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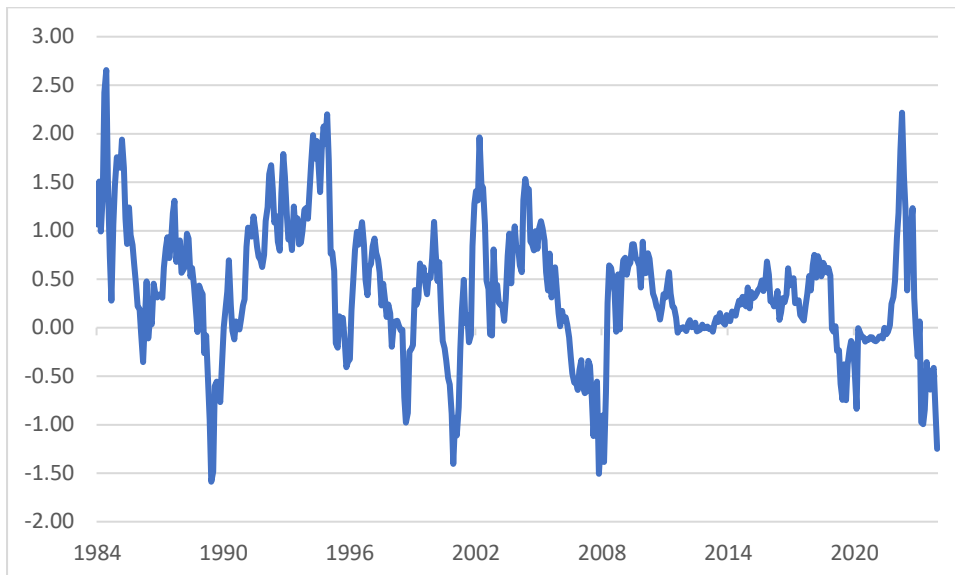
Now comes the hard part: Westminster Asset Management's Investment Strategist Peter Lucas discusses the US bond market, which has rallied in response to falling inflation and dovish noises from the Fed. With a lot of good news now in the price, further gains will require more evidence of an economic hard landing.



The December Bank of America fund manager survey revealed that there was broad agreement on inflation, interest rates and bond yields, all of which were expected to fall in 2024 as the US economy experiences a soft-landing. Indeed, the optimism expressed on bonds was unlike anything seen for years. Last year the consensus was horribly wrong on both America (there was no recession) and China (no post-COVID surge), will it prove to be as wrong on bonds in 2024?

Aside from this worryingly lopsided sentiment, there is another good reason to be cautious about bonds in the short-term: they have already discounted a lot of good news. Two-year yields are already well below short-term interest rates in both America and the UK. Indeed, these differentials are close to thirty-year lows. Furthermore, bond yields are almost as far below fair value (determined by short-term interest rates and trend nominal economic growth) as at any time since the 1970's. In short, bonds will likely struggle to rally further without cuts in interest rates, which is unlikely in the very near term.

US 2-year Treasury Yield minus Fed Funds Rate



Source: Bloomberg, WAM

The good news is that, looking a bit further out, there is a good chance that interest rates **will** be reduced. Inflation rates are down considerably from their 2022 highs and with commodities still down year-on-year and property-related inflation set to decelerate through 2024, the likelihood is

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that we will see more of the same in the months ahead. Plus, the risks of a recession have not gone away. Purchasing Manager Indices say that Europe is already probably in recession; America and Britain are on the right side of the threshold, but only just. Under a US soft economic landing (the scenario favoured by the consensus) interest rates probably won't fall by more than is already factored into the bond market. If on the other hand the landing is hard, the scope for rate cuts will be increased considerably, opening the way for further gains in bond prices.

Looking further out, the prognosis for bonds is less positive. This is partly due to the parlous state of government finances and partly due to the outlook for inflation. If the US economy were to enter a recession today it would do so with the largest fiscal deficit (as a percent of GDP) since at least the 1970's. Normally, the budget balance improves in an economic upturn and deteriorates in a downturn, as the normal stabilisers (e.g. reduced tax revenues and increased unemployment benefit) kick in. In this recovery the deficit has remained large due to a series of large fiscal giveaways by the Biden administration. Excluding COVID, the last six recessions have seen the deficit widen by as much as 9 percentage points (versus GDP). Double-digit deficits (% of GDP) would do little to reassure investors that are already jittery about the size of the national debt and the cost of funding it. Furthermore, as I demonstrated in an earlier strategy note ("Baked in the cake", September 2021) large cyclically adjusted fiscal deficits are inherently inflationary.

Other inflation worries include the Green Agenda (its cost and its impact on commodity prices), deglobalization (cost of onshoring businesses and reduced competition), geopolitics (hot and cold wars), and populism (bad policy making), all of which have been covered in some depth in earlier strategy notes. In addition, we are mindful of the fact that inflation has been the preferred method by which monarchs and governments have dealt with troublesome debt problems for centuries. The bottom line is that I expect inflation to turn higher again before too long.

China remains an inflation wild card. Last year China started as a consensus favourite but went on to underperform almost everything. Now heavily out of favour and with valuations on the floor, China is much better placed to surprise on the upside. Given its role as a major importer of commodities, a resurgent China would support commodity prices and by extension, push up inflation in the rest of the world.

In summary, government bonds look set for a period of range-trading, with the potential for better levels in the event of a US recession. However, the second half of this year should see the start of another upturn in both inflation and bond yields. As the world emerged from the COVID lockdowns, investors and policy makers underestimated the enormity of the inflation problem; they are unlikely to make the same mistake twice.

Peter Lucas

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