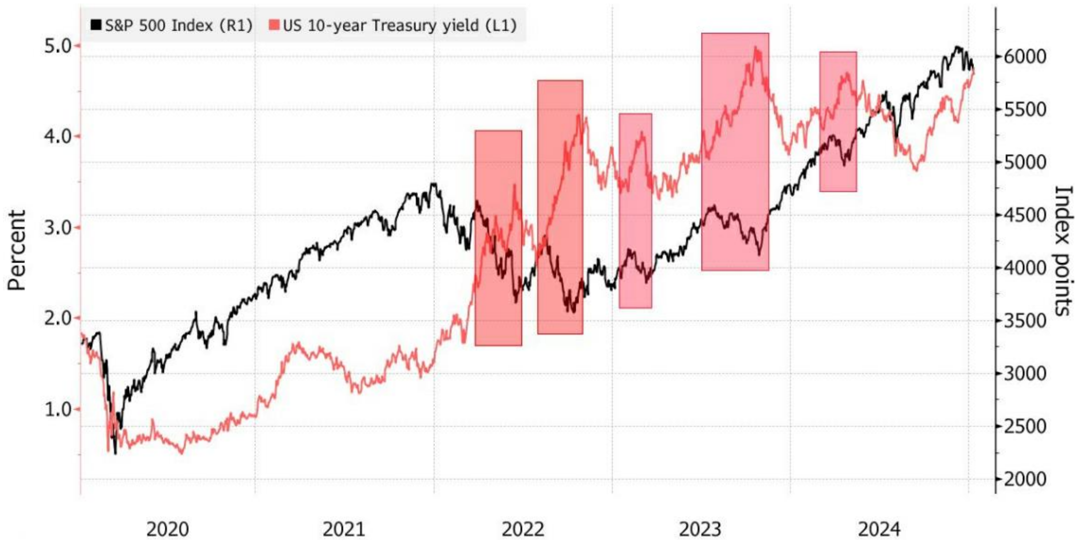
The UK is currently leading the pack with the UK 10-year gilt yield rising to 4.88% and the 30-year gilt yield at its highest since 1998, as it climbed to 5.44% as of 13 January.[1] We want to provide some clarity and reassurance during this period of uncertainty and demonstrate what these recent moves mean for your clients and their portfolios.

Source: LSEG, Reuters

What are we seeing?

Bond yields can rise for both positive and negative reasons, but the root cause for recent movements is being hotly debated. Generally, a combination of strong US economic data, including lower unemployment figures, has led the market to believe that interest rates in the US are going to stay '**higher for longer'** and the Federal Reserve (Fed) will pause their easing cycle. There are also concerns over government spending, rising inflation figures, uncertainty around a second Trump administration and potential trade spats which are deemed to be inflationary. All of these factors appear to have contributed to pushing bond prices down and yields up.

[1] Factset



Source: Bloomberg

Though there is no threshold on what is deemed 'too high' for yields, there are concerns that further, unstable rises could result in a knee-jerk downturn in equity markets. There has been recent evidence of how rapidly rising yields affect equities.

What does this mean?

As always, the real story isn't necessarily the fact that one asset is rising or behaving erratically. It's what the big picture is telling us and ensuring your portfolios are positioned correctly. Focussing on the UK, the increase in debt borrowing costs will put a strain on public finances and cause the new Labour government and policy makers to assess their plans for fiscal and monetary policies. In order to bring down the borrowing burden, their key choices are spending cuts or tax hikes, but their immediate plan remains to be seen.

Additionally, businesses will face increased mortgage rates, increased lending rates and possible reduced consumer spending. This will dampen economic growth and puts a dark cloud over the UK outlook. We are currently running our models with minimal exposure to both domestic UK and UK small caps and so this outlook should have minimal impact.

It isn't all doom and gloom though, as several asset classes tend to flourish as yields rise. Fixed income instruments become more attractive from an income perspective, as although prices fall, the yield will be higher. Short-term bonds can be more attractive due to their prices being less sensitive to rising yields. In the financial sector, banks can benefit from interest rates staying at elevated levels, and insurance companies (such as those held in the Polar Insurance fund, which we own) benefit from the higher yield through enhanced returns on their invested premiums.

Quality companies are considered attractive in times of rising yields mixed with market uncertainty. Their strong balance sheets and steady cash flows allow them to remain resistant to volatility and provide investors with some stability as businesses face rising costs. Quality has been core to LGT's ethos for several years and is reflected in each proposition and offering.

Convexity and opportunity

Although there are many opportunities elsewhere because of these yield rises, we also still see value in the gilt market due to the nature of bond convexity. Bond convexity explains how the price of a bond increases in relation to the reduction in interest rates but in a curved line rather than a straight line. This gives you an **asymmetric return profile** where at these yield levels, investors gain a lot more from a fall in yields then you would lose from a rise in yields of the same magnitude. For example, if the interest rate rises 1%, a 10-year gilt return profile for the year would fall almost 2%. But should the interest fall by 1%, the 10-year gilt return profile would rise by almost 12% over the following year.

	1yr return for bps change in yield						
UK Gilt	+1.5%	+1%	+0.5%	0.0%	-0.5%	-1%	-1.50%
2Y	2.94	3.43	3.92	4.53	4.93	5.43	5.94
5Y	-0.25	1.28	2.83	4.54	6.02	7.69	9.35
7Y	-2.71	-0.35	2.07	4.64	7.14	9.79	12.52
10Y	-5.08	-1.96	1.29	4.83	8.19	11.89	15.70
30Y	-13.76	-8.11	-1.82	5.40	13.03	21.98	31.88

Source: LGT, Bloomberg

Considering the UK and US central banks are on an easing cycle (albeit a paused one), the upside potential that gilt prices are currently displaying is undeniably attractive for investors. However, there are always risks when investing in any asset class and at LGT we recognise that gilts must be used as part of a well-diversified investment strategy. It is also important that we remain receptive to changes in the market and our frequent investment committees allow us to make the necessary trades. We will be closely watching developments in the UK and may use the uncertainty to perform tactical trades around gilts.