

State of Play



26 May 2022

Bond assets have endured their worst start to an investment year in many decades following an unprecedented 40-year bull market. What are the reasons for this reversal and what does the future look like for investors?¹ Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Bond bull market story

Traditionally using bonds as an asset class to diversify and manage the risk of an investment portfolio dates back many decades, as State of Play explored a couple of weeks ago looking at Modern Portfolio Theory. The principle of mixing different asset classes that behave differently along the economic cycle enables investors and fund managers to tilt portfolios to capture additional investment returns and/or seek to mitigate some of the falls in value when markets become bearish.

Bonds have been on an extraordinary journey for more than 40 years since the autumn of 1981 when the yield for 10-year UK Government Debt was over 15%.² This subsequently fell to 0.1% in July 2020.² Since then, as inflation has risen sharply central banks have signalled their intent to bring rising prices down to their respective targets thus triggering a rise in the 10-year yield to close to 2%, causing sustained subsequent falls in bond values, hurting investors looking to mitigate volatility, especially, low risk investors who hold a large proportion of their portfolio in bonds.²

The gradual fall throughout the 1980's was interrupted briefly by 'Black Wednesday' on 16 September 1992 when the UK decided to leave the Exchange Rate Mechanism (ERM) two years after joining.³ European Union member states in 1990 agreed to keep their currency within set boundaries, linked at the time to the German mark forcing them to follow the economic policies of the German Bundesbank which was pursuing anti-inflation policies. Brussels imposed membership of the ERM on member states as a pre-requisite for joining Europe's planned single currency – the euro.³ To protect the value of sterling, interest rates were increased dramatically in a matter of hours on that fateful day, until eventually the government was forced to abandon their membership of the mechanism and reduced rates from 15% to 12% at the end of the trading day.³

Bond yields continued their gradual fall throughout the 1990's and into the new millennium until the financial crisis began in late 2007 forcing central banks to intervene in September 2008, culminating in the beginning of the biggest global monetary experiment in our history designed to avoid financial catastrophe.⁴ The trigger for the financial crisis is expertly explained on the Bank of England's website⁴ – 'In the US, two huge mortgage finance agencies, Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation), were taken over by the US Government (in September 2008). The \$187.5 billion bailout was one of the largest in US history. Fannie Mae and Freddie Mac's main business was packaging up home loans into products called mortgage-backed securities that were then sold on to investors. As the US housing market steadily weakened and then collapsed, so did Fannie and Freddie. The scale of the bailout immediately heightened concerns about the stability of the entire financial system, and institutions already known to be vulnerable came under increased scrutiny. One of these was the leading US investment bank Lehman Brothers.'⁴

Certain institutions were either bailed out by governments, like the Northern Rock Building Society, or forced into mergers with stronger institutions, like Halifax and Lloyds in the UK, whilst Lehman Brothers became the biggest casualty of the crisis closing its doors on 15 September 2008. Following Lehman Brother's collapse central banks worked closely with policymakers to provide confidence and, importantly, liquidity. Firstly, interest rates were slashed close to zero and central banks began 'printing money' (also known as Quantitative Easing - QE) which was used to purchase debt from commercial and retail banks in a bid to free up credit to businesses and individuals as banks had become risk averse. Whilst initially banks were required by regulators to shore up their cash reserves to protect against a repeat in the future, eventually lending restarted, confidence returned, and economies recovered. One of the biggest consequences of QE was more money chased the same number of goods pushing up the value of assets, in particular share prices, but also forcing down the yields on bond assets, triggering a subsequent rise in their price.⁴

Has the bond bull market ended?

It is impossible to be sure about the future for bond assets given the enormous uncertainty that exists today, with rising prices, the Russian invasion of Ukraine, and the supply side disruptions impacting future growth expectations. Since the start of the year through to the end of April, the UK Government bond sell-off totalled an estimated £150 billion, making it the worst bond market fall since the 1980s.⁵ However, investment markets tend to look to the future and price what they think will happen today. In recent weeks the yield on the 10-year government bonds, both in the UK and the US, have flattened having reached recent highs at the end of April/beginning of May.² Is this simply the market pausing for breath, or is there perhaps more to it than this?

Certainly, with the latest inflation data release confirming everybody's worst fears as inflation reached 40-year highs⁶, central banks have reaffirmed their commitment in tackling inflation by raising rates and reducing their balance sheets. However, investment markets will no doubt be assessing whether the impact of rising prices could stifle enough economic demand to allow central banks some breathing room a few months from now. If there is sufficient fall in demand, hopefully avoiding a recession, then central banks will have achieved the soft landing they are looking for, although it cannot be underestimated how narrow the landing strip is.

In part, much of the language recently in 'talking tough' on inflation, in my view, is as more about regaining credibility with investors than necessarily signalling a path for interest rates beyond the next 6-12 months. Central bankers cannot be sure about what will happen next, much like their underestimation about the current spike in inflation, which they insisted initially would simply be transitory. If they increase interest rates too much at the same time as demand cools, then the likely outcome will be a recession, albeit the severity will depend on how far economies shrink and for how long.

The worst-case scenario could be that rates drastically reduce demand alongside sustained cost-push inflation leading to stagflation, as I explained in last week's update. The recent flattening of yields might be a combination of investors assessing how likely each of the outcomes I have just described are, coupled with a sense of uncertainty as the dynamics impacting the future have so many complex influences easily tilting outcomes one way or another depending on the economic climate.

Despite the uncertainties, central banks have begun to implement what is called monetary tightening⁷, the opposite of QE. In simple terms this is driven by two actions. Firstly, they increase interest rates to a normalised level which will clearly depend on economic conditions over the next couple of years. Secondly, allowing existing debt that was created to support the economy during the financial crisis, and recently during the pandemic, to

mature without re-issuing a replacement. Monetary tightening reduces the money supply, meaning less money chases the same amount of goods, arguably reducing the value of assets, which appears to have already begun given the sharp falls in markets in both shares and bonds since the start of the year.²

If the market assumptions about interest rate rises in the future and the pace at which tightening is implemented are proved too pessimistic, bond yields may fall from either current levels, or if they rise further in the short-term, fall back from the point at which the assumptions are proved too bearish. Regardless of the outcome, in my view it is highly unlikely we will see central banks return to extremely low interest rates and quantitative easing unless there is a significant financial shock proving a systemic threat to the global system. Even if the worst were to happen and we experience a return to stagflation, this may slow the pace of tightening or the level at which rates rise to, but it is unlikely to see a return to the monetary experiment we have lived through. All of these questions will be answered in time, meanwhile investors are navigating through uncertainty and trying to focus on the principles of investing. As State of Play has explored in past updates, investing driven by pure emotions can leave investors making the wrong choice at precisely the wrong time.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing [here](#).

Note: Data as at 23 May 2022.

¹ Santander Asset Management, May 2022

² Investing.com, 23 May 2022

³ BBC News, 16 September 1992

⁴ Bank of England, 23 May 2022

⁵ Times Newspaper, 20 May 2022

⁶ Office for National Statistics, 18 May 2022

⁷ Bank of England, 23 May 2022

Important Information

For retail distribution.

This document has been approved and issued by Santander Asset Management UK Limited (SAM UK).

This document is for information purposes only and does not constitute an offer or solicitation to buy or sell any securities or other financial instruments, or to provide investment advice or services. Opinions expressed within this document, if any, are current opinions as of the date stated and do not constitute investment or any other advice; the views are subject to change and do not necessarily reflect the views of Santander Asset Management as a whole or any part thereof. While we try and take every care over the information in this document, we cannot accept any responsibility for mistakes and missing information that may be presented.

All information is sourced, issued and approved by Santander Asset Management UK Limited (Company Registration No. SC106669). Registered in Scotland at 287 St Vincent Street, Glasgow G2 5NB, United Kingdom. Authorised and regulated by the FCA. FCA registered number 122491. You can check this on the Financial Services Register by visiting the FCA's website www.fca.org.uk/register.

Santander and the flame logo are registered trademarks. www.santanderassetmanagement.co.uk.