COLOMA
WEALTH MANAGEMENT

2024 INCOME INVESTMENTS UPDATE

With the ink dry on the Rachel Reeves budget and the winner of the US Presidential election now decided I take a look at the outlook for UK income investments.

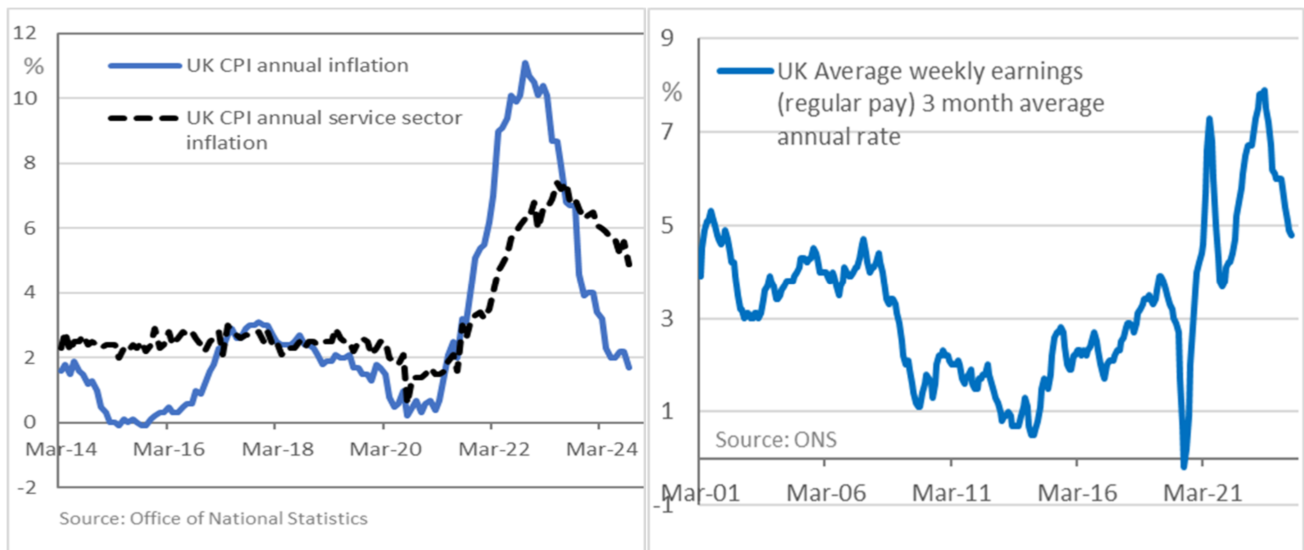
What is the outlook for inflation and interest rates in the UK?

Annual CPI inflation has fallen from a peak of 11.1% to its current 1.7%. The outlook for inflation in the next six months is for it to edge up to around 2.5%. This will be driven by the negative impact on the index of energy price deflation lessening. It also highlights that some underlying inflationary pressures remain. Whilst inflation rates in the goods, energy and food sectors have normalised service sector inflation has remained elevated and is currently 4.9% (see chart 1). High service sector inflation reflects the stickiness of wages and wage settlements (see chart 2). As it is a good indicator of domestically generated inflation it is the key variable that the Bank of England is focused on. Further rate cuts will be conditional on continued falls in wage growth and service sector inflation. The current outlook for wage growth is for a gradual decline as falling job vacancies and a return to a headline inflation rate of around 2% bear down on wage settlements. Additionally, the hike in employer national insurance contributions will also mean that there is less money for increases in wages. So, it is likely that service sector inflation gradually trends downwards which should allow the Bank of England to continue cautiously cutting interest rates.

Are UK bonds attractive on a fundamental basis?

Bonds, when compared to the interest rates available over the last decade, are currently attractive. 10 year UK government Gilts currently yield around 4.5% whilst high quality company bonds yield over 5%. This represents 2.5 to 3 percentage points in excess of the Bank of England inflation target. Whilst the Bank of England lost control of inflation in 2022 and 2023 it has shown itself determined to return it sustainably to 2%. Over the last year it has kept interest rates high in order to squeeze the remaining inflationary pressures out of the economy.

CHARTS 1 AND 2: UK INFLATION AND AVERAGE EARNINGS



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What are the UK risks for UK Gilts and Corporate bonds?

The prices and interest rates on bonds are generally determined by inflation and official interest rates. However, they are also determined by the supply of bonds. At the current moment in time, the UK government is the marginal borrower from the UK bond market. For this financial year it is looking to issue GBP 160 bn of new bonds. This is expected to fall to around GBP 100bn by the end of the decade. However, it would not be a surprise, in a slow growing economy with an ageing population, if there was some slippage in these projections. Material increases in the amount the government wants to borrow risk pushing interest rates on longer maturity bonds higher and prices lower.

What are the risks from abroad for UK Gilts and Corporate bonds?

The main risks from abroad, for the UK bond market, emanate from the United States and the new administration of President elect Donald Trump. One risk is that his campaign pledge to impose tariffs on US imports could trigger a global tariff war. In this case Britain would impose retaliatory tariffs against the United States that would make its imports more expensive. This would increase inflation in the short term and potentially push up bond yields. The other risk relates to Donald Trump's pledge to lower both personal taxes and corporate taxes. With the US government deficit already at around 7 percent of GDP there is not much scope for a large dose of unfunded tax cuts. Indeed, the US debt to GDP ratio of 120% of GDP is fast approaching Italy (140%) and Greece (160%)! Whilst there is no question about the ability of United States government to fund itself there is a reasonable possibility that the markets might demand a higher interest rate on future Trump bonds. If this were the case then interest rates on UK government bonds would also be expected to rise and prices would fall back.

What income investments are attractive in the current environment?

As outlined above, high-quality corporate bonds now offer an interest rate of above 5%. This is also attractive relative to the expected inflation rate of around 2%. The 5 to 10 year maturity range is probably the best area of the curve. This is because, if some of the risks discussed above force interest rates on bonds higher still, there is scope to sell these bonds and buy bonds in the 10 to 20 year maturity range. Examples of corporate bonds that are currently attractive are Heinz 6.25% 2030 and Tesco 5.5% 2033.

Amongst the property and infrastructure shares, Primary Health Properties offers an attractive yield of 7.2%. It rents out surgeries to General Practitioners and has increased the dividend for 27 consecutive years. Londonmetric offers a yield of 6.5%. It offers exposure to the logistics, healthcare and leisure sectors and has increased the dividend for the last 10 years. Finally, Cordiant Digital Infrastructure offers a medium risk option. It invests in fibre, communication towers and data centres. Revenues are growing at around 10 percent per annum and it offers a dividend yield of 5%.

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For information only. Investors should seek professional advice for their own circumstances before making an investment.