About Investing

What does higher inflation mean for bonds?

Investors have become accustomed to uncertainty in recent years and the first half of 2022 brought more of the same, with bond investors in particular now feeling the effects of challenging economic times.

Against a backdrop of rising inflation, driven by factors such as global supply chain challenges, an energy and food price squeeze exacerbated by the war in Ukraine, and labour shortages in some economies, investment markets have had plenty to think about.

The economic environment isn't just affecting bonds. Share prices are under pressure too with, for example, many of the big technology names that led market growth in 2021 suffering sharp falls so far this year. The Nasdaq Composite index is one of the three most followed US stock market indices. It's weighted heavily to technology and was down 23% by 31 May, compared to 13% for the broader S&P 500, which tracks the fortunes of 500 of the largest companies listed in the US.[1]

A perfect storm for bonds

Bonds are loans issued by a government or a company. When you buy a bond, you are essentially lending the government or company money which they promise to repay after a set period of time, often with a set amount of interest or income.

Inflation tends to be bad news for bonds because it eats into the future buying power of the fixed income they provide. As Central Banks start to raise interest rates to try to contain inflation, bonds that better reflect future rate rise expectations in the interest they offer also tend to become more popular. The overall effect is to push down the market value of bonds.

Inflation is at record levels around the world

Global bond markets suffered their biggest fall for more than three decades in March, as they reacted to rising inflation and the prospect of interest rate increases. By the end of April, UK inflation had reached a 40-year high of 9%,[2] remained close to a 40-year high in the US at 8.3%[3] and 7.4% in the Eurozone.[4] Many commentators are predicting further increases over the coming months and Central Banks are making clear their determination to cool things down through further rate rises and other measures to reduce money supply in their economies.

Any investment comes with some level of risk

All of this means that if you're invested in bonds, you may notice that values are down compared to what you're used to and that the buying power of the income you receive from them isn't what it used to be. It's only natural to be concerned about the longer-term impact.

Bonds are often perceived to be a 'safe haven' asset. For several decades now they have also been basking in the glow of a long, steady bull market supported by a downward trend in inflation and, so, interest rates. Following the Global Financial Crisis of 2008/9 rates were reduced to record lows by Central Banks and then held there until very recently.

But while the risks associated with most types of bonds are generally lower than for shares, the impact of current economic conditions reminds us that no investment is risk free.

The main types of bonds you might invest in directly or indirectly include:

- **Government bonds** - also known as sovereign bonds or gilts, these are issued by governments. They are considered the safest form of bond due to the very low risk of a government defaulting on payments.
- **Corporate bonds** - issued by companies to raise money from investors, often to grow or develop the business.
- **Investment grade corporate bonds** - issued by companies considered most financially secure and least likely to default on their loans.
- **High-yield bonds** - issued by less stable organisations, with a higher rate of interest to compensate for the higher chance of defaulting.
- **Inflation-linked bonds** – also known as index-linked bonds. Typically issued by governments, the value and income from these bonds move in line with inflation, as measured by the Retail Price Index (RPI).
- **Short-dated bonds** - usually mature after between one and three years.
- **Long-dated bonds** - typically mature in 10 years or longer.

A mixed range of investments helps you weather volatility

While bond returns are typically poor during periods of high inflation, they can provide valuable income when inflation and prices fall. Shares tend to behave differently.

Inflation can act as a natural drag on the value of returns investors receive. But certain sectors and companies can do particularly well in times of higher inflation and some businesses may have more opportunity than others to increase their prices to keep pace.

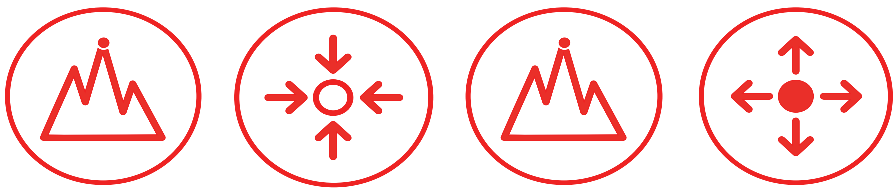
All of this underlines why diversification is so important to help manage risk. Diversification is spreading your money across different investments which tend to behave differently to other asset classes as the economic cycle ebbs and flows.

The closest thing to a free lunch

The principle of diversification came from Modern Portfolio Theory (MPT) in 1952, which showed that investors can reduce the overall risk in their portfolio and match it more efficiently to their risk appetite, with a mix of assets that don't react in the same way to the same market conditions. MPT's creator, Harry Markovitz, argued that 'diversification is the only free lunch in finance'.[5]

Patience is a virtue

History shows that investment markets are always operating against the background of an ongoing economic cycle - peak, recession, trough, and expansion (or recovery) - but we never know how long each stage will last. Investing is for the long-term and that means we can't predict how long it will take for bond investors to see an upturn in values.



Peak	Contraction	Trough	Expansion
The economy hits a high point.	Growth in the economy is going down.	The contraction comes to an end.	The expansion is on the up again.

If you're invested in bonds, don't need access to your money in the short to medium-term and your risk appetite and life circumstances haven't changed since you set your long-term investment plan, then making changes as the economic cycle shifts may not be a good idea.

Selling your investments can be particularly risky at a time like this. You may make paper losses real, miss out on the chance of recovery and still see the buying power of your savings eroded by inflation.

The case for sticking with bonds

1. As a type of loan, the price of a bond on the open market may go up and down in the short-term, but unless the government or company that issued it fails, the holder will get back its face value at the end of its term. So, potential returns may be lower than for shares but bonds, and government bonds in particular, tend to come with a lower level of risk overall.
2. Bonds usually provide a set amount of income, regardless of market conditions – the amount of interest, or income, is agreed at the outset and doesn't normally change so the holder knows in advance how much to expect. Dividends on shares can vary considerably from year to year and may not be paid at all.
3. Bonds can add a good source of diversification to a portfolio – they tend to behave differently from shares, helping to balance out peaks and troughs in performance, whatever is happening in the markets. That means they can have a steadying influence in the most volatile of times.

Making it work for your investment portfolio

Fund managers have the ability and tools to make adjustments that help a fund's portfolio stay on course to meet its objectives in the most challenging of conditions. For example, they can adjust the balance of different bond types as well as the overall balance between bonds, shares and other types of assets the fund may be able to hold.

A diversified portfolio held in one or more funds, each with the benefit of professional fund management expertise, should see you through all market conditions over the long-term. There are always exceptions though. If your objectives or risk profile have changed since your portfolio was first recommended, or you have particular concerns about how current conditions could impact you, it may be helpful to talk things through with a professional financial adviser.

Learn more

Stay up-to-date with our latest **Markets and Insights** at **santanderassetmanagement.co.uk**.

[1] Money.com – Why tech stocks are doing especially poorly during the market sell-off, 31/5/22
[2] BBC – What is the UK's inflation rate and why is the cost of living going up? 23/5/22
[3] CNBC – Inflation barreled ahead at 8.3% in April, 11/5/22
[4] Eurostat – Euro area annual inflation up to 8.1%, 31/5/22
[5] Forbes Books - Diversification Is the Only Free Lunch

Asset Management

Let's be clear!

Investment terms explained

Asset class: A group of investments with similar traits. shares, bonds, property, cash and alternatives are all examples of asset classes.

Bond: A bond is a loan issued by a government or a company. When you buy a bond, the issuer promises to pay a certain amount of income until the bond redeems and is repaid by the issuer. The strength of that promise varies by the issuer of the bond. This is known as creditworthiness.

Bull: A bull market is often defined as having seen or expecting to see rises over a sustained period. An investor who is 'bullish' is one who feels optimistic about the future.

Diversification: Spreading your money across different investments to help manage risk.

Index: A way of tracking the overall performance of a basket of individual investments of a similar type. For example, the FTSE 100 index tracks the performance of Shares in the 100 largest companies by market value on the London Stock Exchange.

Inflation: Measures the increase in price of selected goods and services in an economy over a period of time.

Portfolio: A group of investments that are managed together to meet a particular objective.

Shares (often referred to as equities or stocks): In investing, this is a share of ownership in a company. Investing in a fund gives exposure to underlying share prices without investors actually owning the shares themselves.

Volatility: The extent to which the value of an investment fluctuates over time.

Important Information

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