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Article

The BoE's transmission mechanism isn't broken, just delayed

The Bank of England has raised rates to 5.25% and the market is now pricing in a terminal rate of 5.7%. Our fixed income team believe there is more than enough tightening in the system to slow the UK economy and put downward pressure on inflation. What does this mean for financial markets and how should investors look to position across the yield curve?

PRO Multiple authors UK 04/08/2023 5 min read

Key points

- Markets are pricing in a terminal rate of 5.7% for the UK. We believe this would bring about a necessary contraction in growth to take inflation out of the system, likely in 2024.
- With volatility in rates remaining high, we are taking a nimble approach to interest rate positioning and expressing some curve positions to help reduce the directional risk.
- While we are slightly more bullish on duration, it is hard to ignore the opportunity at the short end of the curve, particularly for investors looking to manage duration risk.

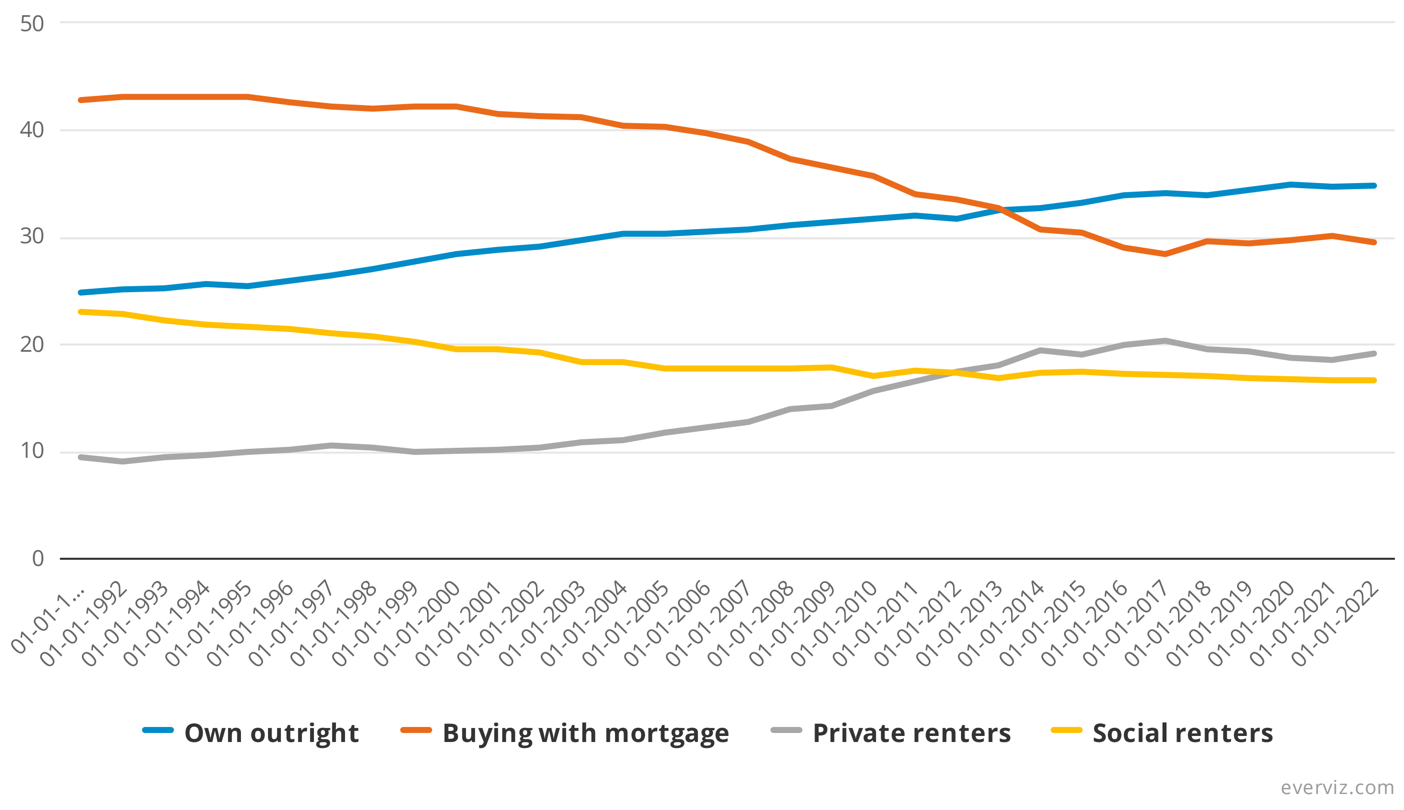
2023 has seen the market re-pricing its assessment for terminal rates. At the start of the year, markets were pricing in a terminal rate for the UK at 4.7%, whereas today this is 5.7%. Inflation has proven to be more persistent than expected in both the UK and globally. Part of the contributing factors to more persistent inflation has been the supply shocks related to Covid, but there are some UK-specific factors as well. Brexit and the increasing number of people who are not employed but who are long-term sick has led to a contraction in the workforce. Both of these have led to a persistence in UK inflation over the US and Europe and made it difficult to get wages to a more normal level.

Slowdown in UK inflation and growth set for 2024

This is prompting many to suggest stagflation is a key risk for the UK. However, the re-pricing in Gilt markets suggesting terminal rates of 5.7% is very meaningful. If this happens, it will bring about the slowdown and contraction in growth that is necessary to take inflation out of the system. The market entered 2023 expecting the transmission mechanism from tighter monetary policy into slowing growth and slowing inflation to be quite rapid. It is fair to say that we've learnt that there are some structural features globally and UK-specific that are delaying this transmission. For example, there is a longer lagged impact from the mortgage passthrough for two reasons, firstly, the proportion of home ownership via a mortgage is lower (see chart below) and secondly, households have been extending their mortgage duration which means the need to refinance is less near term.

This does not mean the transmission mechanism has gone away, however, it is just delayed. So rather than this slowdown in growth and inflation occurring in the second half of 2023, we think 2024 is a more appropriate timeframe.

Fewer households have a mortgage now versus history and more own outright



Source: Fidelity International, English Housing Survey, 15 December 2022.

There is evidence to demonstrate that tighter monetary policy is having an impact. We've had the UK LDI-Gilt-related shock last year, the US regional banking crisis and the spill over into Europe and Credit Suisse, concerns over the commercial real estate sector and more recently concerns over Thames Water. These may look like isolated instances at the outset, but we view these as linked to higher rates. The first dominoes to fall are simply the most interest rate sensitive parts of the economy and there will be more to come.

Now is not the time for big bets on duration

So where does this leave us? Overall, we like duration over the longer term from here. Inflation has likely peaked, and while it may take considerable time to get down to target given persistent pressures, we do expect a further slowdown in growth and inflation which should support lower yields. Duration also tends to perform well amid a slowdown as investors rush to safe haven assets. It has been reassuring to see duration perform well in the nadir of the crises surrounding the US regional banks and Credit Suisse, reaffirming the flight-to-quality status of government bonds. That being said, it is fair to say that our conviction is not great, the BoE will be data dependent and will not commit to a prescribed path of interest rates, meaning uncertainty will remain.

Furthermore, volatility in rates remains high. This means we are taking a slightly more conservative and nimble approach to interest rate positioning than usual and expressing some curve positions to help reduce the directional risk. Now is not the time to make big directional duration calls which could wipe out all of our good credit work.

We are expressing this via a modest long in UK duration and a tactical long in US duration and have opposing curve positions in both markets. In the UK we have a flattening bias, in other words, we expect short end rates to rise relative to long end rates. While in the US, we have a steepening bias, meaning we would benefit from a fall in short end rates relative to long end rates. We expect the Fed to start cutting rates before the BoE as the US seems further along their monetary policy cycle than the UK. These curve positions can support in generating alpha irrespective of the direction of yield changes.

Opportunities remain at the short end of the curve

While we are slightly more bullish on duration, it is hard to ignore the opportunity at the short end of the curve. For investors rightly concerned about volatility and uncertainty in interest rates, a lower duration approach may be a good way to manage duration risk while still picking up some yield. The Fidelity Short Dated Corporate Bond Fund has roughly half the interest rate risk of Fidelity Sustainable MoneyBuilder Income and may be a suitable option in this respect. Furthermore, the inversion of the yield curve means investors can pick-up additional yield by reducing duration, offering a nice risk-adjusted option.
