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Buckle Up! **Investment Strategist Peter Lucas sees the signs that Government bond yield may be bottoming.**

The current COVID period shares a great deal in common with that prevailing immediately before. Pre-COVID, economic growth was being supported by easy monetary policy but capped on the upside by the second-round effects of that policy, a low growth environment that was good for bonds and great for growth shares and gold. However, rising inequality (fed by asset price inflation) meant that this policy environment was sowing the seeds of its own demise, with populist politicians around the world shaping up to ditch austerity and appease the masses with easier fiscal policy. In the fulness of time, this would have changed everything. When we look at the current environment, we see that growth is still stuck in a low range, supported on the downside by ultra-easy policy (now fiscal AND monetary) and capped on the upside by COVID-19 and lockdowns. Not surprisingly, growth shares and bonds have continued to perform. However, as before, a countdown to a massive change in economic circumstances has begun, but this time the fuse is much shorter.

Our July article *Rise of the populists* described how QE was boosting asset prices and increasing the divide between the haves and have-nots, and how this would ultimately lead to easier fiscal policy, higher interest rates and an end to the low-and-slow economic growth environment. Although these trends were already taking shape before COVID-19, the electoral cycle meant that it was always going to be a slow-burn story. COVID-19 changed all of that, with even Germany electing to chuck money at the economy years ahead of schedule. However, whilst COVID-19 remains a feature of the landscape, the likelihood is that economic growth will remain unimpressive and inflation conspicuous by its absence. This explains why investors have gone back to what they were doing before COVID – namely buying bonds, growth shares and gold. However, this environment has a shelf-life: either infection rates will peter out due to herd immunity or countries will develop a vaccine. One way or another, we will get through this and when we do the change in the economic and market environment is likely to be dramatic.

We have been given a glimpse of what is to come in the last few days. On 11th August Russia announced that it had successfully developed a vaccine. Although world leaders and medical experts were quick to dismiss this news, the markets were rather less sceptical with bonds and growth shares experiencing sizeable corrections on the day. Gold and silver experienced their biggest drops for several years.

In the last article *Current opportunities*, the peak in bond prices was described as “only weeks or even days away”. Two weeks on we are already seeing price action suggestive of at top. If confirmed, the implications for markets are clear:

- Government bond yields will adjust higher, possibly significantly.
- Value should be preferred to growth (which is now over-owned and expensive).
- Precious metals should be approached with caution for time being.

Bond yields are low, both in absolute terms as well as relative to inflation, and have substantial scope to rise even in the absence of higher short-term rates (which we probably won’t see anytime soon). The US 10-year yield (currently 0.68%) could easily get to 2-2.5% in this next phase.

In the past five years US growth shares have produced almost three times the return of their value equivalents. This underperformance has left value shares looking cheap even by their own standards. What has been missing to unlock that value is a sufficiently robust recovery to persuade investors that the ‘safety’ of growth shares is no longer required. A bottom in bond yields would be the first important signal that this is where we are heading.

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Commodities are generally cheap by historical standards and should perform well in the years ahead. However, it is important to recognise that gold and latterly, silver have performed well recently because of low and falling real interest rates. Clearly, investors that have bought gold on that basis, will not be happy to see bond yields rising. The best gains for gold tend to be when inflation is accelerating. That is coming but may be some way off. Indeed, the greater focus right now is deflation. In the meantime, investors looking to buy commodities are probably better served looking at more cyclical commodities like oil or copper. And within the precious metals space, platinum continues to look a good each-way bet. Not only is it unusually cheap versus gold and silver, but also its industrial uses mean that it may be more resilient in this next phase.

The bottom line is that we are on the verge of a major gear change in the markets, which will likely herald a period of volatility as investors figure out what is going on and rejig their portfolios accordingly. Brace yourself, things are about to get interesting!

Peter Lucas

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