Santander Asset Management

About Investing

Market conditions mean challenges for portfolio construction

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Even as nations and economies grapple with higher inflation and continue to manage the fall-out of COVID-19, investment professionals must focus on the longer-term and the challenges which lie ahead.

Between the ongoing economic impacts of the pandemic, rising inflation, the war in Ukraine and an ever-increasing focus on environmental, social and governance (ESG) considerations, there are a number of challenges facing those who construct and manage portfolios. Challenges that advisers will want to be alert to in deciding where to place their clients' money.

The inflation outlook for bonds

Ever since the Global Financial Crisis ushered in a new era of monetary policy, bond yields had been falling. A combination of low interest rates and quantitative easing pushed bond yields from over 5% before the crisis hit in 2007 to a record low of 0.1% at the end of June 2020.[1] There were few inflationary pressures during this period as the rise of Chinese manufacturing depressed consumer prices, ageing populations kept growth lower and technology brought down production costs.

More recently, for the first time in more than a decade, inflationary concerns have returned and bond yields are on the rise again.

Inflation at 40 year highs

In June 2022, inflation in the US reached 9.1% before falling to 7.7% in October 2022. In the UK, inflation hit 11.1% in October 2022, a 40 year high in the UK.[2] In its July 2022 World Economic Outlook, the International Monetary Fund (IMF) revised up its global inflation forecasts and said taming inflation should be the first priority for policy makers.[3]

Impact on the bond market

The inflation levels we are facing have caused yields to spike higher (and prices to drop) for longer-dated bonds. For example, 10-year US treasuries rebounded from a record low in mid-2021 to reach over 4% by late October 2022 before falling back below 4% in early November.[4]

Investors in fixed income today arguably face significantly lower risk than those who invested 12 months ago, with yields 3% higher at 4% [5], investors have a very different entrance point.

Many experts claim that most of the carnage is over, therefore now could be a great time for bond investors.[5] Steve Laipply, Head of US iShares Fixed Income ETFs, BlackRock, says 'Most economists believe the Federal Reserve (Fed) will succeed at cooling the economy. If you have this view, bonds look attractive. We haven't seen yields at these levels in years.' [5]

When interest rates were nearly zero, investors had to purchase riskier bonds to generate a respectable return on their investments.[5] However, you no longer need to look very far thanks to the latest interest rate increases. This, combined with the positive market outlook, makes the overall risk profile for bonds significantly lower than they were last year.

Although there has been a correlation between equity and bond markets this year,[5] the normalisation of interest rates and yields should improve the outlook for diversification going forward.

The correlation between government bond markets and various interest rate dependent parts of the stock market is increaslingly clear. High growth technology companies are an obvious area, where valuations have risen on the back of low rates. but a number of the 'bond proxy' stocks (equities that investors buy mainly for their yield) also look vulnerable to higher rates. Real Estate Investment Trusts, for example, are considered sensitive to interest rate increases because

Environmental, social and governance (ESG) considerations

One clear long-term trend is ESG and sustainable investing. Although the COP27 UN Climate Change Conference was held recently, its predecessor, the COP26, will go down with more historic significance as it managed to produce a raft of pledges to scale up clean power and ensure a 'just transition', while several countries set out more detailed plans to reduce emissions.[6]

Fund managers will need to consider a package of new regulations being put forward by the Financial Conduct Authority (FCA) to combat 'greenwashing', including investment product sustainability labels and limitations on the use of terminology like 'ESG', 'green', and 'sustainable'. The measures are among several potential new rules which will protect consumers and improve trust in sustainable investment products.

What is greenwashing?

Greenwashing is the process of conveying a false impression or misleading information about how a company's products are environmentally sound. Greenwashing involves making an unsubstantiated claim to deceive consumers into believing that a company's products are environmentally friendly or have a greater positive environmental impact than they actually do.[9]

There has been growth in the number of investment products marketed as 'green' or making wider sustainability claims. Exaggerated, misleading or unsubstantiated claims about ESG credentials damage confidence in these products. The FCA wants to ensure that consumers and firms can trust that products have the sustainability characteristics they claim to have.

Matching clients to solutions

It's important to look beyond labels and really get under the skin of a portfolio. As the impact of the pandemic fades and new challenges emerge, advisers should play close attention to the underlying assets and objectives when selecting and recommending investment solutions to clients. While ensuring the goals, time horizon and investment objectives are aligned and appropriate.

Find out more

Learn more, visit our website here for more insights into financial markets.

[1] Investing.com, 14 June 2021
[2] CNBC, 13 November 2022
[3] CNBC, 10 November 2022
[4] Market Watch, 14 May 2021
[5] CNBC, 10 November 2022
[6] House of Commons Library, 27 January 2022
[7] Finance Disputes, 4 February 2021
[8] Investment Week, 5 July 2022
[9] Investopedia, 28 November 2022

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