

Inflation risk and rising interest rates get investors in a flap

● Higher GDP growth forecasts by economic organisation is early evidence of a change in trend

Paul Marais

Longer-term bond yields have traditionally been considered a fairly accurate indicator of economic growth and investor confidence. Extensive literature supports the idea of the yield curve as a reliable predictor of recessions and economic activity, including changes in GDP, consumption, industrial production and investment.

All investments come with varying degrees of risk. The key is how that risk is defined: is it a permanent loss of capital, volatility or the spread of potential outcomes? Rising bond yields are one of the investment risks we're seeing at the moment, largely due to fears that inflation turns out to be higher than investors expect.

This is particularly relevant in developed markets such as the US, where much fiscal and monetary stimulus has been directed at Covid-19 relief programmes. Investors are thus being forced to reconsider the yield they get from their investments and whether these yields sufficiently compensate for inflation risk.

The sentiment is that risk is not being sufficiently compensated for and yields are thus rising. Yields on 10-year US bonds, a key indicator, have gone from 0.5% to more than 1.5% in the last year alone. While a single percentage point increase might not seem significant given the trillions of dollars that are physically invested in this asset, the impact is significant.

In the EU, the European Central Bank, which regards higher yields as a threat to Europe's pandemic economic recovery, is trying to rein in the rise in bond yields by increasing the pace of its asset purchases. The slow pace of vaccination rollout in the EU appears to be holding back its economic recovery.

The UK and the US – both of which are successfully rolling out vaccination programmes – appear to be less concerned about rising yields. Yields in the UK continue to rise despite the Bank of England committing to expand its bond-buying programmes. Similarly, the US is seeing rising bond yields even though US Federal Reserve chair Jerome Powell has committed to keeping interest rates low for longer. The US Fed has gone as far as changing its mandate to achieve average inflation of 2% per annum over a period rather than just a breach of 2% being the trigger for higher rates.

Ordinarily these actions would keep yields on bonds from rising. However, if investors are not concerned about rising interest rates, it has to be the risk of inflation that has them anxious. Inflation is arguably the bond investor's worst enemy. Bond prices typically fall when there is an expectation that inflation will rise, with the result that yields are pushed up.

GROWTH FORECASTS

There is already early evidence that we are headed towards an inflationary environment. The Organisation for Economic Co-operation and Development (OECD) has lifted its GDP growth forecasts for 2021.

In developed markets, purchasing managers' indices, which track the prevailing direction of economic trends in the manufacturing and services sectors, have risen well above the 50 level, which is considered expansionary (as opposed to below 50, which is considered contractionary).

Similarly, China's producer price inflation is accelerating. China has for the past few years been an exporter of deflation, primarily through its cheap labour markets. Indications are that this might be changing as it becomes an exporter of inflation.



Happy returns: All investments come with degrees of risk. The key is how that risk is defined: is it a permanent loss of capital, volatility or the spread of potential outcomes? /123RF/Rajesh Rajendran Nair

An exceptionally buoyant oil price, which is likely to translate into inflation at some point, should also be factored in.

A year ago, after the Covid-19-induced 11% spike in yields, local bond yields settled at attractive levels, between 8% and 9% on the theoretical SA government 10-year nominal bond. In reality, there is no 10-year bond in SA, so this yield is implied and based on calculations. SA annual inflation was

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and is about 3%, so much inflation risk premium was built into local bond yields. However, markets are clearly unconvinced that sufficient compensation was built into these yields.

Encouragingly, many of the other risks priced into bond yields a year ago are either no longer present or have shrunk.

A blowout in government finances appears less likely than it did a year ago, the risk of further downgrades appears to be less of a concern, and there is the prospect of getting the Covid-19 pandemic under control with the vaccine rollout starting to take place, albeit at a snail's pace.

SA is not alone in experiencing rising bond yields. US yields have shown similar increases, as have some emerging markets. Credit default swap rates –

the price of insuring against a sovereign default – remain relatively subdued in the commodity-based emerging markets for which we have data. If rising bond yields were a uniquely SA issue we would see this in a change in the cost of insuring against SA default risk vs the likes of Russia and Brazil.

SA bond yields were last at these levels in May and September 2020. The benefit now, however, is that a significant degree of inflation risk protection has been built into the yield and the three key risk events are now behind us.

It's not often that markets give investors a second and third opportunity to reconsider their investment choices.

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