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OCTOBER 18, 2022

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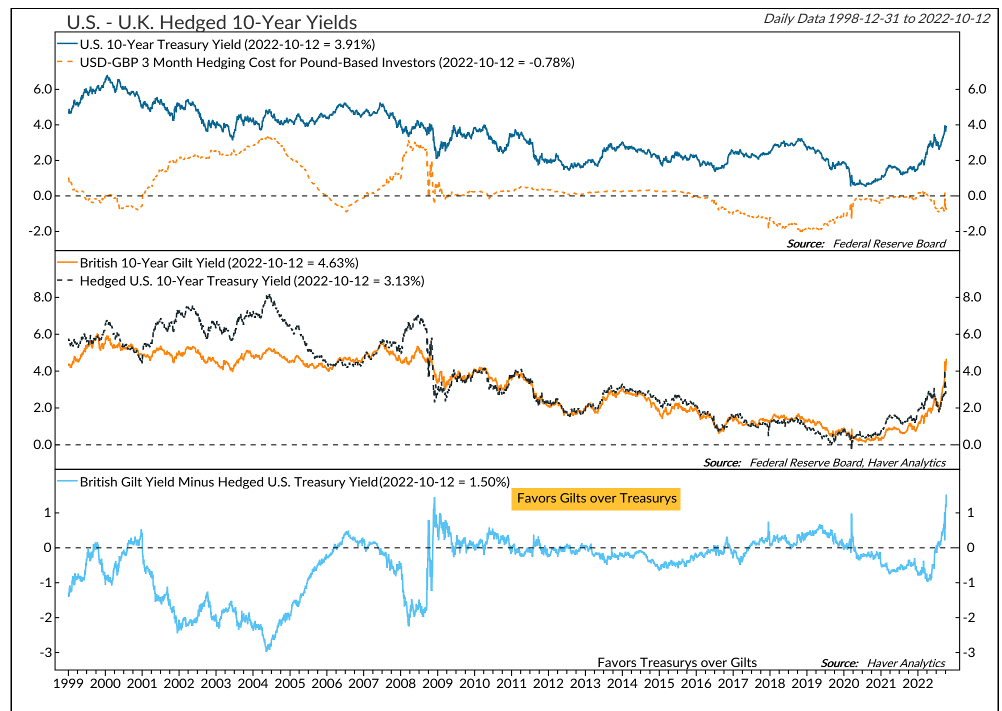
What is the Bank of England fighting?

Key Takeaways

- The BoE is fighting fires on multiple fronts. We don't want to fight them, but we're not sure how to align ourselves.
- The U.K.'s bond market is becoming irrelevant, having shrunk by 37% in relative terms to 4.4%.
- The Treasury is right to worry about liquidity. Urgent action is needed.

U.K. investors might be better off staying home



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Last week we discussed one of the main tenets of the NDR philosophy and our Ten Rules of Research – Don't Fight the Fed! But we apply that rule globally to include all central banks, especially one of the majors.

But with the Bank of England (BoE) it is not clear what it is fighting:

1. Inflation
2. Illiquidity
3. The government
4. The asset management industry
5. All of the above

Ultimately, the BoE has to fight inflation, so higher rates and a flatter curve should be the result. For now, we remain underweight British bonds in a global portfolio with just a 1% weighting.

Even with a reworked budget, the Truss government has lost a lot of credibility to the benefit of the opposition Labour party. But it's not obvious what Labour could do to improve the inflation picture. It may make it worse.

Less relevant

Ever since Brexit, the BoE has been moving to becoming a second tier central bank, if it is not already there. Among the top four developed bond markets, the U.K. has slipped from a peak of 7.0% in July 2015 to 4.4% today.

But investors in the U.K. bond market may be better off staying home on a currency-hedged basis, as shown on the chart.

We have dramatically reduced our weighting in the Sterling Aggregate to a paltry 1% from 10% in early August.

If Yellen is worried about liquidity, you should be too

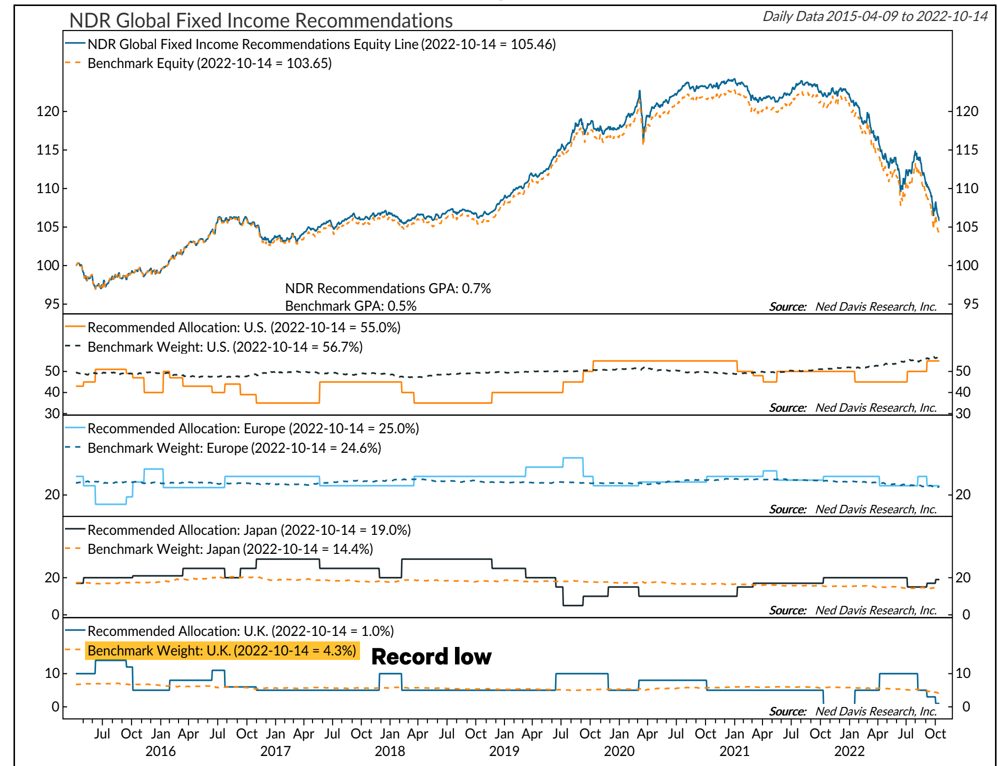
Speaking of liquidity, last week Janet Yellen expressed concern about the lack of liquidity in the U.S. Treasury market.

Please see important disclosures at the end of this report.

Remember, Janet Yellen is now the Treasury Secretary; she is no longer the chair of the Fed.

But her pal current Fed chair Jay Powell has been steadily destroying liquidity from the bond market, as we haven been discussing all year. We have featured the bottom chart but added the QT timeline to show how bad things have gotten with each step of QT. If this keeps up, the unwind of the balance sheet to its stated goal seems aspirational at this point.

U.K. bond market has shrunk by 37% in relative terms



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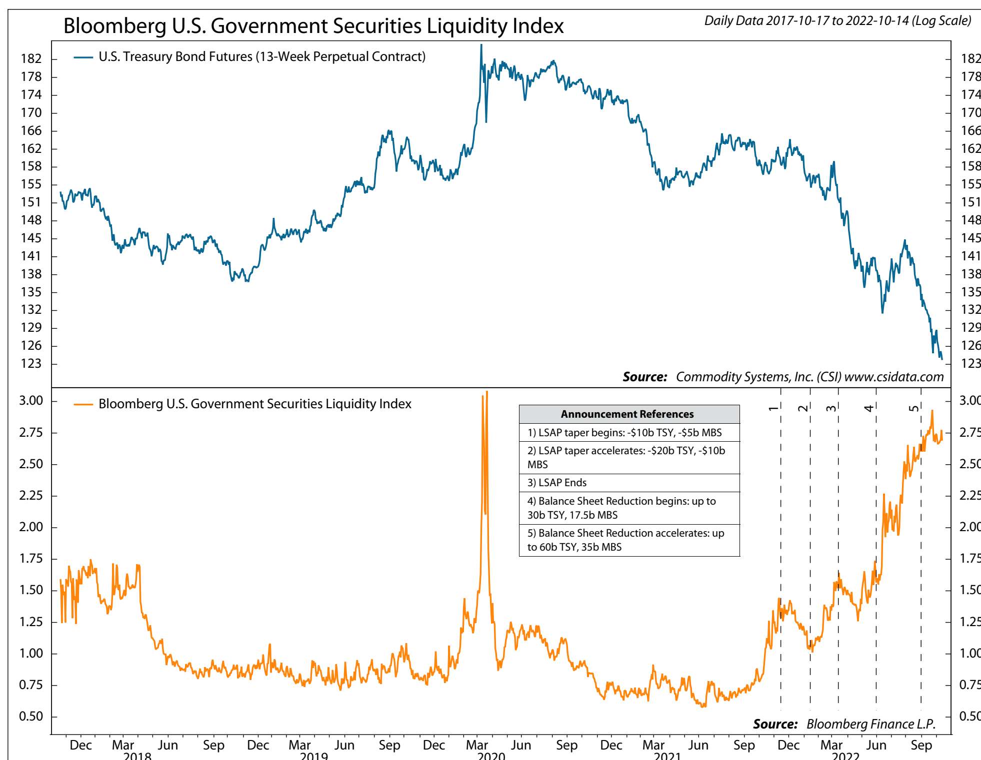
Treasury liquidity is as bad as it was in March 2020



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Additionally, continued problems with U.K. pension funds could spill over into the U.S. market either in terms of British funds selling Treasurys for liquidity needs or investors taking a closer look at other funds using LDI strategies.

Last quarter the Treasury asked its Treasury Borrowing Advisory Committee (TBAC) about whether Treasury should consider regular buyback operations to improve liquidity, among other objectives. The TBAC concluded that poor liquidity likely raises Treasury yields. Buybacks could also reduce the amount of higher-yielding securities and replace them with lower yielding securities. That kind of proposal makes sense. The Treasury should work expeditiously with the dealers to make this happen. Time is of the essence.

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NDR HOUSE VIEWS (Updated October 13, 2022)

For global asset allocation, NDR recommends underweight allocation to stocks, overweight allocation to cash and marketweight allocation to bonds. We are underweight stocks in response to new lows and bearish model readings.

Equity Allocation

U.S. | We are underweight stocks on an absolute basis and relative to bonds and cash. The hawkish Fed has overwhelmed the positive tape development in the summer. We favor small-caps over large-caps and are neutral on Growth versus Value.

INTERNATIONAL | We are overweight U.S., underweight Europe ex. U.K., and marketweight on all other regions.

Macro

ECONOMY | The global economy is in a sustained slowdown due to waning monetary and fiscal support, stubbornly high inflation, and rising geopolitical risk. While the slowdown remains moderate, the risk of severe recession increases in 2023. Global inflation pressures are easing but will remain historically elevated in the foreseeable future.

FIXED INCOME | We reduced our bond exposure to 95% of benchmark duration and expect the yield curve to flatten. We are overweight Treasurys, MBS, and CMBS and underweight high yield. We are marketweight everything else.

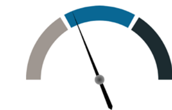
GOLD | Downtrend intact with relatively restrictive central bank policies. We are bearish.

DOLLAR | Recognizing strengthening trend and positive composite readings, we are bullish.

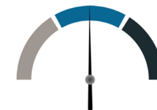
Economic Summary

October 17, 2022

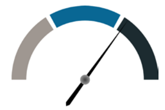
Near term activity: ● Accelerating ● Neutral ● Decelerating



Global Economy
(2.9%)



U.S. Economy
(1.5%-2.0%)



U.S. Inflation
(4.0%-4.5%)

Economic gauges reflect changes in near-term economic activity. Numbers in parenthesis refer to NDR 2022 forecasts.

Global Asset Allocation

● Overweight ● Marketweight ● Underweight

- Overweight: Cash (15%)
- Marketweight: Bonds (35%)
- Underweight: Stocks (50%)

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Equities — Regional Relative Allocation

- Overweight: U.S. (66%)
- Marketweight: Emerging Markets (11%) | Japan (5%) | U.K. (4%) | Pacific ex. Japan (2%) | Canada (3%)
- Underweight: Europe ex. U.K. (9%)

Benchmark – U.S. (61.1%), Europe ex. U.K. (12.2%), Emerging Markets (11.4%), Japan (5.6%), U.K. (3.7%), Pacific ex. Japan (3%), Canada (3.1%)

Global Bond Allocation

- Overweight: Japan (19%)
- Marketweight: U.S. (55%) | Europe (25%)
- Underweight: U.K. (1%)

Benchmark: U.S. (57%), Europe (25%), Japan (15%), U.K. (4%)

U.S. Allocation

- Overweight: Cash (15%) | Small-Cap
- Marketweight: Bonds (35%) | Growth | Value | Mid-Cap
- Underweight: Stocks (50%) | Large-Cap

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Sectors

- Overweight: Health Care (17%) | Energy (5%)
- Underweight: Financials (7%)

Benchmark: Technology (27.5%), Health Care (13.6%), Financials (10.6%), Communication Services (10.0%), Consumer Discretionary (9.5%), Consumer Staples (6.9%), Industrials (7.8%), Energy (3.7%), Utilities (2.7%), Real Estate (2.7%), Materials (2.5%)

U.S. Bonds — 95% of Benchmark Duration

Please see important disclosures at the end of this report.

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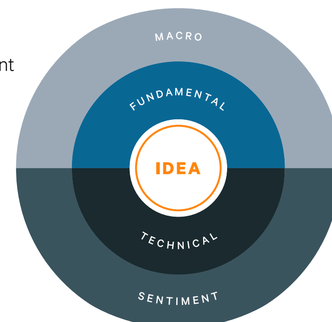

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