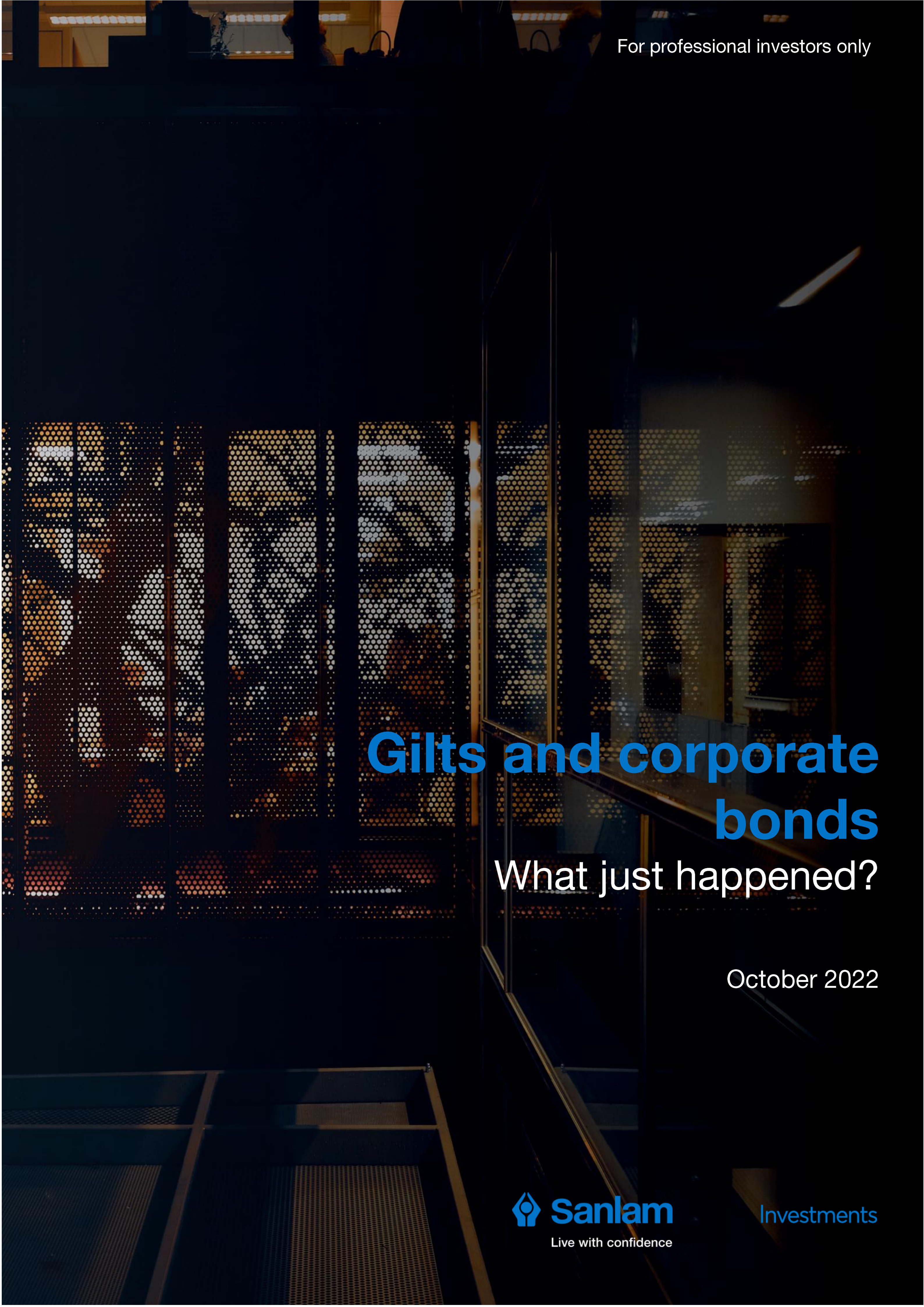

For professional investors only

Gilts and corporate bonds

What just happened?

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Sanlam
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Investments

Gilts and corporate bonds

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The dislocation in *global* interest rate and credit markets in 2022 is severe, with diversified bond market indexes showing negative returns in nominal terms of anywhere between -12 % and -25 %. This is the worst in 40 years - even without taking into account the additional inflation hit of about 10%. Ugly? No – Very Ugly!

However, even that gloomy picture has been put into the shade in the UK through a combination of unique political and financial market turmoil.

In short, September saw poor communication of a new, arguably inappropriate growth-oriented government policy from PM Liz Truss and Chancellor Kwasi Kwarteng to be financed mostly by new government borrowing.

Given an already meaningful amount of UK debt needing to be sold (from a combination of the Bank of England unwinding QE and the existing negative ongoing fiscal position), the somewhat gung-ho, sloppy policy delivery led to a material repricing of UK interest rate and credit risk. Gilts and £-denominated corporate bonds sold off heavily. By itself, that repricing would be a challenging but manageable event: the UK has a solid AA/A credit rating from the major agencies, UK government debt is on average quite long duration (meaning that we are not under huge short-term re-financing pressures) and under normal circumstances there is good demand for corporate bonds from banks insurance companies and pension funds.

However, there turned out to be a hidden systemic point of failure in the financial system – derivatives used by UK defined benefit (DB) Pension schemes: LDI (Liability-driven Investment) swaps.

In very broad terms, DB Scheme regulation from the late 1990s forced the purchase of Gilts and other bonds over many years in order to match cash flow liabilities. As Gilt Yields fell, schemes entered into derivative swaps whereby the scheme paid the secure Gilt cash flow in exchange for some higher, variable yields including inflation-adjusted payments. Leverage was needed for the schemes to earn enough to meet the estimated liabilities. This was all “ok” and stable expect for the fact that the security collateral for the swap was often a UK Gilt and if long-dated, e.g. 30 years, the price falls due to the “Mini Budget” created a huge downward spiral as cash collateral calls meant more selling - which pushed prices down.

Selling what they could to meet collateral calls, the DB schemes drove prices down even further, creating a negative feedback loop which was broken only by formal Bank of England intervention to support the long end of the Gilt market.

Is there any good news?

One silver lining in this maelstrom is that more than £100 billion of £-denominated corporate bonds are trading with cash prices below 80, meaning that at a return of at least 25 % (20/80) is available to investors and often a lot more.

UK tax rules offer a meaningful benefit to individuals who hold bonds directly in taxable accounts – as opposed to in a non-transparent fund wrapper. There is currently a “once in 30 years” opportunity to create model direct bond portfolios for the UK Wealth Management and Private Banking markets.

Recently I have been able to purchase Provident Financial (1 year), ESURE (2 year) Phoenix (9 year) and M&G debt (25 years) all at **10 % annual yield!** These businesses will undoubtedly face challenging times as the combination of food and energy price inflation, higher interest rates and slowing economic activity hurt consumers, but they are large enough and well capitalized enough to withstand even a deep recession without risk of default. If we can continue to re-invest cash from maturing bonds and recycle into 10% yield assets then we will not only make money but over time we will deliver positive real returns because it is wholly unrealistic to expect inflation to remain at 10% and compound there for several years.

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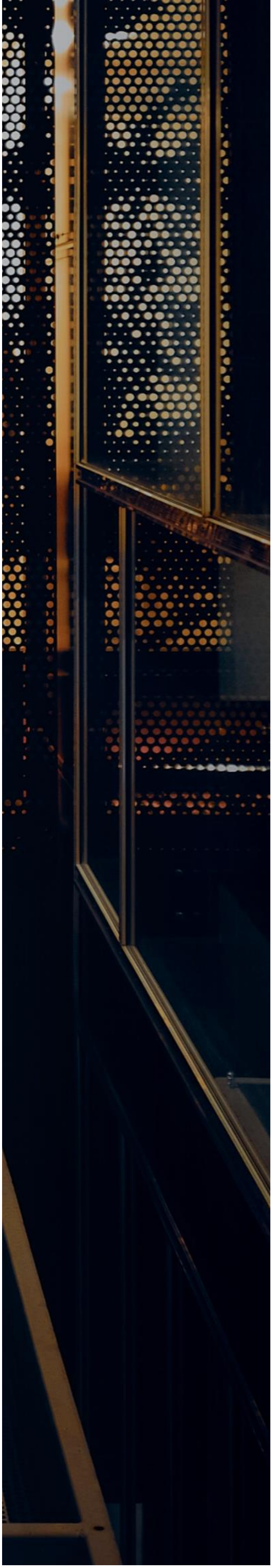

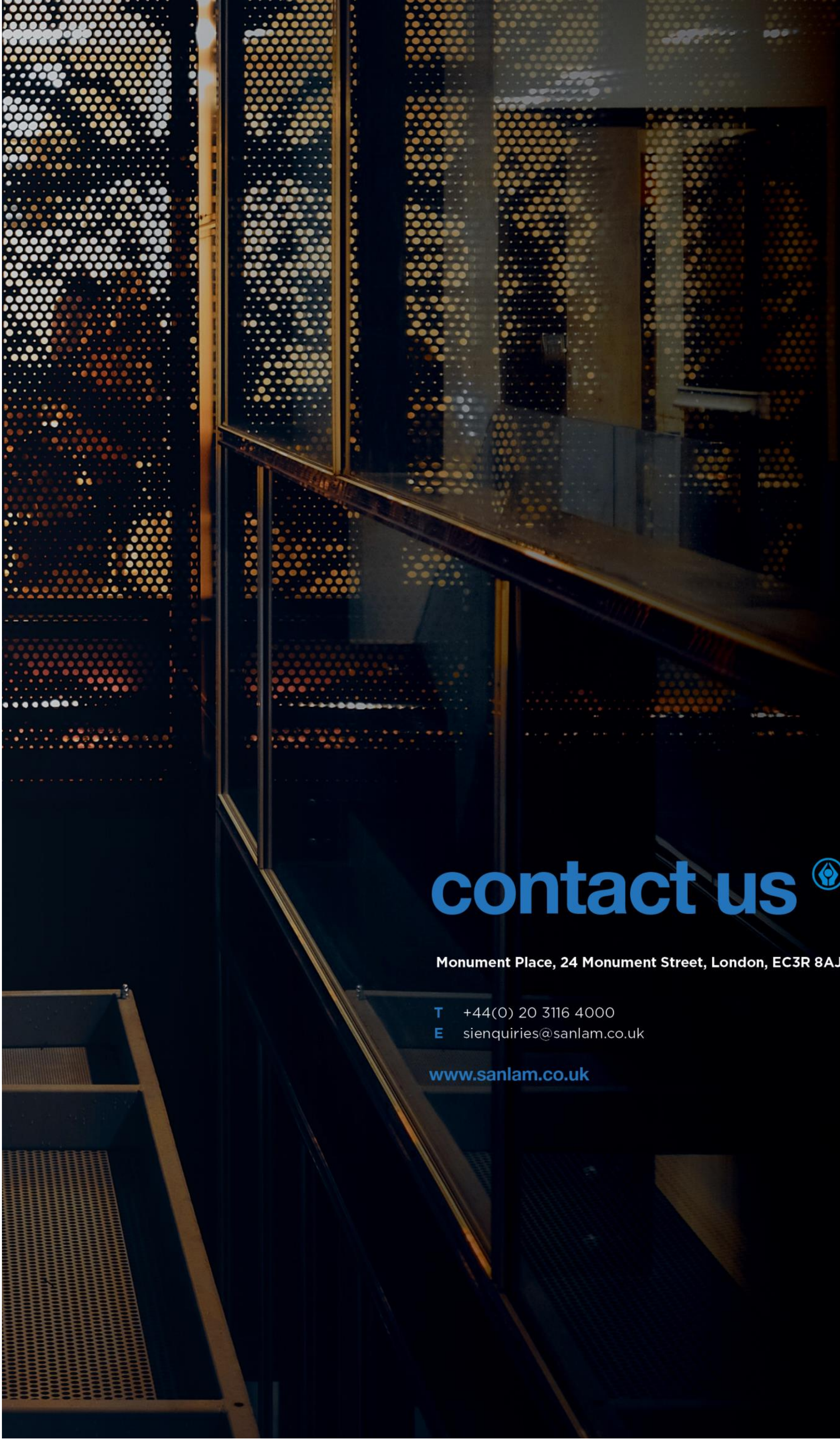

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