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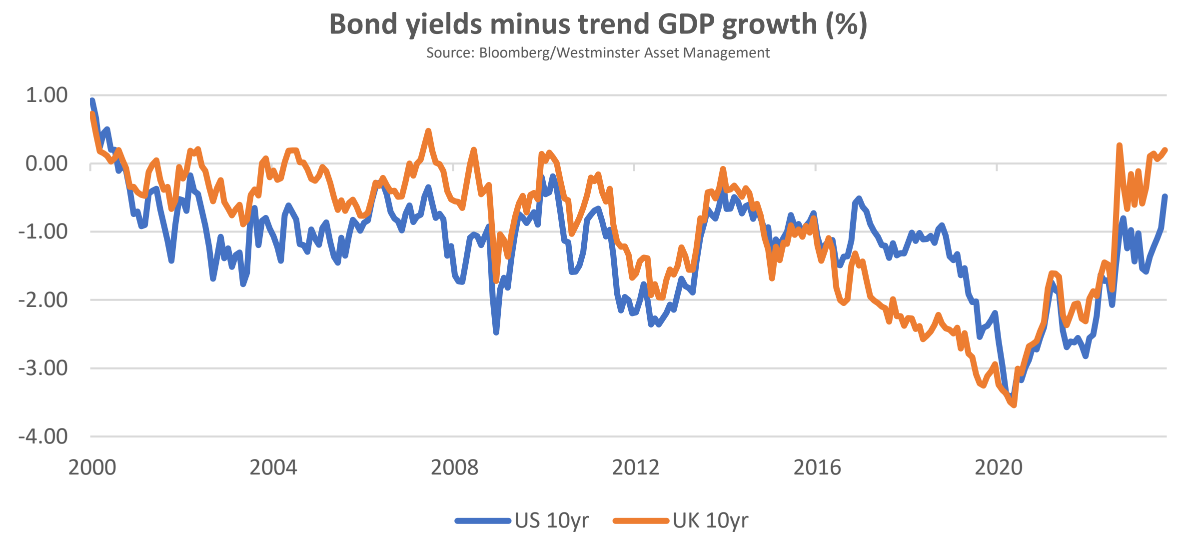
Strategy update

Westminster Assets Management's Investment Strategist Peter Lucas considers the implications of this weeks price action in the Treasury market.

My last strategy note was circulated in late July, a time when many analysts were busily dropping their recession calls and upgrading their forecasts for equities. I was reluctant to follow suit given over-bullish equity sentiment, elevated valuations for big tech and non-zero recession risk. As it turns out, my note corresponded with the short-term peak in share prices, with the equal-weight world index declining over 5% in sterling terms in the last three months. Bonds, my preferred investment, have fared a touch better, but have continued to lose money, due to the continued absence of recession and widening fiscal deficits.

My biggest worry all year has been that recession would inspire a rotation out of equities into bonds. In the event, at least thus far, any equity market weakness has been driven by rising bond yields rather than falling equity markets dragging bond yields down. That might change in the weeks and months ahead, but to date bonds have been the villains rather than the heroes.



With hindsight, it was wrong to place so much weight on the yield curve as a market timing tool. The lead times between inversions and recessions have simply been too variable. Perhaps more importantly, the environment just before recessions can look very much like Goldilocks – slowing, but positive economic growth combined with peaking inflation. In other words, there is always a risk that the yield curve will be wrong for a time, just before it is very right. As an aside, I have recently found that using a 6-month moving average of the yield curve slope reduces the variability of the lead time to just a two-month window (14-16 months). Applying the same technique for this cycle produces a forecast for the onset of recession of November 2023 to January 2024.

The most recent leg down in bonds has all the hallmarks of capitulation, the climactic sell-off that is often seen at the end of major market moves.

1. The sell-off has taken place in the absence of major economic news. The US economy is no longer surprising on the upside in the way that it was earlier in the summer. Higher oil prices have raised some inflation concerns but rent inflation – a big part of the CPI basket – continues to fall in line with expectations.
2. There has been much focus on big debts/deficits and rising borrowing costs, but it is too soon to be talking about a debt crisis. Furthermore, if we do get a recession, there will undoubtedly be buyers for government bonds.
3. US and UK bond prices have dropped into undervalued territory, at least by the standards of the past twenty years.

This combined with the real risk of recession makes me think that we are on the verge of a tradeable rally in bonds.

But what about the long-term? I remain concerned that the current downswing in inflation is just a temporary period of relief, much like the downswings of the 1970's. In 2020 I highlighted three areas of concern in that regard: extreme debt levels, unhelpful demographics, and extreme inequality (leading to populism and generally bad policy making). The events of the past year have merely served to strengthen my conviction on all fronts. Government bonds may be a buy for now, but they are not the buy-and-hold investments that they once were.

Peter Lucas
24 October 2023