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Update on markets

As of 2.30pm on 28.09.22

Another day, another extraordinary development. Since the announcements by Chancellor Kwarteng on September 23 we have seen a spike in interest rates, a drop in the value of the pound and as of 28 September a resumption of gilt buying by the Bank of England.

The actions by the Bank of England are aimed at the long duration end of the gilt market which had been hit very hard. Initially this was deemed to be because of market concerns about the ability of the market to absorb the level of new issuance of gilts likely needed to pay for the energy support and tax cuts announced on September 23.

But on the evening of September 26 came news that mortgage lenders were withdrawing deals as yields were moving so fast and so significantly that pricing mortgages was proving difficult.

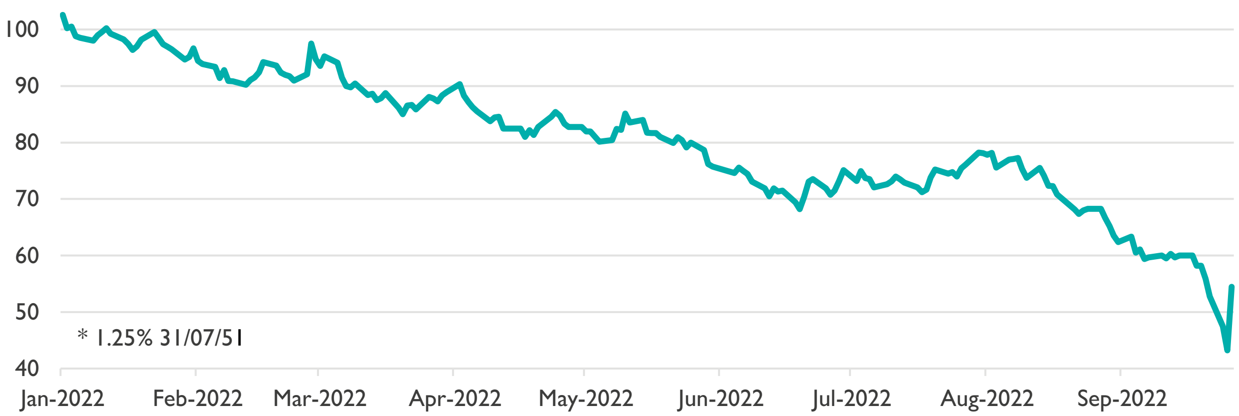
Then on September 27 concerns were expressed about pension funds being hit with margin calls on their Liability Driven Investments. This happens when a scheme uses interest rate swaps or other derivatives to hedge its future liabilities.

The advantage of using derivatives is that the scheme only has to put up the cash for a portion of the value of the derivative and can borrow the rest. This gives the scheme more cash to invest in bonds, equities or property. But when there are dramatic moves upward in rates the scheme will need to put up more cash to cover the increased value of the hedging instrument. This has forced schemes to sell growth assets to meet the margin call. This is one of the reasons for the exaggerated moves in the gilt market and it has also impacted other markets too.

Those two events meant that the spike in yields was running the risk of severely damaging the housing market and the savings industry. Hence the Bank of England's decision to intervene.

The extent of the moves in gilts is evident from the price of the benchmark 30-year gilt. It started the year trading at £103 but sank to £43 on September 27 before the intervention by the Bank of England. The capital loss of 58% this year is just another statistic in a historically bad year for fixed income investors on both sides of the Atlantic. The price chart is below. It has rallied to £54 today. The yield on this bond has gone from 1.24% at the start of the year to 4.98% on September 27, 3.94% after the intervention.

Price of benchmark 30-year gilt *



Source: Bloomberg, Waverton as of 28.09.22

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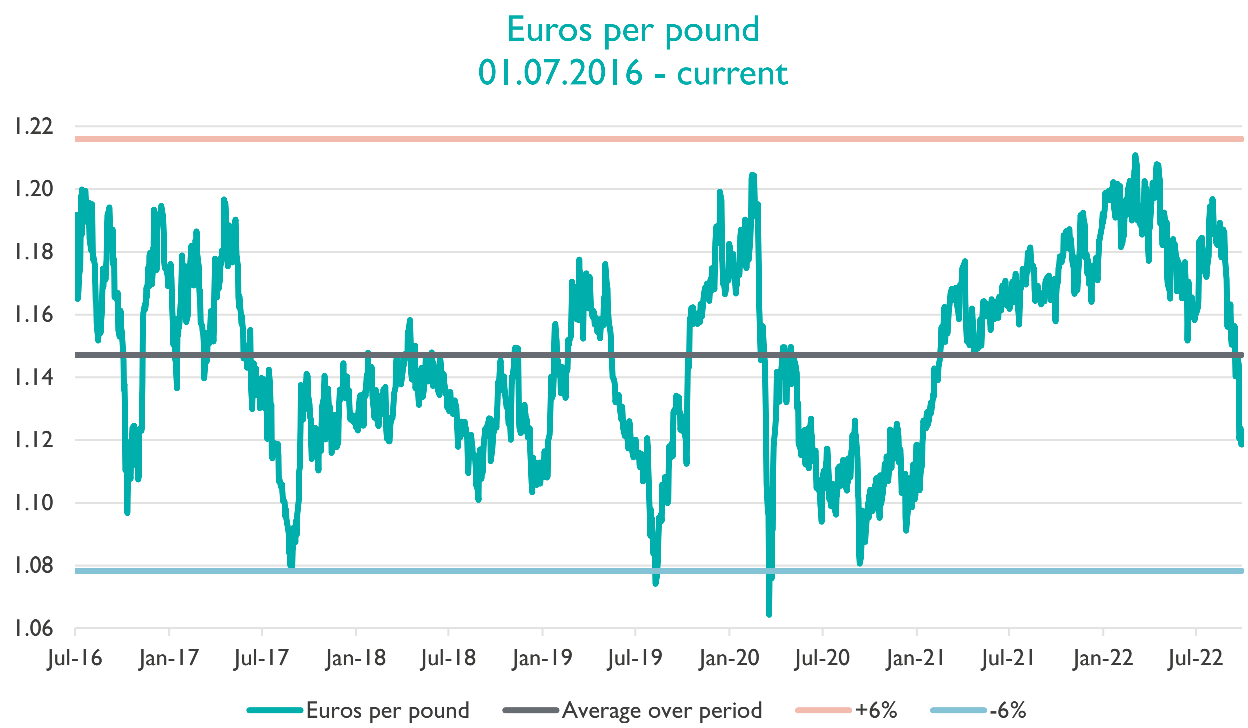
The Bank of England's action is risky. The Bank has begun to reduce the size of its corporate bond holdings on its balance sheet and was supposed to start selling gilts imminently. It now says it will sell gilts starting on October 31. Whether it will be able to do that remains to be seen.

Sterling has been extremely weak against the dollar and that weakness accelerated after the mini budget. But fundamentally the dollar has been supported by the relatively aggressive moves upward in the Fed Funds policy rate in the US in recent months. The Bank risks exacerbating the difference between UK and US monetary policy by doing more QE.

We think the key exchange rate to watch is the sterling/euro rate. We note that since the June 2016 Brexit referendum sterling has been in a trading range against the euro. Both currencies have been particularly weak against the dollar this year and so sterling remains in the trading range, but this week it has moved toward the bottom end of that range.



Source: Bloomberg, Waverton as of 28.09.22

The chart above shows the number of euros per pound since July 1, 2016. The average exchange rate is shown as the black line and we show a range 6% either side of that average. We use 6% as that was the range sterling was allowed to trade against its DM2.90 central rate when it was in the Exchange Rate Mechanism (ERM). Famously sterling was forced out of the ERM in September 1992 when it was unable to hold it.

We note that over the period shown (1,629 trading days), sterling has only been out of a 6% trading range for five days. If it moves out of the range in coming weeks it would be a signal that the concerns about UK sovereign risk had gone even higher than they have appeared in recent days.

Our view is that there is likely long-term value at these levels in sterling assets – currency, gilts, equities and REITs. But with such extreme volatility and such swings in policy response we recommend only putting some eggs in a sterling basket, not all of one's eggs.

Risk warnings

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Fixed income securities are sensitive to interest rate risk (duration) and will increase and decrease in value as interest rates change.