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Investment Management

Window on the World

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Introduction

Very recently and unescapably there have been two major events that investors have followed avidly. The first on the 30th October was the unveiling of Rachel Reeves' first budget – the first Labour budget in 14 years and the most anticipated and talked about budget in a long time – who would have thought a UK budget could come close to being exciting!

And of course, the second and much bigger event for the world was the US Presidential election, which Donald Trump won with a convincing majority. Despite the polls showing the Republicans and Democrats neck and neck for much of the time the outcome was very different to what many thought it would be. For this edition of Window on the World we shall focus on the UK budget and what happened in to markets more broadly in October. We won't be looking at the impact of the US election as there'll be a note covering this very shortly.

With hindsight perhaps it was to be expected that October would be an unusual month as investors awaited the two big events. As it was most equity markets declined following strong gains earlier in the year. Notably government bonds also fell in value as yields rose, once again adjusting in the anticipation of interest rate cuts over the coming months (or lack of) – this is a story we've talked about nearly every month in WOTW because it's what markets have fixated on, and over the past 18 months or so expectations of how many cuts there will be has flipped and flopped as the news flow has either been positive or negative on inflation. Second guessing economic news and how central banks and politicians will react is staple fare for market commentators, analysts and managers, so with Rachel Reeves budget and the White House up for grabs all bets were on or off depending on your view.

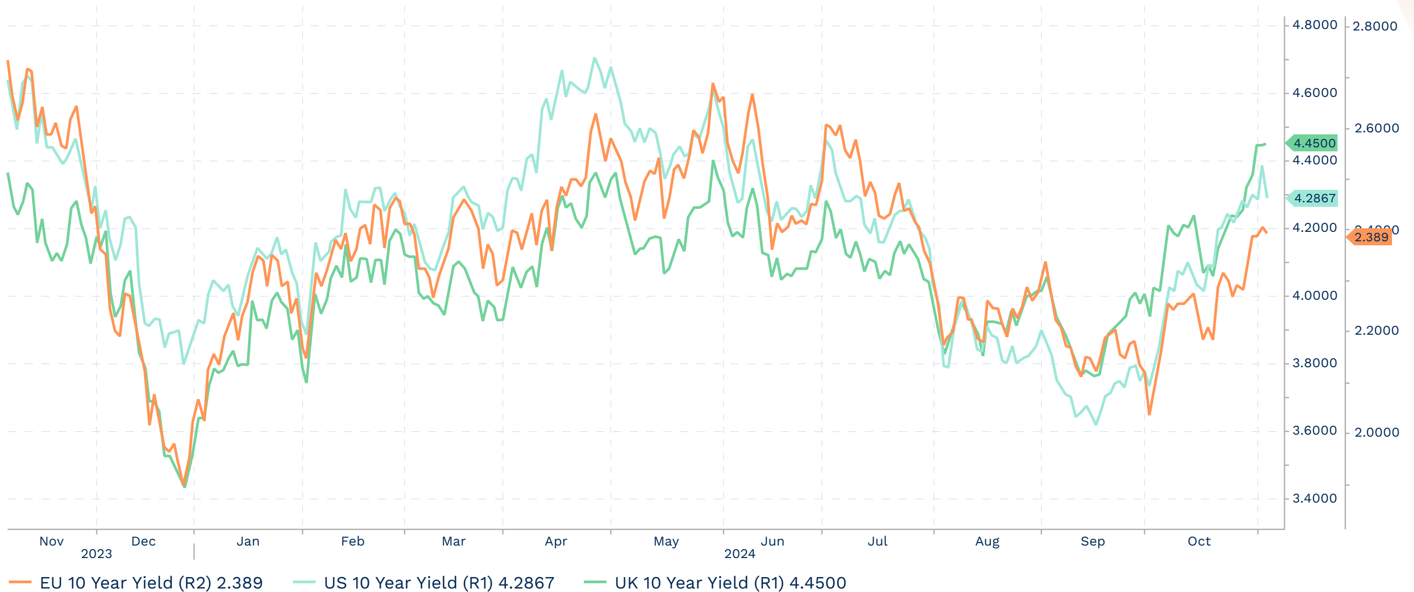
So why have bond yields risen?

Back in September, the Federal Reserve made their first and long anticipated interest rate cut, and they cut by 0.5% – a larger-than-usual reduction, as it typically adjusts rates in 0.25% increments unless responding to market stress.

The fact they cut by more than 0.25% led to speculation they could see 'trouble ahead' or conversely 'they were behind the curve'. This followed a 0.25% rate cut by the Bank of England in August and three rate cuts by the European Central Bank (ECB) who started cutting in June. It's unusual for the Bank of England or ECB to cut rates ahead of the US, so perhaps there was a small element of catching up!

Economic wisdom says that when central banks cut interest rates government bond yields will fall too, only this time they actually rose significantly contrary to typical expectations in a rate-cutting cycle. So, what's behind this unusual trend?

/ UK, EUROPEAN AND US 10 YEAR GOVERNMENT BOND YIELDS HAVE RISEN MARKEDLY SINCE THE FEDERAL RESERVE CUT INTERESTS RATES IN SEPTEMBER



Source: Bloomberg

This counterintuitive rise in bond yields as monetary policy eases, can it seems be attributed to several key factors.

Firstly, volatility in fixed-income markets remains elevated compared to historical norms – or put another way the market (investors) is acutely sensitivity to inflation changes, and anything that may impact inflation. On top of this the world is transitioning into a new higher interest rate environment, moving away from the very low interest rates and ultra-loose policies that we've had for the past 15 years following the global financial crisis. Fifteen years is a long period, and it'll take time to adjust expectations, but this is what's happening.

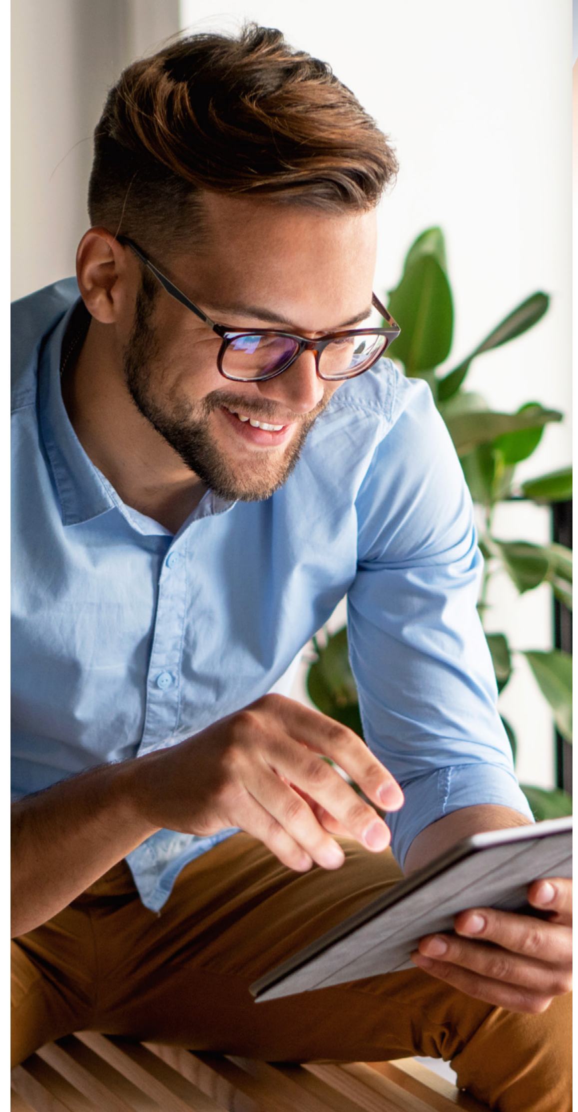
This volatility is particularly evident in the shifting market expectations around the pace of rate cuts by central banks over the past year. As mentioned in the introduction expectations have flip flopped causing significant moves in bond yields – this was seen at the end of 2023, when the market anticipated substantial rate cuts that didn't materialize, and then in the subsequent repricing during the first five months of 2024 – it's been a roller coaster. So once again, markets may have been premature in their expectations, with a familiar "buy the rumour, sell the fact" dynamic at play. Added to this the US economy has been more resilient than expected and has raised questions about how much easing the Federal Reserve actually needs to undertake.

Another big factor influencing yields is increased government borrowing to cover high fiscal deficits; and in both the U.S. and UK expectations have been growing that this is what both governments will do - borrow more. When this happens, investors demand higher returns to offset these higher debt levels.

So, while this shift in bond yields is unlikely to escalate into something more severe, bond markets appear to be adjusting to a new paradigm: a world where inflation remains elevated but manageable, and central banks pursue a normalized monetary policy - i.e. one that is more akin to the period before the Global Financial Crisis, rather than the ultra-loose environment of the past 15 years.

UK Budget – A solid start but more needed

At the end of October, Chancellor of the Exchequer Rachel Reeves unveiled the new Government's first budget. Labour has a longer-term objective for the economy and how to create growth and wants to move away from the short termism of recent years.

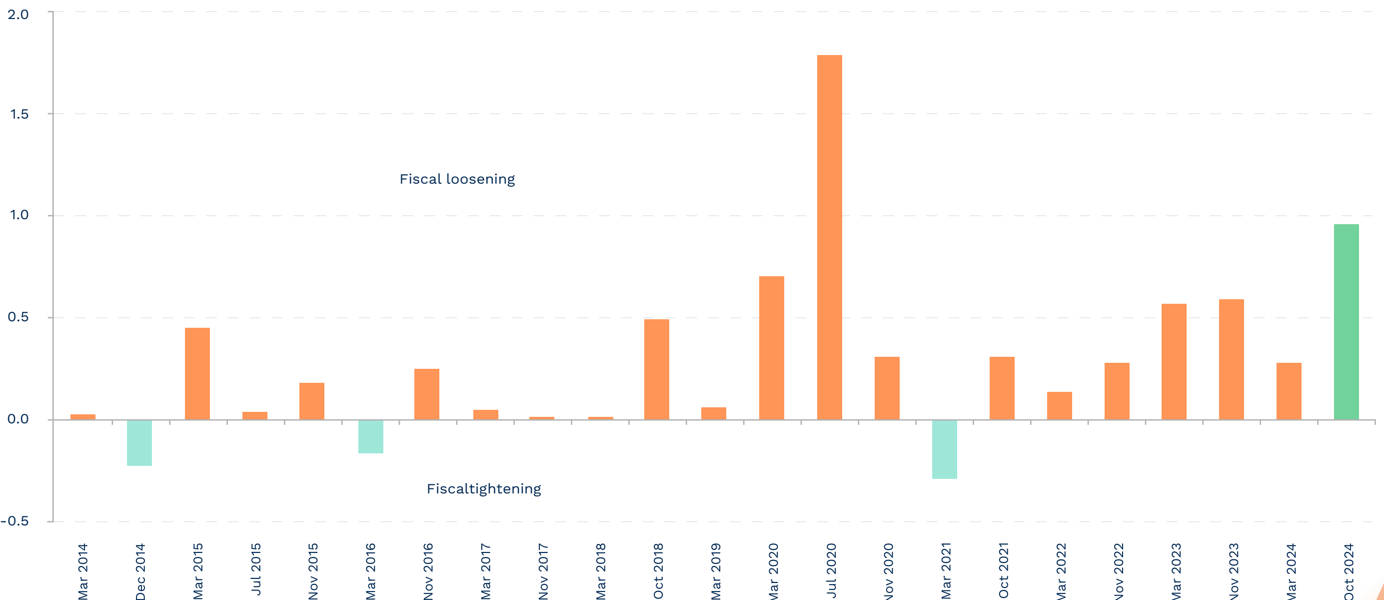


The primary focus was on tax changes and strategies for raising revenues to fund both increased spending commitments and substantial investment initiatives. Widely anticipated and discussed, this budget marked a historic moment with significant scale: higher taxes, amounting to 1.2% of GDP, will push the UK's tax burden to a record high, albeit the UK is not out of kilter with other European countries. This revenue increase is coupled with elevated spending and expanded government borrowing, making it one of the largest budgets in recent history.

This shift sets the UK on a path of fiscal loosening (more spending) that, in the short term, is expected to provide a welcome economic boost. According to the Office for Budget Responsibility (OBR), the spending plans are projected to contribute around 1% to economic growth over the next five fiscal years, with much of this coming in the next two years—a positive development for an economy that has already shown recovery this year.

However, you can't have your cake and eat it and this fiscal stimulus is also expected to edge inflation higher over the next two years, with OBR forecasts suggesting an increase of around 0.4%. This rise in inflation could, in turn, slow the Bank of England's ability to reduce interest rates, potentially slowing the pace of rate cuts.

\ CUMULATIVE FISCAL LOOSENING FROM THIS BUDGET TOTALS 1% OVER THE NEXT FIVE YEARS, THE LOOSEST FISCAL STANCE SINCE 2010 (OUTSIDE OF COVID INDUCED STIMULUS IN 2020)



Source: Redburn, Office for Budget Responsibility (OBR)

As said the Labour government is looking ahead and looking long term – they want to stimulate growth which has lagged behind that of other major developed economies in recent years and ensure that the UK's potential is made more permanent. With this attention is shifting to the long-term implications for the UK's growth potential from the budget – As it stands, the impact appears to be modest. Of the planned £70 billion increase in spending, about two-thirds is allocated to essential day-to-day services – such as the NHS and education – while the remaining third is reserved for investment. However, the investment in education and the NHS are intended as boosters to longer term growth, with a healthy and well-educated population key to the UK's future success on the global stage.

Though vital, it seems likely this level of investment alone is unlikely to dramatically alter the UK's growth trajectory in this Parliament, although the third going into investment will provide a more direct boost. Longer term we believe achieving a more dynamic, faster-growing economy will likely require additional measures.

When all is said and done, this budget represents a positive step in the right direction. Rachel Reeves has emphasized that "the only way to drive economic growth is to invest, invest, invest," which may hint at further growth-focused measures over the government's five-year term.

A choppy month for markets

Whilst economic fundamentals remain solid across many markets, and valuations in most areas appear reasonable, October presented a challenging environment for investors with broad declines in both equity and fixed income markets.

Japan emerged as the strongest performing equity market despite a hawkish stance from the Bank of Japan and political uncertainty following a general election that produced no majority. U.S. equities declined as well, even amid positive economic data and solid corporate earnings, perhaps not too surprising given the knife edge the election appeared to be on. European equities and emerging markets struggled, weighed down in Europe by weaker economic data, especially from Germany, while in emerging markets a stronger dollar caused headwinds. And here at home, UK equities were also lower, echoing international trends.

In fixed income, as we've discussed the rise in bond yields depressed returns as rate-cut expectations diminished, impacting longer-dated assets the most. Credit markets outperformed government bonds, with spreads narrowing very slightly. This weak performance belies the fact that yields across fixed-income investments are near 16-year highs, and that valuations in this asset class remain attractive.

October felt a little like we were on pause, a hiatus ahead of the two big events which were to be watershed moments. In the UK the government has set us on a new path, hopefully of stability and greater prosperity. And with Donald Trump coming back to the White House the outlook for both equities and fixed income markets is already changing; and it won't be just markets that are changed by his presidency!

	Total Return (%)			
	1 Month	3 Month	12 Month	YTD
UK Equities	-1.4	-2.2	14.9	8.2
US Equities	-0.9	3.7	38.0	21.0
European Equities	-3.3	-0.6	22.8	10.1
Japanese Equities	1.9	-2.7	22.3	16.3
Emerging Market Equities	-4.3	3.8	25.9	12.1
UK Gilts	-2.8	-2.2	5.5	-3.3
UK Corporate Bonds	-1.5	-0.9	9.8	0.9
UK High Yield Bonds	0.6	3.2	16.6	9.4
US Corporate Bonds	-2.3	0.9	13.0	3.2
US High Yield Bonds	-0.6	2.7	16.5	7.4

Source: Bloomberg. Total Returns, in local currency terms

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