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Summary – Britain is great – at least at quite a lot of Olympic sporting events. The economy might still not be that bad either. Financial conditions are very supportive and some of the limited amount of hard data we have had since the EU referendum has surprised to the upside. The fall in the exchange rate is usually good for the British economy. If it boosts growth relative to expectations in the near term and the new chancellor kicks off his term in office with a relaxation of fiscal policy, then bond yields might be rising again before too long.

- **Re-starting the printing press** – Reading about the Bank of England (BoE) cutting the bank rate to 0.25% and re-starting quantitative easing (QE) while I was away got me re-thinking about the effectiveness of monetary policy and how exactly QE is supposed to deliver higher growth and inflation. It is well understood that the economic malaise that many developed countries face is a lack of aggregate demand – the total of consumer spending, corporate investment, government spending and net spending on exports from overseas. How does the central bank buying more government bonds help boost any of these areas of spending? It is a fundamentally important question because we have had several years of unconventional monetary policy and we are still concerned about growth not being strong enough and inflation being too low. Now the BoE is responding to the potential hit to growth from 'Brexit' by doing more unconventional stuff. I know it is not a new line of enquiry to question the effectiveness of the current monetary policy stance but it is worth just thinking about it now and again. How does the BoE buying long-dated gilts end up in Mr and Mrs Smith spending more down the local high street? If the answer is that it doesn't, not very effectively anyway, then the debate around the use of fiscal policy is likely to intensify.

- **How does spending benefit** – Conventional economic theory tells us that the most important determinant of the level of spending is the level of income. The more you get paid, the more you can spend. Income comes from employment and other forms of non-wage flows like dividends, rent, transfers and interest. How much of your income you can spend depends on the level of taxes and how much you want to spend of what is left over depends on the preference between consumption today and consumption tomorrow (saving). How much you save depends on expected rates of return, future liabilities and precautions against something unforeseen happening. But a lot of this goes back to the level of income that your receive in the first place. In the aggregate, the level of income in the household sector depends on the level of employment. So if consumers are not spending enough to boost GDP (and keep in mind that consumer spending is typically between 65% and 70% of GDP) then how can QE help? Clearly there is no direct impact on income. The effects are more indirect and, therefore, less reliable. First there is the impact of lower interest rates. This reduces the cost of debt service to borrowers which means there is potentially more disposable income to spend. Lower interest rates may also discourage saving and encourage more borrowing, both of which can boost spending. However, there is also the possibility that people save more when interest rates fall in order to protect the level of future income. Secondly, QE boosts asset prices. This provides a positive wealth effect to owners of financial and other assets. This increase in wealth can encourage more spending as people feel richer. It could also encourage additional borrowing against the increased wealth and that could boost spending too. However, there are a lot of –'ifs, buts and maybes'- in this train of thought. For one thing, the distribution of ownership of financial assets through the household sector is uneven with more wealth concentrated in higher income brackets and research has suggested that these have a lower propensity to consume. So QE can impact spending but it is rather hit and miss. In contrast, cutting income tax directly boosts disposable income. Increased government spending directly creates an increase in income through higher spending on goods and services and more employment. It is not hard to see that fiscal policy is more direct than monetary policy. Economists will argue that Ricardian equivalence exists which means households will save more if the government spends more in anticipation of taxes going up in the future, thereby neutralising the fiscal expansion. However if some of this is 'monetised' via QE then this condition may not hold.

- **Pounding lower** – The same logic holds for the impact on corporate spending. QE does not directly impact corporate revenues and only will if consumer spending picks up. However, it does reduce the cost of capital so creating opportunities to increase investment spending. Perhaps there is more scope to pay dividends if interest costs are less, boosting household sector income. But maybe companies won't invest if there is no visible sign of revenues increasing. A lower exchange rate should help, coming about as a result of monetary easing, as it will positively impact on net external demand and reduce consumption of imports, thus adding to GDP. This is likely to be the most obvious transmission mechanism for the UK economy, at least in the short term. In the past the UK economy has shown itself to be incredibly sensitive to movements in the exchange rate. There is no shortage of examples of a big sterling depreciation leading to a growth spurt. It happened after Britain left the European Exchange Rate Mechanism in 1992 and again following the decline in the value of the pound after the banking collapse of 2008. One potential source of upside economic surprises could be the response of net exports to the decline in the pound's value. With a large current account deficit this is certainly welcomed.

- **Economy, better than some think?** – So far the most recent policy of UK asset purchases has boosted asset prices. Gilt yields are much lower than at the time of the referendum (85 basis points on 10-year, 95 basis points on 30-year) and equity prices are much higher (FTSE100 up 10%, FTSE250 up 20% from the post-referendum low). The sterling trade weighted exchange rate is 12% lower than its value on the day of the referendum. So financial conditions have eased considerably in the wake of the Brexit decision and it is little wonder that, so far, the economic data has not justified the most gloomy of predictions about what would happen to the UK economy. Just look at the retail sales data for July. The Bloomberg consensus was for a modest rise of 0.1% but instead sales were up 1.4% on the month. Inflation in July was marginally higher than expected as well, and the labour market has held up so far with 8,600 fewer people claiming unemployment benefit in July. Prior to the referendum, employment growth remained strong (and remember there was a lot of talk about companies being cautious ahead of the vote even if the opinion polls had been suggesting a victory for Remain). In the three months to the end of June, the UK economy created 172,000 new jobs.

- **Curve flattening to go** – So what does this all mean for sterling bonds? The rally in the market since the BoE signalled further easing has pushed UK interest rates and bond yields closer to core European markets than to the US. Looking across the bond complex, the search for a 3% yield is a pretty forlorn one on this side of the Atlantic. One has to delve into lower rated parts of the bond market in both euro and sterling to get 3% and, indeed, that means going to the single B bucket and below in European high yield markets. The US is still different with most high yield sectors still above 3% and the longer maturity parts of the investment grade market also offering that level of prospective return. Back to the UK though and the movements in gilt yields have been very interesting. The curve has flattened and the spread between 10-year gilts and the base rate is now roughly the same as the spread between 10-year Bunds and the European Central Bank's deposit rate. If we take Mark Carney at face value in terms of his reluctance to reduce UK interest rates into negative territory, then there may not be much more scope for 10-year yields to decline a great deal more. However, the spread between 30-year gilts and the bank rate is greater than the equivalent in Germany and there still seems more scope to see long dated yields fall in the UK, especially with the supply and demand dynamics at the long end of the curve. This is more of a tactical trade in terms of relative value on the curve given the QE environment. Its merits as a buy and hold investment though are questionable given the current market price of 152.38 and a 3.5% coupon for the next 30 years…the yield to maturity is just 1.29%.

- **Over to Number 11** – Much depends on the policy mix now. There is certainly more debate about how fiscal policy could be used along with unconventional monetary policy to address the deficiency in aggregate demand. If any increase in government budget deficits is funded by central bank buying then interest rates and bond yields could stay low. If the government spends on infrastructure funded by an increase in the central bank balance sheet then there is no liability to the private sector yet the economy benefits from a net increase in the capital stock. Yields might rise if this is deemed to boost future growth and some of the additional debt could probably be sold to pension funds and insurance companies. Let's see what the government announces in the autumn but the mood music seems to be some relaxation of fiscal policy in the UK which could ultimately put a floor under yields at or near current levels. The technical momentum remains very strong in the bond market but valuations are crazy and if the policy regime changes even a little then the long period of declining rates could be reversed somewhat.

- **Yield where there is risk** – Elsewhere in the bond market you can get a higher potential return for taking higher risk. While the high yield markets as a whole are now priced for perfection, the lower rated single-B and CCC cohorts offer some eye-watering yields – around 13% in both the US and European markets for bonds rated CCC. But make no mistake, these are risk assets. The default rate expectations are significantly higher than in the rest of the high yield market. According to Standard & Poor's, the long-term average default rate for US corporate bonds rated CCC and below is 25% compared to 3.8% for single B-rated. That is a big jump in risk and explains the 7% difference in yield between the single-B Bank of America/Merrill Lynch (BAML) index and the equivalent CCC index. It is more like equity risk in terms of expected volatility and the correlation with risk-free fixed income assets. The excess return of the CCC index has been negatively correlated to Treasury returns over the last 10 years to the tune of -0.44. At the moment the oil sector still represents most of the default risk but with oil prices rising above $50 per barrel the yield of close to 19% at the front end of the CCC sector in the US market should attract yield hungry investors, at least in the short term with continued good momentum in the market.

- **True Brit** – What a summer of sport. Acute embarrassment at England's display in the Euro's has given way to tremendous pride at the performance and medal haul of Team GB in Rio. Clearly investment pays off in the long-term and the establishment of lottery funding for sport in the UK marked the beginning of the huge improvement in GB's success across a wide number of disciplines. The fact that so much money has gone into football in this country, because of ever bigger television coverage deals, without noticeably benefitting the national team is a scandal. It seems that once the club owners, the agents and the players have taken their share of the TV rights, there has not been much left for investing at the grass roots level – which is in contrast to what has happened in cycling, athletics, gymnastics and rowing. Maybe it will change but in the meantime the gorging circus of the Premier League is underway again. One game is not much to go on but United seem to have a better chance of challenging than they have the last couple of years. Liverpool will be unpredictable, Arsenal will find it hard to grind out more than fourth and a 5,000 to 1 shot is very unlikely to win the league. Maybe it's the halo of glory around seeing the likes of Jason Kenny, Mo Farah, the Brownlee brothers and Laura Trott dominate their events in Brazil, but I don't quite see football in quite the same life affirming way at the moment. So hail Britannia and long may our Olympians continue to enjoy success.

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All data sourced by AXA IM as at 19 August 2016.

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