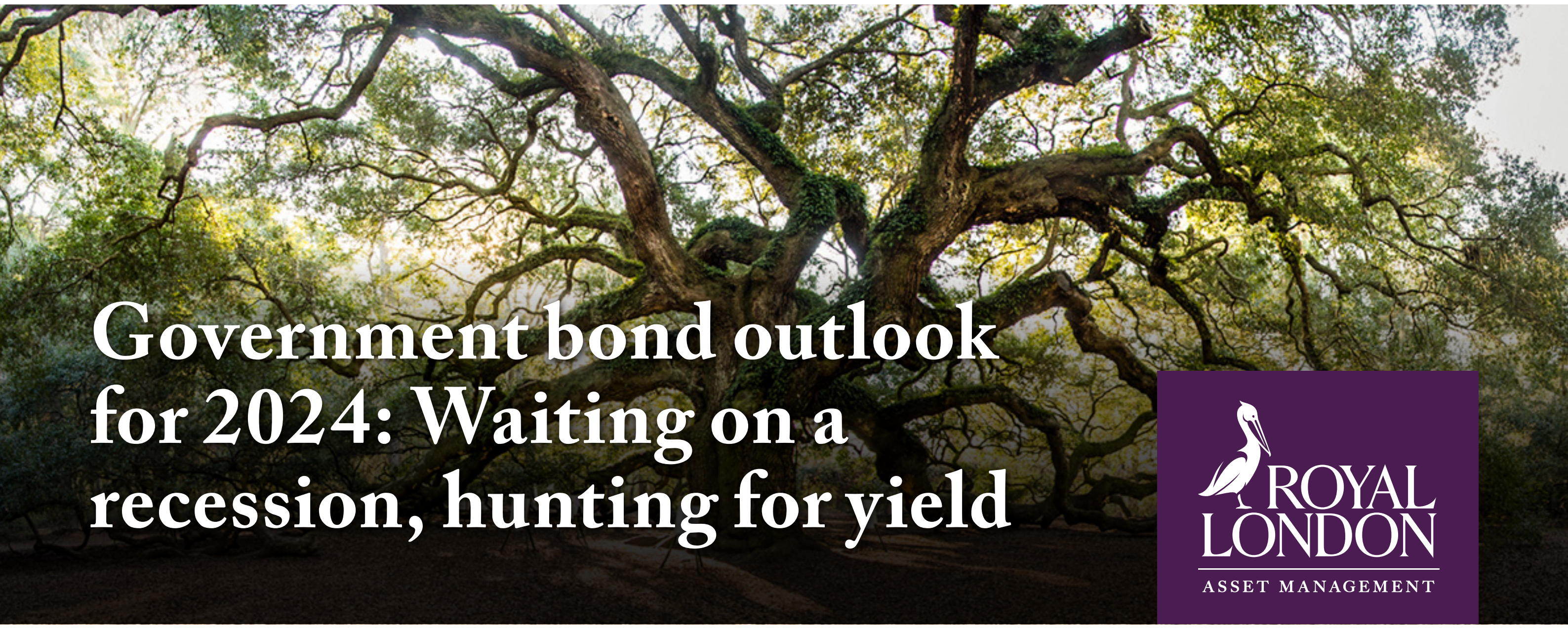

Government bond outlook for 2024: Waiting on a recession, hunting for yield

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Should you be dovish or bullish gilts?

Looking to next year, there are multiple events we need to consider when trying to predict how markets will react: there is a lot of supply coming; there is an expectation where the increased volatility (Figure 1) seen this past year may well continue. Given this, it is easy to present a case to be positive or negative on gilts. Government bond markets find themselves at a really interesting juncture following this summer's rally.

Figure 1: Gilt volatility has been high – over the year and intra-day

Source: Bloomberg. Chart shows UK gilt 10-year yields daily open, high, low and close during 2023 to 21/11/23

Generally, the Rates team is pretty downbeat on the UK economy's prospects for next year. Our Senior Economist Melanie Baker feels the outlook is lacklustre with a technical recession still assumed in the next 12 months, but a modest one.

We feel interest rates have peaked – with perhaps one more hike to come from the Bank of England (BoE) but ultimately if there is one more, or no more, the difference at this point will be negligible. We have seen stark rises in rates across major global economies, and these tighter lending conditions will eventually curtail economic growth as they work their way through the system and lead to downward economic trends.

What, if any, pain lies ahead?

While there are likely no more hikes on the agenda, what will cause problems is the increasing 'higher-for-longer' narrative that has emerged. Central banks look in no mood to start lowering rates as inflation is predicted to remain sticky: we have always maintained that the difficulty with the current higher inflation environment is getting back to central bank targets of 2%, not necessarily lowering it from its double-digit highs. Getting from 11%/12% to 4%/5% was the not difficult task, getting from 4%/5% to 2%/3% is where the pain will be felt. So, will central banks have the stomach to cause this hardship? Will the political will be there when jobs losses are mounting and a recession kicks in?

One thing to keep an eye on: the US Federal Reserve has a different mandate to the two major central banks here in Europe – the European Central Bank (ECB) and BoE. The Fed has to worry about both growth and price inflation, while the other two are tasked with keeping prices under control. With the BoE and ECB largely following the path of the Fed so far in this rate-hiking cycle, we are looking for clues that they may decide to forge their own way and when they feel confident enough to start cutting rates irrespective of whether the Fed has or hasn't.

Will the banks wait for a recession before starting to cut? Or will they feel the recent trend of no growth is good enough to start cutting?

Macro factors will continue to frighten central banks

Historically, central banks set monetary policy based on forward-looking inflation rather than being driven by spot inflation and the most recent economic indicators as we see today. When and if they return to looking at forward indicators, cuts should happen before inflation actually gets back to target. Bond markets have priced in cuts, we all know they're coming, but the only question that now matters is when they will happen.

In our view, at the beginning of this hiking cycle, central banks were behind the curve, then had to play catch up in an attempt to rein in rocketing prices, but now they are looking to gently corral the economy into a soft landing. This means the story of any impeding recession will be central bank-led based on how quickly their rate increases can work through the economy. If prices don't come down, rates will remain high. But, it is worth pointing out that bond markets have priced in rate cuts for 2024 – meaning any potential recession will need to happen soon.

With five-year gilt yields about 100 basis points below base rates as we come to the end of 2023, there is no surer sign that markets see rate cuts coming in the next few years – it is just about deciphering when, and how quickly, they come.

> "Bond markets have priced in cuts, we all know they're coming."

How will yields react when this recession comes?

If this predicted recession is a deep one, then yields will fall more than expected, but an intriguing issue to keep an eye on is the increased amount of gilt supply coming our way. Therefore, we expect to see yield curves steepening.

In a recession, investors seek out quality, which typically means we see buyers in the front-end of the curve, and with rate cuts typically being front-end led, we expect to see curves steepen. This is an environment that favours shorter maturities, making it hard to make a strong case to be in an all-maturities fund over a short duration equivalent. We see a rally more focused in the 10-year and shorter portion of the curve.

> "We expect to see yield curves steepening."

This makes it hard to find the sweet spot on where to invest, but never has the old adage of 'cash is king' rung more true than in the current environment. As a manager of money market and short term fixed income portfolios as well as gilts, we believe that investors are being paid reasonable rates to take on little risk, and it could be worthwhile parking assets while shorter-dated yields remain this high.

The real fun will begin when these yields begin to fall and investors begin hunting for yield elsewhere.

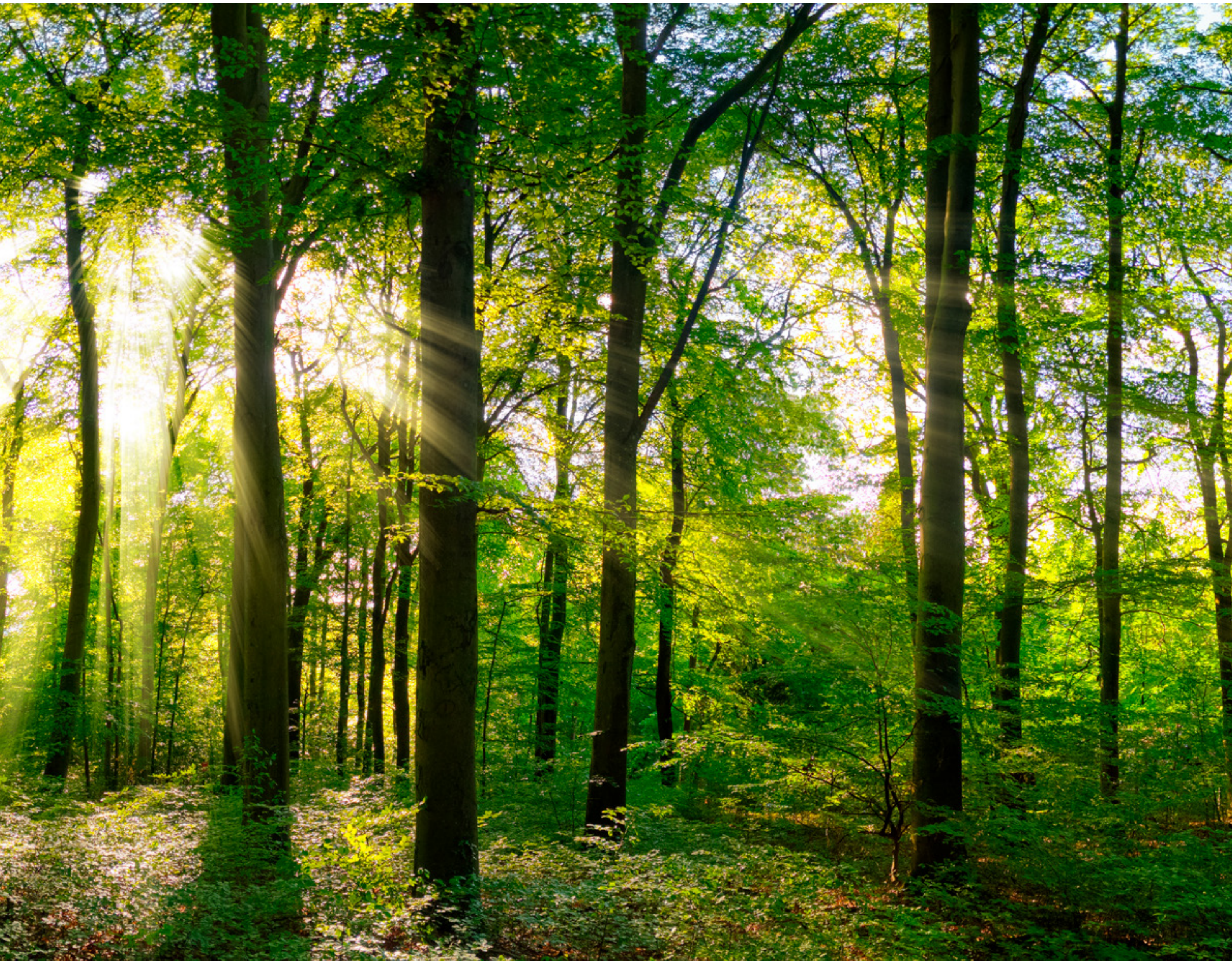
Where will this yield come from?

We see a lot of volatility ahead, which will be caused by investors looking to move assets back out of cash and into other vehicles in an attempt to maintain the current yields being offered. There is also a series of macro factors to consider: geopolitics in the Middle East, elections in the US, a continued heightened focus on monthly economic indicators, and increased supply.

As this volatility continues, we feel it has never been more important to be an active manager. While it is hard to be certain about an end point for gilt yields by the end of 2024, we do expect those macro factors and uncertainty around them to lead to some swings in yields which in turn provides opportunities to tactically trade around these events.

We are seeing markets becoming more and more concerned with fundamentals again – which is where we feel comfortable. Growth looks set to remain lower than long-term trend levels, and inflation needs to get back to 2%-2.5%, so yield curves will need to steepen from here. Therefore, we will look to be overweight the front end of the curve while holding an underweight position in the long end.

“We feel it has never been more important to be an active manager.”



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