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What a week – Here's a summary of what's been happening in UK markets

Thursday 22 September. The Bank of England (BoE) says we may already be in a recession. Energy support package takes pressure off BoE to raise rates aggressively. If they slowdown interest rate hikes and we are in a recession (or heading into one), UK government bonds would offer good value over the next 18 months or so.

Then on **Friday 23 September,** the chancellor unveils the largest tax cuts in decades.

Gilt yields rise – because of unfunded tax cuts (unexpected) and energy support measures (expected). The bond market is questioning the sustainability of the UK government's debt-funded spending plans.

SIDE NOTE – yields on government bonds have been rising as inflation around the world has been higher than expected and central banks hike interest rates to tackle inflation. When bond yields go up, prices go down. When you invest in bonds you get your money back when the bond matures, but if inflation is high the amount you get back will be worth less, so you demand a higher return (yield) and/or you pay less for them (lower price). That is why bond prices have been falling this year

A cut in taxes for households and corporates is likely to keep inflation higher for longer.

To fund these tax cuts, the government will have to issue more gilts. The BoE had also said last week that it was looking to start selling the gilts it had bought to support the economy during the Covid pandemic. So new gilts are now being issued and gilts are being sold to the market. Who will buy these?

To compensate for higher inflation and the uncertainty around these unfunded cuts, investors will want a higher return (yield) on their bonds. So, **we've seen yields go up and prices go down.**

Over a quarter of UK gilts are owned by overseas investors (Source: ONS, Debt Management Office). These investors have already suffered losses in gilts – because they've fallen in value and British pound has been falling. In part, the British pound has been falling because the USD has been strengthening. Most currencies have depreciated in value against the USD this year because as fears of global recession increase, you want to go to a perceived safe currency, which is of course the USD.

Source: Bloomberg

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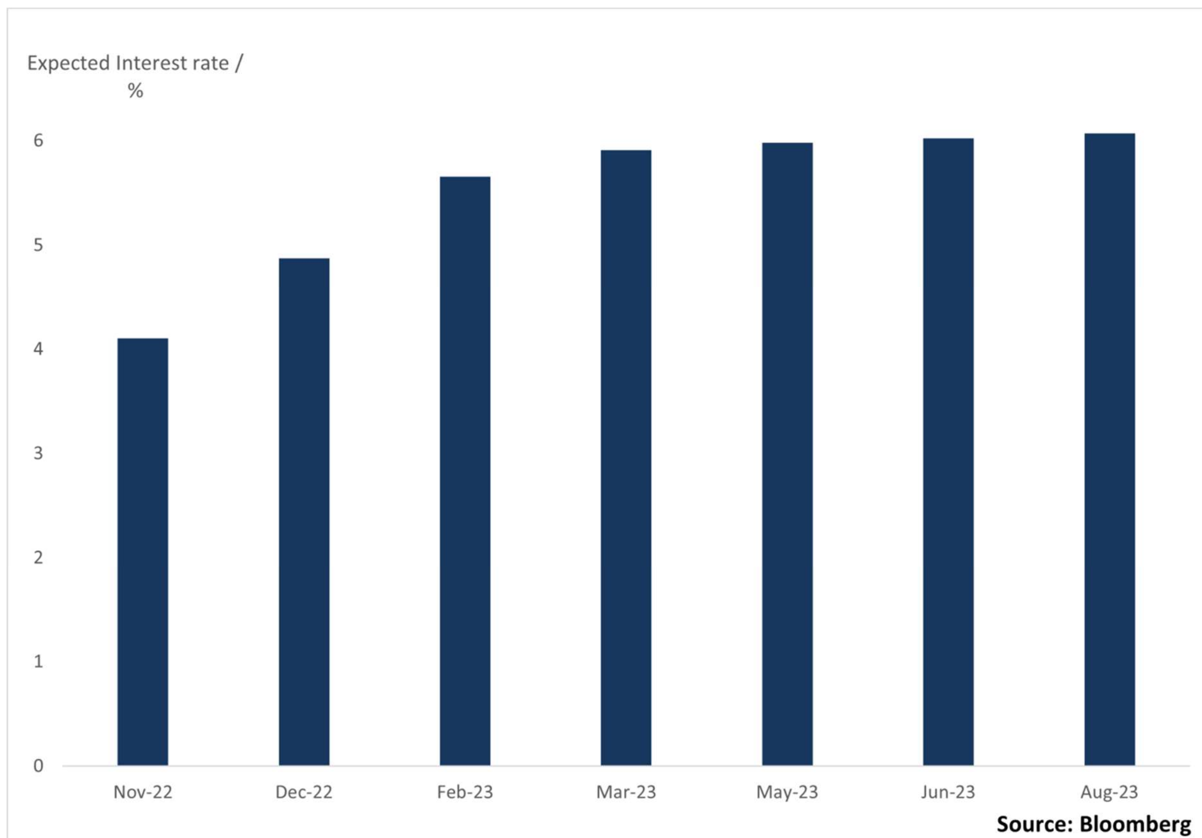
BUT, when the government announced the new tax cuts on Friday, **sterling fell aggressively** and continued to do so today as investors worried about an unsustainable fiscal policy (fiscal policy is the government's approach to borrowing and spending).

To combat these unfunded cuts and a sharp decline in Sterling, markets are now expecting interest rates to reach 6% in the UK by next spring/summer. WOW! That feels excessive.



Is there a silver lining? Perhaps. At time when UK government bonds are cheap, the UK pound is cheap and markets have gone too far with interest rate expectations, perhaps UK gilts are now offering good value over a medium-term horizon? Gilts that mature in ten years' time now offer investors an annual yield of more than 4% - such a generous yield hasn't been seen since 2010

Right now, markets are expecting the Bank of England to step in and take some emergency action – possibly even calling another meeting to raise interest rates just a week after the last meeting. The aim would be for the bank to regain some economic credibility and ease market jitters.

However, in the short-term we would expect to see continued volatility in gilts and sterling.

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