The Autumn Fall

September has proved to be the worst month so far in 2023 for bond markets and equities, largely on the back of the "higher-for-longer" mantra from central banks on interest rates. In particular, a very hawkish line from the Federal Reserve has hammered US markets over the past month. The S&P 500 fell by 5% in September, while ten-year Treasury yields jumped by over 50bps, hitting 4.65%, their highest level since 2007.

Encouraging US inflation data over the summer had given markets hope that interest rates may have peaked. Thus, they have been surprised by indications from the Fed that it could hike rates by a further 25bps to a 5.5-5.75% range before the end of the year. Even more damage has been done by Fed guidance that rates are likely to be kept above 5% in 2024. Back in July, the expectation was that US rates would fall to below 4% by the end of next year.

It is the scaling back of rate cut expectations in virtually all the main economies that has done the real damage to bonds, with negative knock-on consequences for stock markets. Other negative factors are also at work. Oil price have unexpectedly risen to close on $100 a barrel, pushing inflation back up again in some countries. There is also a growing realisation that bond issuance will remain at high levels in the face of rising budget deficits as economies slow. The US Federal Budget deficit will be around 6% of GDP this year and is likely to rise to 7% in 2024.

Meanwhile, central banks as well as hiking rates, are also engaged in quantitative tightening. This is being done by allowing large amounts of their bonds holdings to mature without replacing them. This means they have to be refinanced in the market, adding to supply pressures. The rise in bond yields since 2020 has been dramatic in the face of the completely changed monetary policy environment. In the US, ten year yields have risen by over 400bps from their trough of 0.5% three years ago. Ten year UK gilt yields have climbed from 0.1% to 4.5%. In the Eurozone, ten year German yields have risen from -0.6% at end 2020 to near 3%.

Big rises in bond yields have significant consequences. It puts pressure on public finances as budget deficits and maturing debt have to be financed at much higher interest rates. Property markets can also come under pressure as mortgages and commercial property loans face much higher financing costs, with associated rising bad debts.

Higher yields can also spell trouble for global financial markets as equities suffer on a relative valuation basis when bond prices fall, as has been evident in the past month. It can also unsettle currency markets. We have seen fresh gains by the dollar in recent months, both on risk aversion and with US rates rising to particularly high levels. Meanwhile, low yielding currencies can get hammered, as has happened to the yen in the past two years. It is likely to remain a challenging environment for both financial markets and borrowers until rate cuts start to appear on the horizon.

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