CAMBRIDGE
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Change in the air

It is not often that market action in the UK capital market moves the global capital market dial, given our domestic stock market comprises just 3.1% of the global total and 4.1% of the global total government bond market. However, over the course of October, far bigger bond markets – like that of the US and Italy – have experienced significant changes in the wake of what happened last Friday in the UK.

We write about the vagaries of the UK's government bond market and its consequences in an article below entitled "Gilt Trip" – and not all of them bad. The current government has been much derided for suggesting that its issues are all a direct result of circumstances elsewhere and there is little doubt that its members took a remarkably cavalier approach in making policy. They have found it difficult to own up to their mistakes, although clearly that appears to be changing somewhat as we write.

However, Prime Minister Liz Truss does have a point – except she may have been under a misconception on the UK's fiscal wiggle room relative to the US. Russia's invasion of Ukraine has destabilised Europe's energy markets which has forced all of Europe (including the UK) to expand near-term fiscal deficits again. Most importantly, (and perhaps indirectly caused by Europe's stress) the relative insulation from the rest of the world's problems enjoyed by the US has pushed risk-averse global capital towards the safe haven of the US dollar.

The US economy has had a series of tremendous boosts to its ability to attract capital, starting with former President Donald Trump's corporation tax-cutting policies designed to bring capital home to support blue collar jobs. Then the pandemic caused yet further challenges of supply security, with the Biden administration effectively subsidising large amounts of investment, for example to re-shore micro-chip production.

The US Federal Reserve (Fed) has abetted this, although it cannot be blamed for doing so. Thus, the US dollar has motored ahead, and interest rates and bond yields have risen in parallel to expanding economic activity. In particular, the sharp rise in yields on US inflation-linked bonds has been at the heart of the stresses in the global economy.

One can think of the rest of the world as facing a massive competition for capital. In that environment, it might seem strange for the UK government to make a policy choice to try to grab more capital, at a point when the costs have been made almost unbearable. To blame circumstances now suggests Truss et al. were unaware of the situation when devising the policies. It's no wonder the Chancellor of the Exchequer is now a different person.

Global markets have been cheered by signs that the UK is unwinding its policy choices, lessening the fight for capital. Indeed, should the government reverse the bulk of policies that capital markets balked at as fiscally irresponsible, then rates and yields may revert to the trajectory they were on before September's fateful fiscal event. Whether they will fully, will largely depend on how much of the trust in UK institutions lost by international investors can be regained. Last week saw Andrew Bailey, governor of the Bank of England, losing his much-needed cool with both the pension fund industry and the UK government for their apparent inability to grasp the urgency of the situation. But perhaps this episode may in the end help to re-establish trust in the UK's institutions, rather than being remembered as a major central bank gaffe as most commentators interpreted it. This week will undoubtedly give us more to ponder over.

From the global perspective, beyond the UK's domestic woes, the October 2022 UK bond market crisis will be remembered as the moment when central banks around the world were forced to grapple with something they have been denying for many months. Namely, that their formidable efforts in forcing the inflation genie back into the bottle have unveiled fragilities in the global financial markets, that may now hamper their ability to follow through with their inflation fighting strategy. The dependencies on ultra-low interest rates they had allowed to build up since the Global Financial Crisis, mean that the risk that something, somewhere in the global financial ecosystem would break – or at least seriously buckle – has now become apparent.

In the case of the UK, the damage may have been limited by the reversal of political miscalculations. However, it is not hard to imagine other scenarios where central banks may have to intervene more substantially to prevent their inflation fighting efforts not just causing a mild recession, but a far deeper credit default cycle than currently anticipated. Last week's 'Fed speak' comments by central bankers told us they have got the message, and in the US, last Thursday's biggest daily turnaround stock market rally since 2020, despite hot inflation and implied rate rise news, tells us that equity investors likewise believe central banks have just lost the worst of their biting strength in their fight against inflation. It seems their own past profligacy has just caught up with them and that attempting to turn the bond yield 'tanker' around may well require gentler steering from here.

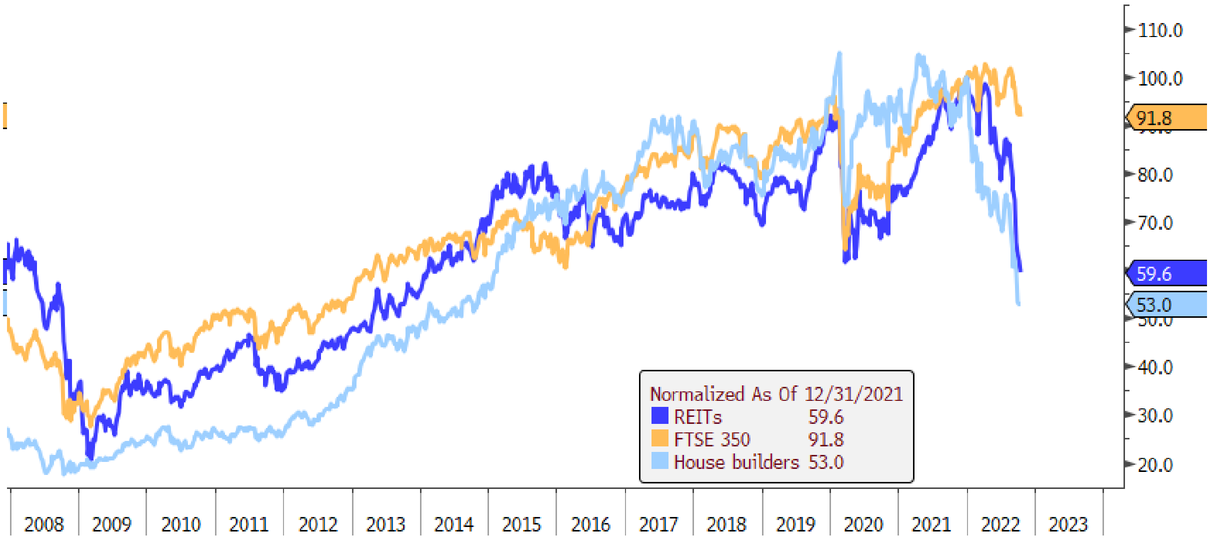
Will the UK property downturn change the investment landscape?

In the wake of Kwasi Kwarteng's ill-received budget, mortgages were the hot topic. Lenders pulled swathes of mortgage products in expectation of sharply higher interest rates from the Bank of England. When those products were reintroduced a few days later, the rates offered were three to four times higher. The potential effects on consumers and households were well-publicised – and the backlash therein was no doubt a big motivator for the government's partial U-turn.

While news outlets have been understandably focused on the effects on households, damage has also been done to equity markets – particularly to property funds and house builders.

UK REITS and house builders

Total return indices, rebased to end of 2021



Source: Tatton IM, Bloomberg: G1100

F3REITS Index (FTSE 350 Real Estate Investment Trusts Index GBP) UK REITS Weekly 31DEC2007-14OCT2022 Copyright© 2022 Bloomberg Finance L.P. 14-Oct-2022 08:04:01

The chart above shows the performance of UK real estate investment trusts (REITs – in dark blue) and house builders (light blue) against the wider performance of Britain's stock market (yellow). As the difference between these lines shows, both have suffered substantially more than the broader market throughout the year, and the latest drama has precipitated another swipe down. The building sector has nearly halved in value since January, while REITs have lost around 40%.

Clearly, these problems precede the fiscal fallout – though it undoubtedly made the situation considerably worse. Both sectors fared well throughout the pandemic, buoyed by an increase in consumer savings and property deals. But the sharp contraction of monetary policy since the beginning of the year has made conditions extremely difficult.

The property sector is inescapably tied to interest rates and wider financial conditions, on the basis that property transactions are almost always geared investments. This is because both individuals and companies borrow to build or buy property, making loan-to-value metrics a crucial factor. Like any leveraged trade, if borrowing costs go up sharply but the underlying assets do not, losses quickly spiral. It makes things worse that the current situation follows a prolonged period of low interest rates, since valuations (particularly compared to rent levels) get pushed higher when capital costs are low, giving them lots of room to fall.

The harsh context aside, we should not underplay the particular damage wrought over the last few weeks. The chart below shows representative credit spreads for the REITs sector – the yield difference over government bonds. While these have climbed rapidly throughout the year, they have catapulted in the last month. Spreads are now worse for REITs than at the height of the pandemic market panic. Bear in mind also, that government bond yields themselves were close to zero back then, while they are now in the mid-single digits. That means overall borrowing costs for REITs have become excruciatingly high.

It is safe to say that some property companies have hit 'stressed' levels. On top of higher borrowing costs, property fund outflows have been huge since the end of September. According to a *Financial Times* report last week, investors pulled more than £100 million out of commercial property funds in the 10 days after Kwarteng's mini-budget – eight times the amount withdrawn in the previous three weeks. Together with soaring borrowing costs, this means property funds have been all but drained of their available liquidity.

The open-ended property funds that survived after the 2016 and 2020 shake-outs have been sellers of assets over the past year as interest rates have been rising. Over the past two weeks, additional selling pressure has pushed them into a near-ban on redemptions (*Investment Week* reported that Blackrock has extended the pay-out period to two years).

Investor redemptions impact open-ended funds, quickly soaking up their limited cash and therefore forcing asset sales. Being closed-ended, REITs do not face investor equity redemptions and so do not need to sell assets in normal times. However, they still face a form of redemption because they borrow to supplement the equity capital. Thus, some REITs have also been sellers through the course of this year.

It is no surprise that commercial property is the focal point of this credit crunch. Occupancy levels in offices have never fully recovered from the pandemic as hybrid working has become much more normalised. London-based property is the hardest hit of the bunch: last month, developer Landsec sold Deutsche Bank's new City headquarters for £191 million less than it had hoped to receive earlier in the year. The table below is from Sue Munden of the Bloomberg Intelligence Real Estate team and is from the end of

September. Sue estimates that the London office segment has declined further to a fall of 42.6% from current asset values on their books.

Implied Asset-Price Decline by Segment

Billion Euros	Logistics	Offices London	Offices Paris	Diversified	Retail	Index*
Market Cap	20.0	4.7	18.0	16.5	15.6	135.7
Net Debt	8.5	2.6	29.8	24.4	37.3	203.7
Enterprise Value	28.5	7.3	47.8	40.9	53.0	339.4
Total Assets	35.8	12.5	79.0	68.0	91.6	559.1
Implied Asset Value Change (%)	-20.2%	-41.6%	-39.5%	-39.8%	-42.2%	-39.3%

*Bloomberg Intelligence European Real Estate Index, Including Residential Property and Nordic Companies

Source: Company Filings, Bloomberg Intelligence (as of 27th Sep 2022)

So, the additional and sudden shift in interest rates means more may be forced into selling assets, putting downward pressure on property prices. For some, it could lead to the 'doom spiral' of leveraged assets – falling values and higher costs leading to forced sales leading to even lower asset values and even higher debt payments. But unlike the mini-version faced by some pension funds the previous week, property is unlikely to be given the same level of protection by the Bank of England (BoE).

With the UK probably already in recession, commercial property is one of the most vulnerable sectors. This would be the case even without the supply-side inflation pressures and fiscal imprudence, since house building, and purchasing are extremely cyclical. We are also seeing this stress spread to banks with large property-related loans on their balance sheets – many of which have seen their share prices come under pressure. It seems that, having (somewhat) stabilised the pension fund problem in recent weeks, property is the new site of financial and economic instability.

Unfortunately, for many property companies, there is little they can do about the situation. Balance sheet management has improved vastly in recent years, and property funds have made themselves much more resilient. But with the tide turning against them, some will probably fail – barring a shock turnaround in the underlying trends.

"Some" is the keyword here. Improved balance sheets mean many of the larger players –particularly those unrelated to danger areas like inner city office space – will be able to weather the storm. When they come out the other side, they will find a significantly cheaper market ripe for plundering. LXI, for example, has lost just 20% of its value year-to-date, compared with more than 50% for Workspace Group. If that disparity continues, the future could start to look bright for LXI and its better-performing peers.

The discerning investor knows the best time to buy is when things are at their worst – since that is when discount opportunities are at their greatest. Of course, the caveat is that one has to know when things are at their worst, which is why we advise against attempting to "catch a falling knife", so to speak. Opportunism will surely return, but things are likely to get worse before they get better.

Gilt trip

The BoE's emergency intervention three weeks ago was vital in stopping the gilt market bleed that the now former Chancellor's unfunded tax cuts had triggered. But Governor Andrew Bailey is keen to remind everyone that what the Old Lady giveth, she can taketh away. Early last week, Bailey responded to extension requests on the BoE's bond-buying programme by firmly telling UK pension funds "you've got three days left".

And surely more market volatility ensued – which at the time of writing has given way to optimism that the UK government will deliver at least a part U-turn on its unfunded spending spree that had turned pension funds into forced gilt sellers. In any case, before the newfound optimism, sterling dropped hard and fast immediately after Bailey's comments, once again breaking the $1.10 threshold. Yields on 30-year gilts jumped back up to the previous highs of 5.1% during intraday trading, having finished the previous week just below 4.4%.

Fear spread that pension funds would once again come under extreme pressure, with volatility pushing up collateral demands and making them forced sellers once more. The downturn was not limited to the UK either: US stocks fell sharply with investors fearful about global financial contagion. Swings to extreme pessimism, as uncertainty filters into the market, are not unusual. And, to a certain extent, the BoE, which still has to tighten monetary policy to get a handle on inflation, may have deliberately employed the "carrot and stick" approach. It is also worth bearing in mind that thanks to the BoE stepping in, sterling is, on a trade-weighted basis, not the weakest developed market performer. Indeed, Japan's currency, where interest rates stay ultra-low, has underperformed the UK.

Over the course of last week, renewed volatility forced the BoE into more emergency buying. Wednesday and Thursday saw on average around £4.5 billion in bond purchases (of a possible £10bn day). Privately, BoE officials have reportedly told banks that bond purchases could extend beyond the end of last week to avoid a cliff-edge scenario – contrary to the Governor's firm line. The back and forth has led to complaints of mixed signals. Bloomberg's John Authers said Bailey's comments would be remembered as an "all-time central banking gaffe," while former BoE economist Danny Blanchflower tweeted that any policy reversal would make the Governor look "like a fool again".

But the BoE chief is in an unenviable position. His team is tasked with taming runaway inflation, while avoiding a financial crisis triggered by government action that markets deemed fiscally profligate and irresponsible. In the current environment, these goals pull in opposite direction.

Exceptionally high inflation requires exceptional monetary tightening. This is made more pressing by the government's anything-but-mini-budget, which is thought to add more fuel to inflation pressures through already tightest labour market conditions in decades. This is likely to necessitate sharper interest rate hikes in the months ahead – than would otherwise have been necessary. But the threat of pension fund collapse requires liquidity injections. Setting a timeline on these injections threatens to create a cliff-edge scenario, but open-ended purchases would undermine any monetary tightening done elsewhere. More crucially even, it would risk undermining the precious credibility the BoE has just partially regained since it started fighting inflation in earnest. The BoE line was always that bond purchases were an emergency provision and would be dialled down when the immediate threat was gone.

Of course, the fact that longer-term gilts have climbed higher than they did in the budget fallout, makes the immediate threat look more present than ever. But here it is important to distinguish between bond yields and bond volatility. While policymakers are desperate to minimise volatility, they do not want to minimise yields. Indeed, they *cannot* be seen as doing so, since that would imply yield-curve-control (a tool for monetary expansion) at a time of fiscal expansion and sky-high inflation – which would lose them all credibility on price stability.

The government authorised the BoE to purchase up to £100 billion in the gilt market, of which a fraction has been used, while gilt market volatility has certainly reduced. Pension fund managers rightly point out that there are still issues in the structure of the market, but these issues are not justification for pinning yields at a certain level. This is clearest in inflation-linked bonds, which the BoE was also forced to buy last week. Their real yields (i.e., after inflation expectations) have climbed sharply since the fiscal event, but they are still below the post-war historical average.

In the last decade and a half, we have become used to near or below-zero real yields. But with the world in a sharp supply shortage (now mainly labour and fossil fuels), it is reasonable to think that these have to move higher over the long-term to re-establish balance between supply and demand. Currently, RPI-linked ten-year gilts yield 0.75% (above retail inflation). Runaway inflation necessitates some compression of activity from the BoE, meaning these real yield levels look justified. In fact, these yields arguably look attractive to global investors.

That might seem a bizarre statement, given that BoE intervention seems to be the only thing keeping gilt markets intact. But the sharp sell-off of the last few weeks had more to do with pension fund 'fire sales' because of a structural weak link in UK pension regulation, rather than underlying fundamentals. Without these distortions, there would likely be many willing buyers for yields which are at decade highs. This is particularly true given the way UK inflation-linked bonds are calculated relative to RPI (retail price index) rather than CPI (consumer price index), which tends to overshoot inflation estimates compared to consumer price measures.

Indeed, if pension funds can overcome short-term problems, they would probably be both willing and able to pick up gilts at discount prices. Much has been written about the liability-driven investment (LDI) model used by pension funds, which requires high collateral payments to cover potential losses from the sell-off in gilts (margin calls) in times of volatility. But the irony of the situation is that fundamentally, higher gilt yields are a positive for any fund with long-term liabilities, and hence also for LDI. With rising bond yields, the discount factor for liabilities goes up and the current valuation of future liabilities goes down. All this is only beneficial provided there is enough liquidity to meet margin calls on the asset side. That is exactly what the BoE's interventions over the last few weeks were meant to provide.

On a longer-term basis, UK bonds look like a bargain. This is true of corporate as well as government debt, with investment grade credits spreads widening dramatically over the last few weeks. One way to interpret this is as a sign of looming (or already present) recession, which will increase bankruptcies and tighten credit conditions. But the bonds in question are *investment grade*, meaning they are from large and stable corporates likely to weather any storms ahead.

The recent mayhem has caused many commentators to liken the UK to an emerging market, with fiscal imprudence and policy divergence from its central bank. But Britain is not an emerging market – it has highly functional financial and corporate structures and a highly skilled workforce. Recent bond movements bely this, but arguably suggests there are now bargains to be had. This is not to say that we expect a sharp rebound – there are far too many intractable short-term problems for that – but there could be healthy returns in the future and, for the time being, yield-based return contributions we have not seen in over a decade.

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17th October 2022

Global Equity Markets

Market	Fri 15:47	% 1 Week*	1 W	Technical: Short	Technical: Medium
FTSE 100	6872	-1.7	-119	⬊	⬂
FTSE 250	17090	-1.5	-263	⬊	⬊
FTSE AS	3749	-1.7	-66	⬊	⬊
FTSE Small	5731	-3.3	-196	⬊	⬊
CAC	5942	+1.3	+75	⬊	⬊
DAX	12457	+1.5	+184	⬂	⬊
Dow	29906	+2.1	+609	⬊	⬊
S&P 500	3627	-0.3	-13	⬊	⬊
Nasdaq	10497	-1.5	-156	⬊	⬊
Nikkei	27091	-0.8	-221	⬊	⬂
MSCI World	2412	-0.2	-6	⬊	⬊
CSI 300	3842	+1.0	+38	⬊	⬊
MSCI EM	855	-4.8	-43	⬊	⬊

Top 5 Gainers

Company	%
DS Smith	+10.4
International Cons	+9.7
Rentokil Initial	+6.1
Next	+5.9
Dechra Pharmaceut	+5.6

Top 5 Decliners

Company	%
Fresnillo	-9.6
Endeavour Mining	-7.2
Intermediate Capital	-6.8
BAE Systems	-6.7
Anglo American	-6.3

Currencies

Pair	last	%1W
USD/GBP	1.123	+1.3
GBP/EUR	0.868	+1.2
USD/EUR	0.975	+0.1
JPY/USD	148.35	-2.1
CNY/USD	7.192	-1.1
Bitcoin/$	19,450	-0.3

Commodities

Cmdty	last	%1W
Oil	91.71	-6.3
Gold	1650.0	-2.6
Silver	18.475	-8.2
Copper	341.6	+0.9
Aluminium	2359.5	+0.5
Soft Cmdties	221.90	-1.8

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	9.9	8.6	14.3
FTSE 250	3.9	7.6	11.6	16.4
FTSE AS	4.0	9.4	8.8	14.5
FTSE Small x Inv_Tsts	4.1	5.9	9.0	15.5
CAC	3.3	11.6	9.4	15.2
DAX	3.7	12.0	10.0	13.8
Dow	2.3	15.7	16.0	17.0
S&P 500	1.8	17.3	16.2	18.3
Nasdaq	1.0	20.0	23.7	24.4
Nikkei	2.0	15.1	14.8	17.8
MSCI World	2.3	14.4	14.5	17.2
CSI 300	2.3	13.0	12.6	12.8
MSCI EM	3.5	8.6	10.4	12.7

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Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	4.17	-0.07
UK 15-Yr	4.53	-0.01
US 10-Yr	3.98	+0.10
French 10-Yr	2.90	+0.10
German 10-Yr	2.30	+0.11
Japanese 10-Yr	0.25	-0.00

UK Mortgage Rates

Mortgage Rates (Nationwide)	14-Oct	14-Sep
Base Rate	2.25	1.75
2-yr Fixed Rate	6.14	3.64
3-yr Fixed Rate	6.14	3.74
5-yr Fixed Rate	5.64	3.61
10-yr Fixed Rate	5.34	3.73
Standard Variable	5.10	4.89

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values

** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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