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BROAD FIXED INCOME WEAKNESS

The consensus view among investors seems to be deflation is finally coming to an end, to be replaced either with inflation or even stagflation. If that turns out to be the case, all types of fixed income such as conventional and index-linked gilts (ILG), corporate bonds, and high yield credit will suffer.

Although counter-intuitive, index-linked bonds hold the greatest danger of all as it takes a much greater price move to change the yield on an ILG than it does on a conventional gilt. ILGs went up much more in the bond bull market and currently offer a negative yield.

It follows that these will fall much more in a bear market until their yield is better aligned with other fixed income assets.

The reason is that if conventional gilts move to a positive real yield as is likely, then ILGs will also decline in value to a level where they offer a positive yield.

Anyone looking to switch conventional bonds into index linked bonds at the current yields because they are worried about inflation has simply no understanding of the driving forces that determine ILG prices.

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