Rathbones
Look forward

Review of the week

10 October 2022

Credibility is the currency

The Bank of England has kept the gilt market greased and the Chancellor has brought forward the date he will reveal his detailed fiscal plans, easing pressure on the UK. Meanwhile, inflation still reigns supreme in investors' minds.

Often a central bank's promise to do something is all that's needed to fix a problem in the market. When a promise *doesn't* work it tends to mean a central bank is no longer credible to the market, a worrying sign. So it's good news that the Bank of England (BoE) has revealed that only about £5 billion was used of the £65bn it allocated to buy long-dated gilts after the mini-budget and subsequent jump in yields upended pensions with liability-driven investment (LDI) strategies.

It's doubly good because the BoE doesn't really have too much wiggle room here. According to investment bank RBC, because of past quantitative easing, there's only £90 billion-odd of 20-year-plus gilts that the BoE could buy before it owns more than 70% of all the gilts circulating in this area of the market, a limit that the bank has imposed on itself. While it has committed to doing so, the BoE really does not want to buy any more gilts.

Because of the lack of take-up, the BoE says it can offer to buy more than £5bn of long-dated gilts, if required, on each of the last five daily auctions before the scheme wraps up at the end of this week. The central bank has also announced a Temporary Expanded Collateral Repo Facility. A 'repo', or repurchase, facility is effectively a pawn shop for institutions, with much less stigma than the ones on the high street. A large investor who needs to raise short-term cash can effectively ask their bank to access a central bank's repo facility to swap government bonds for cash and the ability to repurchase them shortly after. (Like, say, a pension fund trying to post more money as collateral with an investment exchange after its LDI hedging went south.)

This repo facility allows large amounts of government bonds to be converted into cash without crashing the price in the market. The BoE has expanded its repo facility so it will now accept investment grade bonds issued by non-financial companies and inflation-linked government bonds, rather just typical conventional gilts. It seems that the bank is worried that stressed sellers of high-quality sterling corporate bonds might have to dump assets to meet cash requirements, causing prevailing borrowing costs to blow out yet higher. Expanding the repo to these assets is a way to prevent that before it happens.

Another area of strain from September's leap higher in yields is open-ended, or unit trust, property funds. Many UK property funds allow investors to buy and sell units that settle in only a few days. Meanwhile, it takes these same funds a good few months or more to sell a commercial property. This mismatch is a perennial problem in ways you can probably spot. When lots of unitholders want to sell, the funds can't raise the cash quick enough to meet redemptions, so they 'gate' their funds - lock people in - and start fire selling assets to raise the cash required to release their investors. Not ideal.

The latest run on property funds was sparked by higher yields that are likely to push property prices lower, all else being equal. An impending recession is also not a great scenario for property values. And so, with dull predictability, property investors have run for the door and several funds have had to freeze redemptions. Investment trusts, or closed-ended funds, are a better form of property investment because large-scale sales by fundholders don't force the funds' managers to sell their assets in distress. Instead, the people selling must do so at a discount to the true value of the fund, i.e. the sellers bear the losses not those who stay for the long term. Open-ended property funds are favoured by many fund management companies because they can grow in size much more quickly and easily than closed-ended funds, which require the creation and issuance of new shares and all the cost that entails.

Finally, the last mini-budget-induced strain was political: Chancellor Kwasi Kwarteng has been under pressure to release his detailed fiscal plan and costings ahead of his scheduled 23 November deadline. Kwarteng will now complete his homework a couple of weeks earlier, with an announcement set for 31 October. The independent fiscal watchdog, the Office for Budget Responsibility, will reveal its analysis of the plan at the same time. That means the Chancellor will update the country (and investors) a few days before the BoE's next interest rate decision on 3 November. The next UK rate hike is widely expected to be at least 75 basis points; if investors find Kwarteng's plan uncompelling, it may need to be a full percentage point or more.

Inflation matters above all else

After a better week, stock and bond markets were thrown off-kilter on Friday because of continued strength in American job creation. Nonfarm payrolls showed 263,000 people took new jobs in September, 13,000 more than expected. The US unemployment rate fell back to 3.5% from 3.7% in August.

This punctured the hope of many investors that the Fed may soon slow its hefty regimen of interest rate hikes. That meant investors reappraised their forecasts of prevailing interest rates and yields for the coming months, sending US government bond yields higher once again. And higher yields mean prices of 'growth' stocks fall, so stock markets sank. Inflation is the key to investors' mood and will continue to be for months yet. US CPI inflation has been drifting down from its 9.1% peak in June, yet at 8.3% it's still very high. September's number will be released on Thursday; economists believe it will drop slightly to 8.1%. The greater the fall the larger the likely uptick in markets. Yet if it goes higher, markets will probably drop like a stone.

Investors are searching for clues about whether inflation will continue decreasing by gauging indicators of economic activity. Anything that suggests America is in rude health - stronger jobs market, unexpectedly high retail spending - sends stocks lower because it means the US Federal Reserve (Fed) is more likely to be aggressive with its interest rate hikes. Anything that suggests weakness - muted PMI business surveys or factory orders - is taken as evidence that the Fed may be able to ease off because inflation should continue to cool.

Another concern for inflation-wary investors was the shock cut to oil production announced by OPEC last week. The oil cartel, which now includes Russia, decided to implement deep cuts to production - roughly 2 million barrels a day, or 2% of global oil output. Brent Oil was roughly $90 a barrel at the time of the announcement, much higher than the long-run average for prices. In response to the cuts, the price has risen swiftly to touching distance of $100 a barrel.

More expensive oil means higher petrol costs for everyone, including American households. Yet it also means more cash in the pockets of oil producers, including Saudi Arabia and Russia. The US saw the move as a snub by Saudi Arabia and further evidence of the nation's allegiance with Russia, against the West, in its war in Ukraine. However, OPEC members say they are adjusting production ahead of a worldwide downturn, which they believe is coming and which will reduce the demand for energy. The US has been releasing millions of barrels of oil from its emergency stockpiles to reduce the cost of oil, which has irked OPEC. Relations between the US and the Middle East don't appear likely to improve any time soon and the fight will no doubt play out in oil markets.

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