16th August 2024

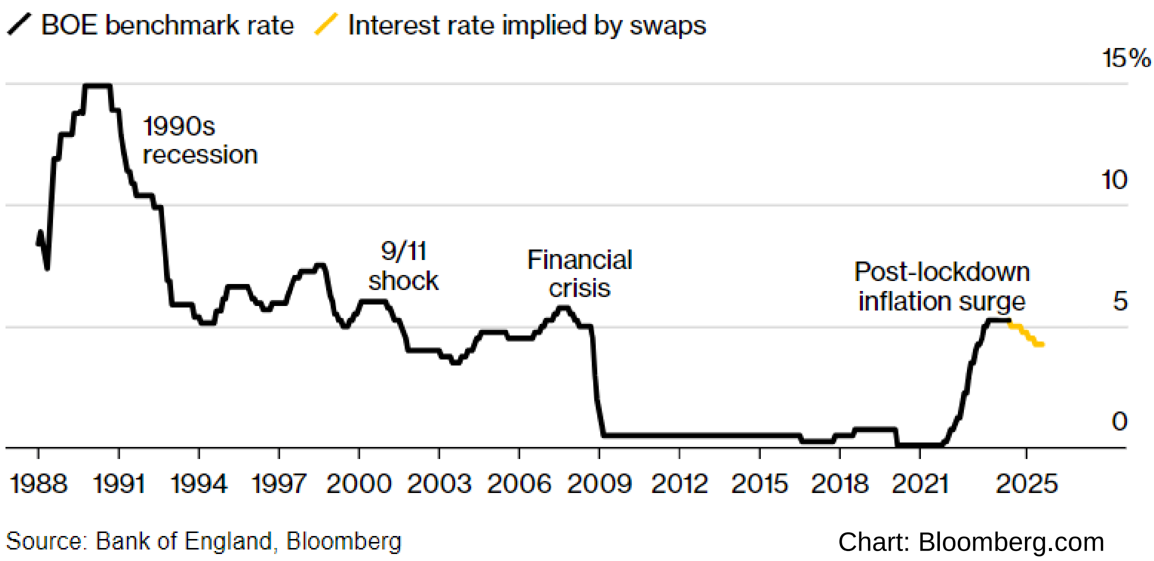
UK rate cuts: duration delivers

- Bank of England rates peaked at 5.25%
- As interest rates decline, bond values increase
- Longer duration bonds deliver in a falling rate regime

Interest rates have peaked

Following over a decade of near-zero interest rate policy (or "ZIRP") to support repairs to the financial system following the Global Financial Crisis, Bank of England interest rates rose dramatically from 0.10% to a peak of 5.25% in the effort to contain inflation which rocketed following Covid[1] and exacerbated by the Russia/Ukraine war and related sanctions.

Fig.1. BoE policy rate history and market-implied policy rates as at May 2024



Bond values move inversely to interest rates, so as rates soared in 2022, bonds nosedived in nominal terms. In real (inflation-adjusted) terms, the impact was even more severe.

[1] https://www.bloomberg.com/news/articles/2024-05-11/bank-of-england-heads-for-historically-slow-rate-cutting-cycle

Perfecting the pivot

One of the key themes in our 2024 Outlook was "perfecting the pivot" – navigating the expectations as to when and by how much Central Banks would start cutting interest rates. Interest rate cuts would ease financial conditions more generally, and be positive boost for bond values specifically. And the longer the duration, the bigger the boost.

For investors in the UK with GBP-denominated assets, the Bank of England (BoE) policy rate directly impacts savings rates, mortgage rates and the yield on Gilts and UK Corporate Bonds. So for investors whose bond allocation consists of predominantly sterling denominated bonds, the Bank of England pivot is more relevant than the Fed pivot.

As readers of our weekly email will know, our expectation was that the ECB would cut rates, followed by the BoE, followed by the Fed, owing to their very different trade offs between inflation, employment and growth. So far, the ECB and BoE have cut rates. The Fed pivot is expected in September.

Navigating interest rate volatility

During the course of the year, we have been recommending to UK discretionary managers and financial advisers' investment committees to extend bond portfolio duration gradually in anticipation of the BoE to pivot and start cutting interest rates.

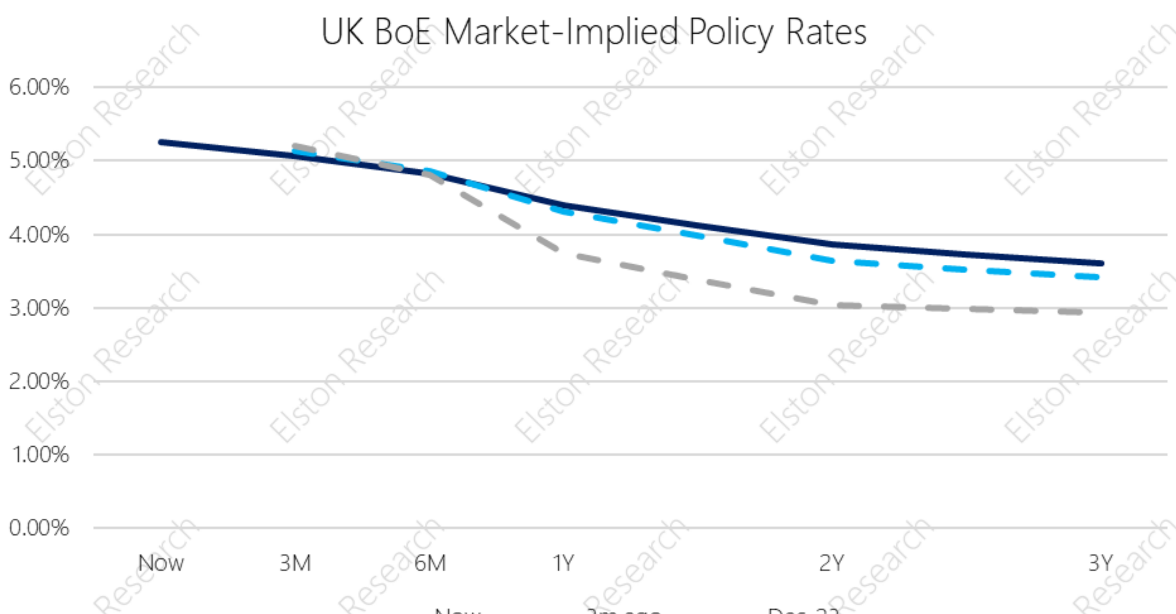
On platforms, this can be done using by blending bond index-tracking funds with different durations, and is subject to the usual platform dealing cycles. Within managed bond funds, this can be done by blending bond index-tracking ETFs with different durations. This has the advantage of speedier implementation, more granular exposures and a secondary layer of liquidity making them an efficient way to construct a bond portfolio.

Watching the curve

We look at market-implied interest rates to understand what institutional investors are expecting at any point in time as regards the likely path for policy rates. These are derived from the futures and swaps markets. Futures and swaps are used both for interest rate hedging and speculative purposes and are therefore a broad efficient market.

The implied interest rates for the UK as at end June (before the first rate cut was announced) looked like this.

Fig.2. Market-implied policy rates as at end June 2024



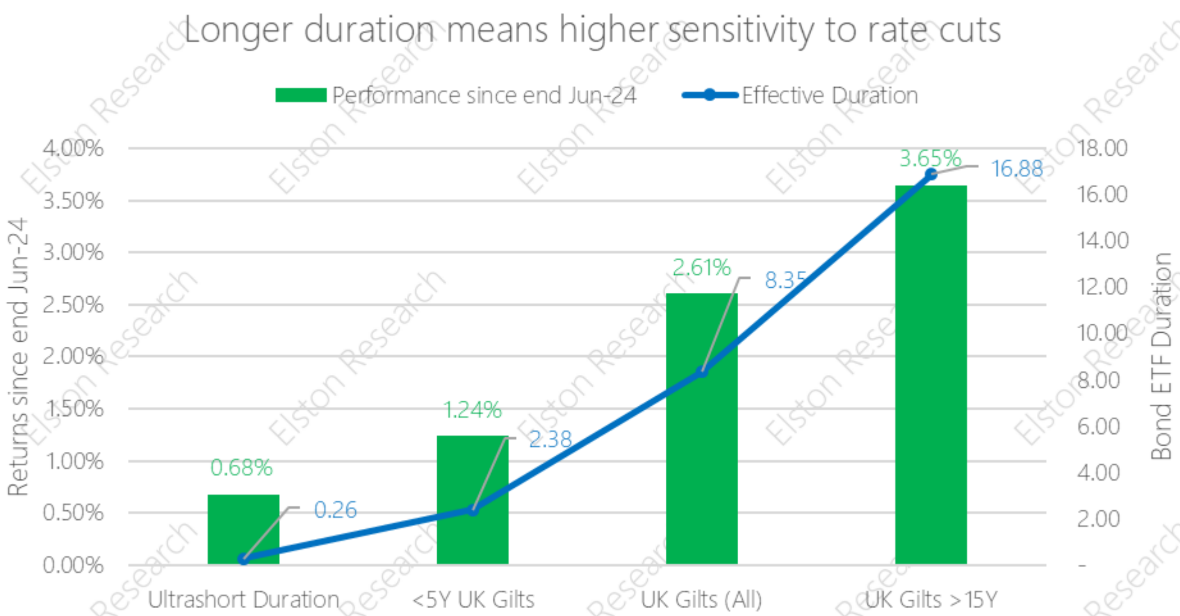
Source: Elston research, Bloomberg data

Bond investing using ETFs

The performance of different UK investment grade and gilt ETFs of different maturities since end June 2024 is shown below.

The relationship between longer bond duration and stronger performance in a falling interest rate environment is as expected.

Fig.2. Selective Bond ETF performance data



Source: Elston research, Bloomberg data

There are plenty of bond ETFs to choose from enabling investors to select what issuer type, credit quality and maturity profile they want to choose from. Our bond ETF selections are available to our clients.

Summary

Whilst interest rates were low and stable, navigating bond duration was less relevant, hence the focus was predominantly on credit quality in the quest for yield.

Now that interest rates are normalised and dynamic, adaptively navigating bond portfolio duration – as well as credit quality control – is critical.

Whether this is done as a portfolio level or within a managed bond fund then becomes an implementation decision.

Henry Cobbe, CFA

Head of Research, Elston Consulting

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https://www.elstonsolutions.co.uk/insights/category/bonds

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