MORNINGSTAR Wealth

A Message from Our Chief Investment Officer

Are yields high enough?

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For Financial Professionals and their clients

Key points

- Rising bond yields
- Markets pricing in higher interest rates
- Competition for capital is hotting up

AI reasserted its grip on investors in August as IT outperformed, supported by ongoing dealmaking and rising corporate earnings. But it was debt markets that came into focus with government bond yields rising after the July pullback.

So what does that tell us about future bond returns? A simple rule of thumb is that current yields are a good starting point for what to expect. So for 10-year government bonds that means about 5.3% for UK and 5.0% for the US. In both cases these are the highest yields for many years and offer a significant margin above current inflation and current cash rates. This is good news for income seeking investors.

The catalyst for the recent rise in bond yields has been an energy-led inflation surge which in turn is expected to trigger a rise in interest rates.

The Iran war is directly responsible for that rise in energy prices as Tehran has used its control over the Straits of Hormuz and direct attacks, to dramatically reduce the supply of energy from the Middle East.

So higher energy prices mean higher inflation everywhere, but as previously mentioned the impact is small and not long lasting because of structural changes in the demand and supply of energy. While the conflict could sustain the inflation surge, it's an increasingly unpopular policy in the US which means conditions can change very quickly.

The question for investors now is whether the rise in yields provides enough of a margin of safety to make bonds attractive both as an income yielding investment and a source of diversification for growth shocks. The evidence is mounting that we are fast reaching this point. Markets are priced for Central Banks to raise interest rates by approximately 1% rise in the UK and US within the next 12 months, from levels that are already well above current and expected inflation rates. Were this to happen, it would depress economic growth and reduce demand led inflationary pressures.

The accelerating spending on AI capabilities and rapid adoption means AI is already impacting productivity, reducing barriers to entry and intensifying competition. This powerful deflationary pulse is also reducing wage pressures and the risk of a wage price spiral.

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What about the war for capital that is pushing up yields? Compared to prior comparable booms, much larger amounts of capital have been raised and are being invested. We can't tell when and how this demand for capital will dissipate but there is a limit on the amount of data centres, computer chips and servers needed. So like all prior booms, the demand for capital will fall from the extreme levels of today and this will reduce one factor pushing up real interest rates.

What about large government deficits and debt? The jump in longer dated bond yields reflects the growing cost of financing this debt load, as cheaper debt rolls off and there is less buying from Central Banks and Defined Benefit pension schemes. The real issue is whether government debt levels are sustainable. It's extremely rare for governments to default, especially when they have large assets, powers to direct domestic savings to fund themselves and they are democracies whose voters are heavily invested in that debt. Changes in governments also mean changes in fiscal policy so it should not be assumed that current US fiscal deficits will continue into the future.

The bottom line is that government bonds offer a good margin of safety, attractive income yields, higher than normal real returns and diversification from growth shocks.

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