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***Gilt Edged Opportunity*: After an extraordinary few weeks in the markets, Westminster Asset Management Investment Strategist Peter Lucas considers where we are in the cycle and some potential investment opportunities.**

The message of my last article ("Soft Landing?", August 2022) was one of caution. Equity markets had enjoyed a strong upswing following several months of losses, which I argued was a false dawn. My reasoning was simple, that the US Federal Reserve was determined to break the back of inflation and was willing to do whatever it took to achieve that outcome. With recession risks very much on the rise, I expressed a preference for bonds over equities, with the latter expected to revisit the downside.

These forecasts have produced mixed results. Equities are down 5-10% and back to their lows for the year, thereby vindicating my caution. Although US Treasuries *have* beaten the S&P 500, they have still inflicted nasty losses on investors. That was not the expected outcome. Although economic activity is cooling, it has not done so sufficiently to deter the Federal Reserve and other central banks from talking tough on inflation and on interest rate policy. That has unsettled the bond market and pushed yields to new highs for the year, particularly in the UK where investors have had to contend with a big fiscal giveaway.

During the past three decades property prices have enjoyed a tailwind of falling interest rates due to falling inflation and ever easier monetary policy, particularly in the wake of the 2008 financial crisis. The COVID-induced easing in monetary policy provided the rocket fuel for global property markets to move into bubble territory, levels that could only be sustained if interest rates stayed low. But that is clearly not what happened. Indeed, at one point during the recent chaos, some UK banks decided to withdraw from the mortgage market altogether. With affordability levels through the floor, the immediate prospects for residential property prices are not good, something that will just add to the misery of cash-strapped consumers. The point is that the outlook for the economy is increasingly uncertain, and the focus of central banks will eventually shift from beating inflation to protecting jobs and the economy.

We might well have witnessed the first step in that direction in the UK, where the Bank of England has just announced a two-week bond purchase program to stabilize the long end of the gilt curve. The fall in gilt prices this year has been a wonder to behold. Indeed, at one point this week the longest dated inflation-linked bond was down over 80% from its December 2021 high. With gilt prices dropping several percent day after day, something clearly needed to be done to restore confidence, both inside the UK and abroad. Hence the gilt purchase program. They still intend to commence quantitative tightening (sales of gilts) at the end of October. So, in summary, the government is initiating an extremely easy fiscal policy, while the Bank of England is tightening on the one hand and easing on the other. What a confused mess!

Two years ago, I said that central banks might try to resist the expected rise in bond yields with quantitative easing ("When does a lot of debt become too much?", June 2020): "if central banks try to arrest any resulting rise in bond yields, it could be akin to pouring petrol on a fire". The Bank of England has described its bond buying program as "temporary". Let us see how that plays out for them.

Inflationary pressures are dropping across a broad front as bottlenecks ease and economic activity cools. Commodities are down a quarter. The US ISM Manufacturing Prices Paid, and Business Supplier Deliveries indices are virtually back to levels prevailing before the pandemic. Property-related inflation is still high but should cool markedly in the months ahead as higher mortgage rates start to bite. Under the watchful eye of voters and politicians, central banks remain focused on engineering a drop in core and headline inflation rates. However, these are lagging indicators, which means that there is a real risk that central banks overcook the goose, leading to a hard rather than soft landing for economies.

Either way, bonds are heading for a longish period of relief. The immediate prognosis for equities is less encouraging; if the landing is hard (recession) as I expect, the likelihood is that equities will continue to struggle for the time being, with the ultimate low unlikely to come until next year. Incidentally, for those inclined to bet on a better outcome for the economy should look to commodities rather than equities given their secular underpinnings (green agenda demand and/or low inventories) and the insurance they provide against geopolitical risk. When central banks do finally 'pivot' (switch from fighting inflation to protecting jobs) one of the main beneficiaries will be gold given its heightened sensitivity to liquidity and interest rates. My analysis also indicates that gold shares perform particularly well in recession, so their time in the sun may finally be at hand.

Before I sign off, I would like to make this observation. The UK is currently having to endure criticism, concern, and even ridicule, but are things really better elsewhere? To my mind, Europe looks as big a mess, if not worse. UK Gilts currently yield 2% more than German Bunds, a 30 year high. That looks like an opportunity to me.

Peter Lucas

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