

# The September Outlook

## Market Stance

### WHAT HAS UNSETTLED GLOBAL BOND MARKETS?

**Cyclical pressures have forced global bond yields higher since the spring. Fiscal vulnerabilities have been less relevant**

#### Commentary

- Stronger inflation pressures have led to expectations of higher policy rates from central banks, without undermining long-term inflation expectations
- Long-term real interest rates have increased, with firm economic growth and higher AI financing requirements contributing to this rise
- Caution over the sustainability of government finances persists, but has not accounted for the recent rise in global bond yields

#### Upshot

- Higher bond yields imply higher feasible fixed income returns than at the start of the year, although Saranac continues to find longer-term bonds unattractive

### CENTRAL BANKS

**Arguments for holding rates steady are becoming weaker**

#### Commentary

- Inflation expectations are likely to rise again as a result of the renewed rise in energy prices globally
- In the US, inflation remains above target and the labour market is firm, although there is some evidence of falling wage pressures. Pressure on the FOMC to hike is rising
- In Europe, the ECB has already hiked rates and left the door open to further hikes later this year. The BOE will likely be more cautious in its approach

#### Upshot

- The market has swiftly priced out the possibility of rate cuts this and next year, providing some upside for fixed income should the macro backdrop deteriorate from here

### THE GLOBAL ECONOMY

**Some evidence of a mild cyclical upswing, in part owing to the ongoing AI capex cycle**

#### Commentary

- The renewed energy shock will reduce output in some parts of the world, but in aggregate the global economy has been far less sensitive to the oil price than feared
- Across the major economies, Europe and Asia are more exposed to higher energy prices, while the US economy is more insulated
- Monetary policy has limited efficacy in dealing with inflationary supply shocks, but central banks likely have to act to maintain credibility

#### Upshot

- Latest energy price shock creates asymmetric risks, but the probability of a global recession this year remains relatively low

### SARANAC MULTI ASSET POSITIONING

**Finding the right balance**

#### Commentary

- Broad equity valuations remain somewhat elevated, while credit spreads have little room to tighten further
- Inflation remains stickier than central bankers had hoped, meaning monetary policy has remained more restrictive after the short-lived easing cycle that started late last year
- However, yields on fixed income appear increasingly attractive when viewed against the earnings yield available from equities

#### Upshot

- We feel a more diversified asset allocation has merits. Importantly, our portfolios are not aggressively positioned for the very worst market outturns, tactical tilts are relatively moderate

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# What has unsettled global bond markets?

**SNAPSHOT**

Global bond yields have risen for six months, but the move is primarily cyclical, not dominated by increased fiscal concerns: markets now expect modest rate rises rather than cuts, on energy-driven inflation and firmer growth.

Yield curves have flattened, with short rates rising most. Fiscal concerns would have steepened them. No major fiscal news, or 'Liz Truss' moment, has emerged to warrant the observed rate changes.

UK yields are high relative to other developed markets largely because of ingrained inflation, not primarily because of fiscal risks unique to the UK.

Saranac does not hold long-term bonds, but is not cutting duration for shorter maturities: higher starting yields have improved prospective returns.

**1. A framework to understand interest-rate changes**

Global bond yields have been rising for six months. Why? The answer is critical in assessing financial market prospects. In particular, do higher yields reflect a change in cyclical conditions which warrant higher long-term interest rates? Or do they reflect the emergence of more pernicious factors which are combining to make the world a much riskier place, with higher yields reflecting, for example, higher political uncertainty or increasingly unsustainable fiscal positions in a number of countries? These possible explanations are of course not mutually exclusive, but a robust understanding of why global bond yields have risen is a necessary base to establish where they might go next.

What drives interest rates? It is helpful to restrict a wide range of potential causes to two main groups, and also considers the full spectrum of interest-rate maturities, from overnight to thirty years and more. For shorter-term maturities, central bank interest rates are of pivotal importance. Of course, these rates are not determined in isolation, but rather reflect official responses to broader cyclical conditions, in particular trends in growth and inflation. However, the impact of policy rates fades for longer-term yields, and beyond ten years or so other factors are more influential - for example, the credibility of fiscal policy, and shifts in the financial policies of long-term investors such as insurance companies and pension funds. Central banks do influence longer-term yields when implementing or unwinding quantitative easing (transactions primarily in long-term bonds), but this is a different policy tool to setting short-term interest rates, particularly at very short maturities.

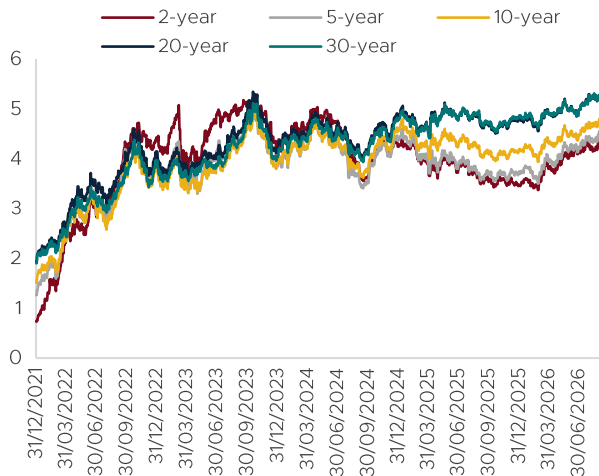
**2. Recent trends in bond yields: a changed cyclical environment more relevant than heightened fiscal concerns**

What does this framework suggest has been the main driver of rates this year? A slightly longer term context is helpful here.

### The Long Read

CHART 1

#### US Interest Rates at Different Maturities

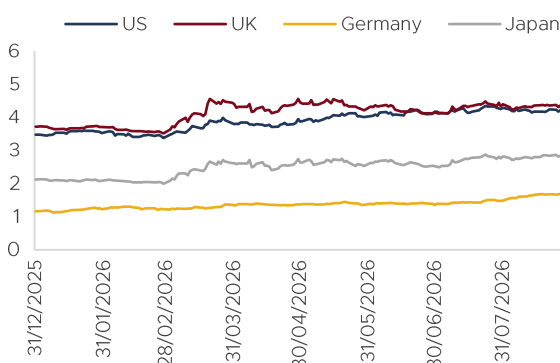


<sup>1</sup>Source: Saranac / Bloomberg

Since the sharp repricing of bond yields in 2022, the ten-year US yield has been in a range of around 3.5% to 5% (chart 1). The current yield of 4.9% is close to the top of this range, but it is not unknown territory. Shorter-term US yields are around mid-range. Interestingly, yields at much longer maturities, 20 years and beyond, have broken out of the top-end of their post-2022 range, having started the year closer to the top end.

CHART 2

#### 2-year Market Interest Rates



<sup>2</sup>Source: Saranac / Bloomberg

This highlights the importance of acknowledging the relevance of different influences on interest rates of different maturities. The international dimension is also important here. Outside the US yields have been in a shallow upward trend since 2022. Spreads against US bonds have gradually narrowed, and UK yields have risen above their US equivalents.

This long-term picture is important, but it does not fully capture the processes which have driven bond yields higher at all maturities since the spring. Some stylised facts of the past six months have been that:

- The rise in yields has been a global phenomenon.
- Yield increases have been broadly similar across countries, with only limited changes in differentials at each maturity.
- In all countries (except Japan) short-term rates have risen more than long-term rates. The gap between short-term and long-term rates has therefore narrowed.
- Put technically, the yield curve has flattened. Long-term rates are still higher than short-term rates, but by less than was the case earlier in the year.

The simplest starting point to explain these developments is to appeal to a change in central bank interest-rate policy, and expectations of what central banks may do going forward. In the early part of this year, there was widespread expectation that the next policy moves in Europe and the US would be for rates to be cut slightly. A combination of the higher inflation resulting largely, but not solely, from the higher energy prices arising from conflict in the Middle East, and also in general somewhat firmer economic growth than expected, has shifted the global cyclical background.

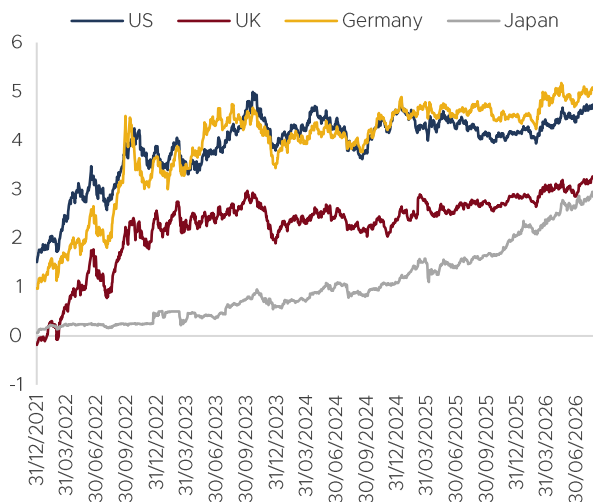
There is now a widespread consensus that the next move by all major central banks will be to raise policy rates, albeit modestly (chart 3). It is therefore unsurprising that short-term rates have, since February, risen by more than long-term rates, given that the changed cyclical background has more

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significant implications for short-term rates – not least because the energy-price driven rise in inflation is expected to be temporary, not a multi-decade phenomenon.

CHART 3

### Global 10-year bond yields



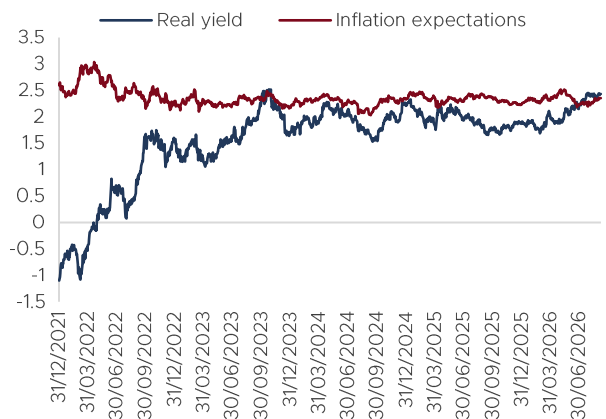
<sup>3</sup>Source: Saranac / Bloomberg

In explaining longer-term yields, it is helpful to divide a conventional nominal yield into two components: the real interest rate and inflation expectations. Data for the US send a very clear message: all of the rise in ten-year bond yields since the spring has been the result of higher real interest rates, as inflation expectations have been broadly stable (chart 4). Indeed, it is striking that longer-term US inflation expectations have now remained unchanged over a multi-year period, across a wide range of economic and financial environments.

If real interest rates have been the prime mover underlying the rise in yields, what explains the rise in real rates? One clear candidate is the exceptional increase in corporate profits in the past year: if companies can borrow profitably at higher interest rates, governments too will face higher debt costs. A related argument in this respect has been the surge

CHART 4

### US 10-year real interest rates and inflation expectations



<sup>4</sup>Source: Saranac / Bloomberg

in external financing by some US IT firms to finance AI expenditure, with greater debt issuance pushing up yields for all borrowers. Taken in isolation, this argument holds water, but it also needs to be placed in a broader context. The aggregate borrowing requirement for all US companies has increased by much less, as the frenetic pace of financial market activity in the US IT sector masks a much less substantial borrowing requirement for companies in many other sectors. In addition, the consensus view is that the surge in external borrowing to finance AI projects may be a feature of the next year or two, not a sustained rise in bond supply. Nevertheless, the capital market requirements of these larger firms are still likely to have contributed to the upward pressure on yields.

### 3. Fiscal sustainability and dysfunctional US policy

Where does this leave the scope for rising market concerns over long-term fiscal sustainability as a driver of this year's rise in yields? The challenge with seeing this as the prime cause is that such concerns would be most relevant at longer-term maturities, leading to steeper yield curves – a wider gap

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between short-term and long-term yields, and a steeper yield curve. As noted, this has not happened: short-term rates have risen by more than long-term yields in recent months. In addition, fiscal challenges do not arise at the same time across countries, not least because elections and policy changes in different countries operate on different timetables. As a result, idiosyncratic political developments are likely to be correlated more by chance. As noted earlier, however, the changes in interest rates, and in yield curve slopes have been similar across countries since February. This suggests that a common cyclical factor has been more important in explaining higher yields, not least because it is unclear what major fiscal news has emerged. No country has had a 'Liz Truss' budget. This is not to deny the relevance of fiscal policy to bond yield determination, rather to claim that a deterioration in the global fiscal background has not been the main cause of the rise in yields in recent months.

The rise in short-term US rates has also been attributed in part to new FOMC Chairman Warsh's abolition of forward guidance, the previous official Fed view on the expected trend in interest rates. This has inevitably led to less clarity over the Fed's likely policy stance going forward, potentially rising uncertainty and hence volatility. Some market commentators claim that this may have raised yields by 0.1% to 0.25%, but this estimate seems high: the downgrading of forward guidance occurred at a time when the case for the Fed to raise rates was building and other FOMC members have continued to offer forward-looking views supportive of such a move.

A further potentially destabilising element around the same time was Treasury Secretary Bessent's instruction to the Treasury to buy back twenty and thirty year bonds, shifting some financing to shorter maturities. The amounts involved are modest, and the market impact has been very limited. Importantly, it has seemed odd that just at the time that the Fed was moving to a policy stance involving higher bond yields, the Treasury was looking to

depress them. The main impact of this policy incoherence seems, however, to have been reflected in a weaker dollar, and may also partially explain the rebound in the gold price in recent weeks.

#### **4. Higher UK bond yields primarily reflect higher inflation, not unique fiscal stresses**

The UK offers an interesting case-study in terms of understanding the relative balance between fiscal and cyclical drivers of interest rates. Why are UK long-term yields the highest amongst the major developed economies? Much press coverage relates these higher rates to UK government borrowing, and changes in yields - particularly rises - as reflecting shifts in investor sentiment over its fiscal position.

However, UK government debt relative to GDP is lower than in the US and Japan, and only moderately higher than the Euro area. It seems an unpromising source of the UK's higher borrowing rates.

Moreover, its budget deficit is slightly lower than the Euro area, and half of the US's. Even allowing for the US's better established reserve currency status, the UK does not stand out as uniquely vulnerable on this measure.

Higher UK 10-year yields seem rather to reflect predominantly higher UK short-term rates, with these higher policy rates required because the UK has a more deeply-ingrained inflation rate than other countries. The gap between 10 and 20 year rates of around 0.5%, which is a better summary measure of the possible impact of fiscal risk, is not discernibly higher than the average of other developed economies. Of course, if the UK's fiscal stance alone is primarily responsible for higher UK inflation, its primacy as a determinant of interest rates can be established. However, there is little evidence that this is the case.

There have also been specific UK factors which have accounted for the rise in long-term yields independently of fiscal policy. For example, UK defined benefit pension schemes, at one stage the

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dominant institutions in the long-term gilt market, have pared back these purchases significantly. At the same time, the Bank of England has been more aggressive than other central banks unwinding bonds purchased through the quantitative easing policy after 2008. This is likely to have raised 20-year yields, but in reducing exposure to volatile short-term interest rates, and in this respect supports the sensitivity of the UK public finances to spikes in short-term rates.

The probable lesser role of exposed fiscal positions in the major countries in explaining the recent rise in bond yields should not of course be taken to imply their limited relevance looking forward. Higher bond yields imply higher debt service costs, and while these take time to materialise (only a minority of outstanding debt is replaced every year), the arithmetic is unforgiving, and places constraints on tax and spending policies. Higher rates can be added to the growing list of pressures on government finances. However, there is no easily identifiable level of debt relative to GDP, or a budget deficit, or debt service costs which bring these sustainability considerations to the fore, not least because sustainability is a highly fungible concept. For example, there are clear political constraints on higher personal income tax rates in the UK. However, this does not disguise the fact that specific measures, for example, a 2% rise in personal tax rates can have a material impact in pushing UK public finances towards a more sustainable path.

**5. Bond yields and bond prices**

The tone of this article may seem, on a superficial reading, to suggest that fixed income has been an asset class with poor returns. This was obviously the case in 2022, which saw one of the largest rises in bond yields in a short period in recent financial history. However, at the end of that brutal adjustment, the highly pertinent fact is that yields had risen to a level which made fixed income a more accessible asset class. Higher bond yields imply, arithmetically rather than judgements, higher

returns for investors in government bonds. At the same time, rising bond yields depress returns.

How have these offsetting features played out this year? We illustrate this issue for returns on the Bloomberg corporate 1-10 year index. Two features stand out. First, absolute returns have been positive this year, if only by a very modest amount: there have been no material capital losses. Second, this index, like many others, has underperformed cash, but again very modestly. The higher initial level for bond yields has provided an important source of compensation which has offset the impact of rising yields.

**6. Saranac fixed income positioning**

Which fixed income themes are embedded in Saranac fixed income portfolios? First, as has been the case for the past decade, we do not own bonds with maturities of over ten years. This has made a material positive contribution to absolute and relative returns. We recognise the global fiscal risks, even if we also believe that these have been of limited relevance in explaining the recent rise in yields. At some stage, a significant repricing of long-term bonds might make these investments more attractive, but that time has not yet come. Saranac seeks to provide attractive absolute returns to fixed income investors, but even a modest rise in interest rates at long-term maturities can deliver significant losses. An immediate rise in interest rates of 1% point would lead to a capital loss of over 10% for an investor in a 20-year gilt, but less than 4% for an investor in a 5-year gilt – and if that move in rates was a one-off, the income from the coupon would lead to a positive return in under a year.

Second, we do not own government bonds in countries where the immediate fiscal risk is both high and rising – for example in France ahead of next year's elections.

Third, we are not reducing our exposure to duration despite the rise in yields. On the contrary, the higher

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level of initial yields facilitates achieving higher returns than six months ago. Investors looking to achieve a dollar real return of 2.5% over ten years can now simply buy an inflation-linked US Treasury bond which will deliver this return. This level of real returns has not been attainable in the US inflation-linked market for almost 20 years. Such a return is not far behind consensus expectations for the return from a diversified equity portfolio over the same time period. Absolute return investors can not only access higher yields, but this higher starting point reduces the sensitivity of bond prices to any future rise in yields.

In short, we recognise short-term cyclical and longer term structural risks to fixed income returns, while also exploiting the wider opportunity set which the rise in yields has brought about.

# SARANAC

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