The Federal Reserve recently announced that it is preparing to slow the flow of liquidity provided by its bond buying programme.

While the precise timing of the tapering is uncertain, the implications for the US economy and for bond markets are significant and should be considered in terms of investor portfolios.

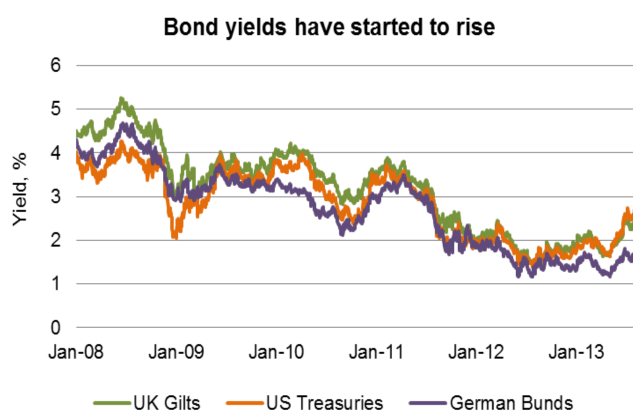
In this article, we weigh up the prospects for bonds and describe our current strategy.

Economic View

C. Hoare & Co.
PRIVATE BANKERS SINCE 1672

From 2008 to 2012, government bonds proved a valuable hedge against the economic turmoil, especially as central banks were committed to keeping interest rates low and aggressively buying bonds. As investors everywhere chased the safety of bonds, and demand was kept artificially high by central bank activity, yields fell steadily to all time lows with bonds becoming increasingly expensive in the process. Indeed, many were offering negative real yields if held to maturity, particularly after the deduction of income tax.

Please note that in this article, we refer to bonds in terms of their yields. For clarification, yields move in the opposite direction to their prices, so that rising yields result in capital losses for bond investors.



Source: Bloomberg, 10-year yields to 31st July 2013

The turning point in bond markets came earlier this year with Ben Bernanke announcing that the Federal Reserve was preparing to reduce the pace of its bond-buying programme and with investors finally acknowledging that the economic growth outlook was indeed improving.

Signs of improving economy

For the past year or so, we have been highlighting the importance of better employment and housing data in the US, as they help boost the economy both directly and indirectly. Consumer and corporate confidence levels have risen, leading to improvements in spending and jobs creation.

Conditions are also improving in the UK and Europe, albeit not as smoothly as in the US. Second-quarter GDP data in the UK suggested a broadening out of growth to most sectors.

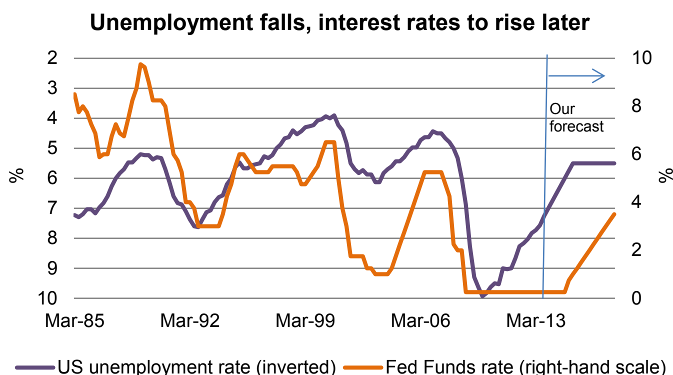
While China's slowdown places question marks on Asia and emerging markets, we think that economic growth from a global perspective looks promising.

The corporate sector is in good financial shape and valuations are reasonable. This should be a positive environment for equities and potentially property, but it is a very different story for bonds, which do poorly when the economy performs well and interest rates are set to rise.

Interest rate rises, but when?

With interest rates in most major economies at nearly zero, the only real questions are (1) when rates will begin to rise and (2) how aggressive tightening will be. The first one is helped by the fact that central bankers have been providing the market with clearer guidance, and in Bernanke's recent statement, he did not suggest that the Federal Reserve would be bringing forward rate rises. This makes them easier to predict over the next few months at least.

We maintain our view that US unemployment will continue coming down towards the 6.5% target. If that is the case, and economic growth remains on track, we could see the first US rate rise late in 2014 or, more likely, early in 2015.



Source: Bloomberg, to 30th June 2013. Forecasts are those of the C. Hoare & Co. Strategy team

Like his American counterpart, new Bank of England governor Mark Carney is keeping a close watch on unemployment and is somewhat more relaxed about inflation in the short term. As recovery in the UK economy is not yet fully established, we expect the first UK rate rise in late-2015 or early-2016.

The European Central Bank (ECB), meanwhile, remains steadfast on using monetary policy to meet its inflation target, so that any spike in inflation could put pressure on the ECB to react. That said, we expect inflation to be less of an issue for the rest of this year and the next, enabling governments and other bodies to concentrate on ways to stimulate the economy, which is still some way from a sustainable recovery. As such, we may not see rates in Europe rise until sometime in 2016.

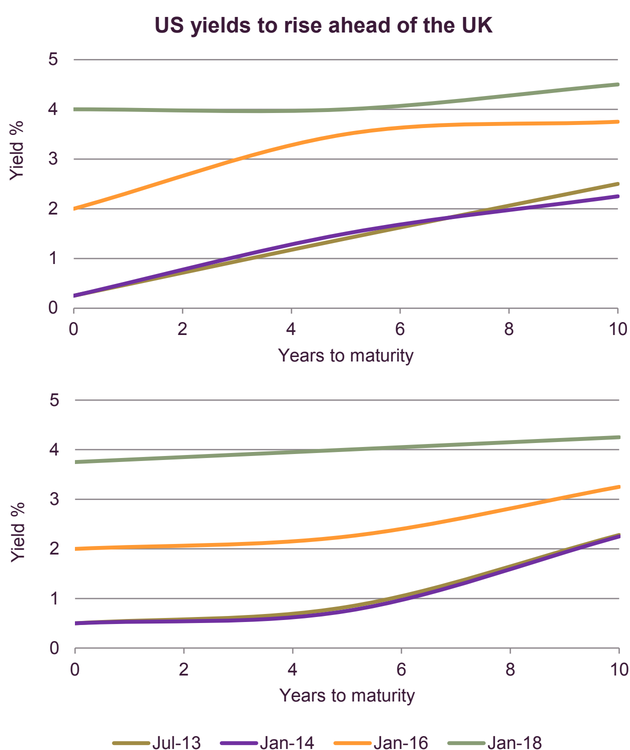
Turning to the second question, we believe that once central banks begin to raise rates, they will follow a gradual path towards a more normal level of 3-4% in the US and the UK by the end of 2017. This is predicated on our expectations of a very modest recovery and subdued inflation.

If either of those factors turns out to be stronger than the central banks predict, they could raise rates more quickly. If, however, growth proves more sluggish than expected, the central banks may delay rate increases. It is only this latter scenario that would be positive for bonds.

The outlook for bonds

Understanding when and how quickly interest rates will rise helps us to determine fair value for bonds across the maturity spectrum, from very short-term bonds through to bonds maturing in 10+ years. As with any other market, bonds react more to expectations than to actual events.

Although yields have already risen from their lows, we do not believe the full extent of interest rate rises has been priced in, especially for medium and longer -dated bonds. As shown in the charts below, we expect yields in the UK and the US to continue rising gradually to more normal levels over the coming years, with the green line showing our expectations for yields in 2018.



Sources: Bloomberg (for Jan-13 yields) and C. Hoare & Co. (for estimated yields in other periods). The top chart shows our expectations for the progression of yields in the US; the bottom chart shows the UK.

In late 2011, we began selling down the government bond holdings across our portfolios, as we believed yields below 2% were expensive. The proceeds from these sales went into areas of the market that at the time offered better growth potential and cheaper valuations, such as corporate bonds and equities.

Why hold bonds at all?

While we are unlikely to see a repeat of the stellar returns that bonds produced in recent years, they still offer characteristics that should be useful in today's market environment. An allocation to bonds should help preserve capital and smooth investment returns, while bonds also produce reliable income streams.

So, yes, we believe it still makes sense for many of our customers to hold bonds in their portfolios, but we think it is important to reduce how sensitive they would be to rising interest rates. The measurement of this sensitivity is called duration and is influenced by the bond's time to maturity and its coupon rate.

For example, a bond maturing in 10 years will fall in value much faster than a bond maturing in one year if interest rates were to rise. Likewise, a bond paying a coupon of 2% per annum would fall faster than one paying 6%.

Bonds with low duration are also less volatile, making them increasingly attractive in an environment where interest rate rises are now somewhere over the horizon but there is still plenty of debate on the precise timing.

Our strategy for the current environment

Getting your bond strategy right is just as important now as it was in recent years, when investing in government bonds was a relatively cheap way to hedge against falling interest rates, loose monetary policy and economic slowdown. Now, we believe that reducing duration offers a reasonable way to continue investing in bonds while mitigating the impact of potential policy tightening and an improving economic outlook.

We have sought to identify funds that should benefit from rising yields, or at the very least protect capital. Such funds effectively buy very short-dated bonds and sell bonds with 10-15 years to maturity.

This strategy will, at some point, have run its course, and when yields catch up to what we believe are accurate interest rate expectations, bond markets will revert to classic fundamental drivers, such as economic news and simple supply and demand. We will then adjust our position accordingly.

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Published on 7th August 2013 by C. Hoare & Co., 37 Fleet Street, London, EC4P 4DQ. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.