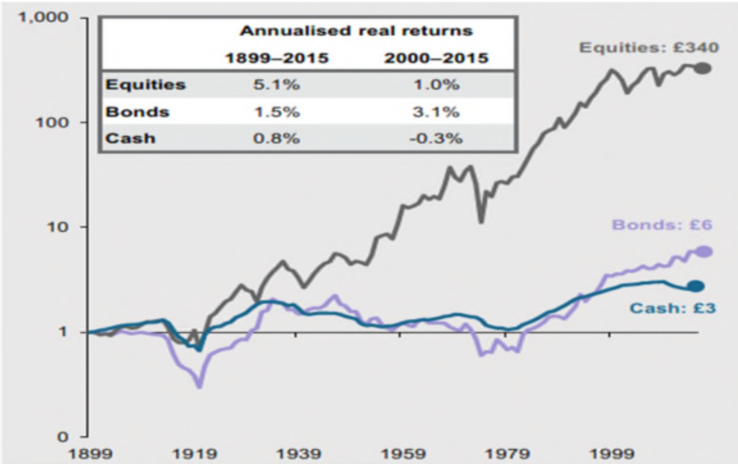
Over the longer-term equities have provided investors with a higher inflation-adjusted return than both bonds and cash, as shown in the chart below. However, between 2000 and 2015 investors would have been better off owning bonds (gilts) than shares in companies. In that period bonds returned 3.1% per annum whilst equities returned 1% per annum. Over the same time period, when adjusted for the impact of inflation, cash held on deposit would have lost 0.3% of its purchasing power on a yearly basis.



Total return of £1 (adjusted for inflation)

Bonds have enjoyed a period of sustained positive returns over the past 30 years, which coincides with a steady decline in global interest rates.

Interest rates have long been considered as the primary tool for central bank officials to control monetary policy. Whenever central banks wish to slow an economy's growth rate and restrain inflation, they raise interest rates (known as tighter monetary policy) and conversely when they wish to spur growth and increase the money supply, they lower interest rates - expansionary monetary policy.

Over the last 30 years there have been five cycles within which the UK and US central banks have raised interest rates but on each occasion the peak interest rate has settled at a lower level than in the previous cycle. As such the interest rate at which the governments of the UK, US, Japan, and Germany have been able to borrow has been steadily falling and those investors who have held longer-dated debt with higher interest payments have made strong capital returns.

We believe that the beginning of the end of the 30-year bull market in traditional fixed interest assets has arrived. If we are right then the average investor will have to re-assess how they think about fixed interest investments and recognise that such investments may carry significant risk in the years ahead.

"As I have noted, unless unanticipated developments adversely affect the economic outlook, the process of scaling back accommodation likely will not be as slow as it was during the past couple of years."

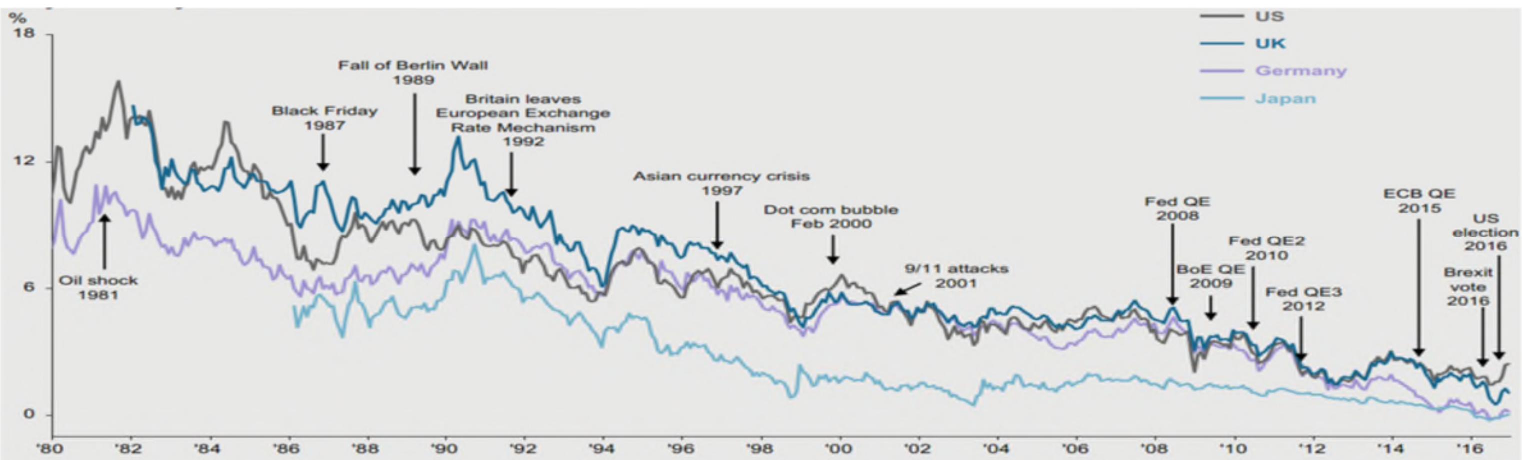
– Janet Yellen – March 3rd 2017

Whilst this may sound like diplomatic bluster surrounding the timing of when they will increase interest rates, prior to Janet Yellen's speech in Chicago at the end of last week markets were pricing in a 40% chance of an interest rate hike in the United States in March. It is now assumed (with a 94% probability) that the Federal Reserve (the Fed) will raise the reserve rate by 0.25% to 0.75-1.0%. That will represent the third interest rate rise in this cycle and it is anticipated that the pace of future increases this year will be far quicker than 2014 and 2015, as the recovery in the US economy accelerates.

Whilst the US is in the enviable position of being able to 'normalise' interest rates in light of a return to full employment and meeting its 2% inflation target, both the Bank of Japan and the European Central Bank appear to have concluded that negative interest rates have not provided the stimulus initially anticipated. They have instead chosen to stimulate growth and inflation by utilising a different monetary policy tool that we are all now very familiar with - a programme of massive quantitative easing.

The European Central Bank has thus far bought some €1.5trn in bond assets in order to stimulate growth, however interestingly they have now started to taper back their purchases and speculation is rife that this reduction may accelerate through the latter part of 2017. So whilst they aren't increasing interest rates, from a monetary perspective this action could have a similar impact to the rate rises implemented in the US.

However things are different in the UK. The prospect of protracted Brexit negotiations has led to an expectation that the first interest rate rise won't take place now until 2019 and you can currently fix a 2-year mortgage at 1.5%, akin to a monthly interest rate not seen since the 1970s.



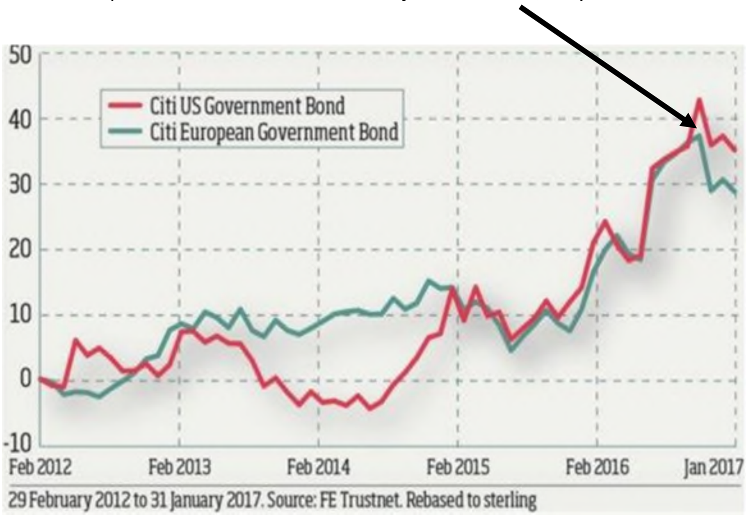
10–year Government Bond Yields

We, however, agree with many that the spectre of high imported inflation alongside a continuation of better than anticipated growth data might lead to a re-evaluation of this and a subsequent rise in gilt yields. Even if economic data were to slightly disappoint, the longer-term correlation of UK government bonds with the US equivalent is high, as demonstrated in the 10-year yield chart on the previous page. Thus, with the Fed raising rates and Trump's expansionary plans it is likely that UK yields will follow the US's lead at some point.

If interest rates are now starting to rise in earnest, how should investors react to this changing environment? Several of the forces which have enabled central banks to consistently lower peak interest rates over the past 30 years including rising inequality, high saving rates and an ageing population, are going to remain in place. As such we still believe that fixed income remains an important component of a diversified portfolio.

The chart below, however, shows that in the last couple of months the value of both US and European bonds have started to fall in anticipation of tighter monetary conditions.

US and European bond values have started to fall in late 2016/early 2017



If the interest-rate cycle has turned, where will the changes be most acutely felt?

"We have come to that point again when the risk-off portions of fixed income portfolios may well present us with much unwanted mark-to-market risk."– Twenty-Four Asset Management CEO – 7th March 2017

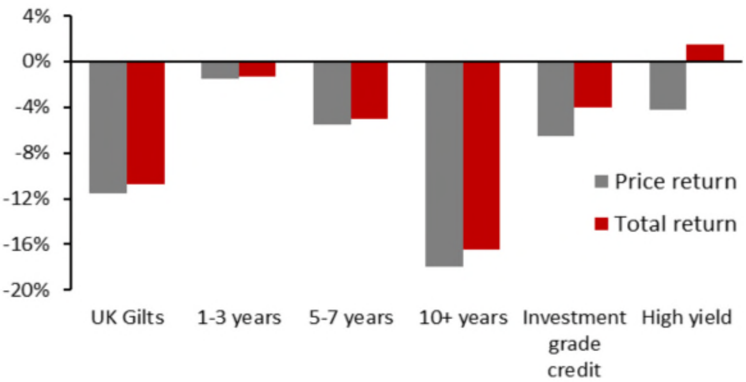
UK Government debt prices have rallied through February and short-dated German debt is almost at record lows. As the CEO of Fixed Income specialist Twenty-Four suggests, the traditional perception of UK government bonds as low risk may be turned on its head in the years ahead. He goes on to suggest:

"Many managers have sleep-walked into large government bond positions simply because they have appeared the safer assets."

The chart above/right shows how differing investments across the fixed interest spectrum might react to a 1% rise in local interest rates. Who would have thought that if you buy a 10-year UK gilt today, with a 1% rise in interest rates you will probably lose 10% of your starting capital? Yet this is the relationship between rising interest rates and government bonds, so expect some choppy times ahead.

In the past we have likened investing in gilts to picking up pennies in front of a steam roller. Increasingly you are being paid a small reward for taking an increasing amount of risk, as this particular steamroller starts to accelerate.

The negative impact of a 1% rise in local interest rates on asset values:



Furthermore, conventional wisdom has it that government bonds are safer than corporate bonds. Yet longer-dated bonds are more sensitive to interest rates than their shorter-dated equivalents because there is more uncertainty as to what might happen to inflation in 10 years compared to inflation now. So, because the average UK government bond has a longer maturity date than the average company bond (Investment Grade credit), when the Bank of England raises interest rates government bonds will on average be worse affected by the change than their 'riskier' cousin, the corporate bond. Other types of debt instrument, such as high yield and investment grade bonds are also typically issued with higher interest payments (coupons) than government debt. Therefore, you are paid more for taking risk with these investments and yet could possibly be taking less risk than with government bonds if interest rates rise. This demonstrates how topsy-turvy the fixed interest markets have become and is an example of the risks faced by many investors over the coming years.

What other debt instruments might we consider?

1. Company debt rather than Sovereign debt

As noted above the perception is that government rather than corporate debt will be more sensitive to higher interest rates. Over the past three years the differential between the yield of corporate debt and government debt has been stable at about 1.5%. This interest differential and an improving economic environment should, to an extent, protect company bond holders from some volatility and downside risk.

2. Shorter Duration

Duration is a way of measuring to what extent bond prices are likely to change when interest rates move. Generally, the higher the duration of a bond or bond fund (meaning the longer you are locked in to a specific interest rate and the longer you must wait for the return of capital) the more sensitive the price will be to a change in interest rates.

Hypothetical illustration of the effects of duration: % change in bond prices if rates spike 1%

Government debt will typically be associated with longer maturities. For instance, the UK's First World War loans were only repaid in 2015 and thus are potentially most exposed to duration risk.

In recent years there have been a number of funds launched with a mandate to invest in shorter duration bonds to mitigate interest rate risk whilst still generating a coupon over and above current cash returns. There should also be less chance of default for a bond that has less time to maturity and so investors are taking less risk by buying these bonds.

3. Flexible Strategies – "strategic bond funds"

In the same way as equity investors are now able to profit when the share price of a company falls, fixed income investors can invest with the aim of generating a positive return when the price of a bond falls. Typically, when held within a fund structure the manager will look to take advantage of situations where he/she feels that one country's bond or currency is relatively expensive compared to another. This type of hedging, when successful, can lead to strong returns even when interest rates are rising.

Do we need to act now?

There is a widely-held view that since the Financial Crisis central banks have taken such extraordinary steps to try to restore economic growth that they are not likely to step in as soon as the green shoots of a recovery appear and risk stymieing a potential recovery. In other words they will allow inflation to move above their targets, typically 2%, for a sustained period before raising interest rates at a quickening pace. Yet if this is not how central banks react, many investors will be caught-out in a big way and so we think it is sensible to be prepared. We can still see merit in retaining exposure to a number of fixed interest instruments but believe it is sensible to reduce exposure to the most interest rate sensitive investments and to choose carefully any new type of fixed interest investment owned.

It is going to become even more important over the next year or so to analyse the market's expectations for interest rate rises and to react quickly if they change. A marked deviation, either in slowing or quickening the pace of rate rises, will very quickly affect an asset class that has been complacently perceived for far too long as low risk and an easy way to make small returns. Investors are advised to watch out as the steamroller gathers pace.