2025 INCOME INVESTMENTS OUTLOOK

In recent months there has been a big sell-off in income investments. With 10 year UK government gilt yields now approaching 5% we look at whether this represents a medium term buying opportunity.

What are the reasons behind the recent sell-off in the UK income investments?

UK income investments have sold off for two key reasons. Firstly, there has been a lot of concern that Trump's promised tariffs on US imports will be inflationary for the global economy. Secondly there has been disquiet, following the budget, over the amount that Rachel Reeves wants to borrow from the UK government bond market in the next few years. For example, the Office of Budget Responsibility projects that the government will need to borrow, net of redemptions, over GBP 100 bn per annum for the rest of the decade.

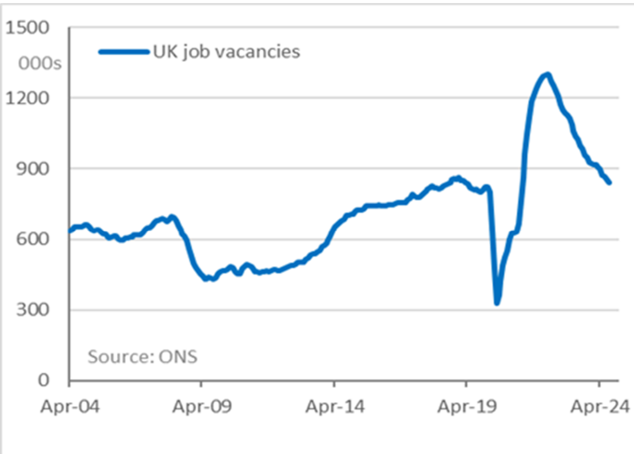
Will President Trump's policies be inflationary?

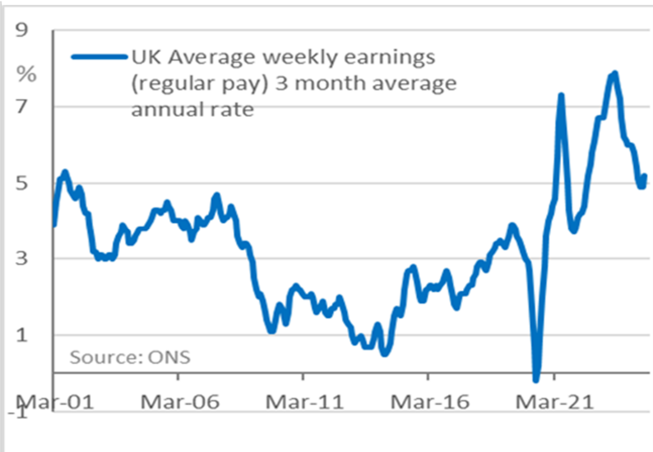
President Trump was elected on a platform of higher tariffs, lower immigration and lower taxation. With the US economy already close to full output the markets view these policies as potentially inflationary. Indeed, interest rates on US 10 year government bonds have risen a percentage point to just below 5%. For the global economy the campaign promise to impose a 10% universal tariff on all US imports is particularly problematical. Such a move would likely prompt retaliation from other countries thus pushing up inflation around the world. How literally to take his election pledges is difficult to judge. Some have argued that they should be interpreted as a negotiating tactic to further American interests. However, we will only know for sure when Trump takes office at the end of the month.

What are the key issues for the UK economy and financial markets?

For the UK the underlying issue is that the economy does not generate enough growth to pay for the rising costs associated with an ageing population. This partly reflects structural problems like planning policy and the provision of capital to grow businesses. However, it is also a function of the current high interest rates. Indeed, the Bank of England is currently constrained from cutting interest rates by high wage settlements that have fed through into high domestic inflation. So, the immediate question is when will wage growth normalise

CHARTS 1&2: A WEAKENING LABOUR MARKET SHOULD FEED THROUGH INTO SLOWER WAGE GROWTH





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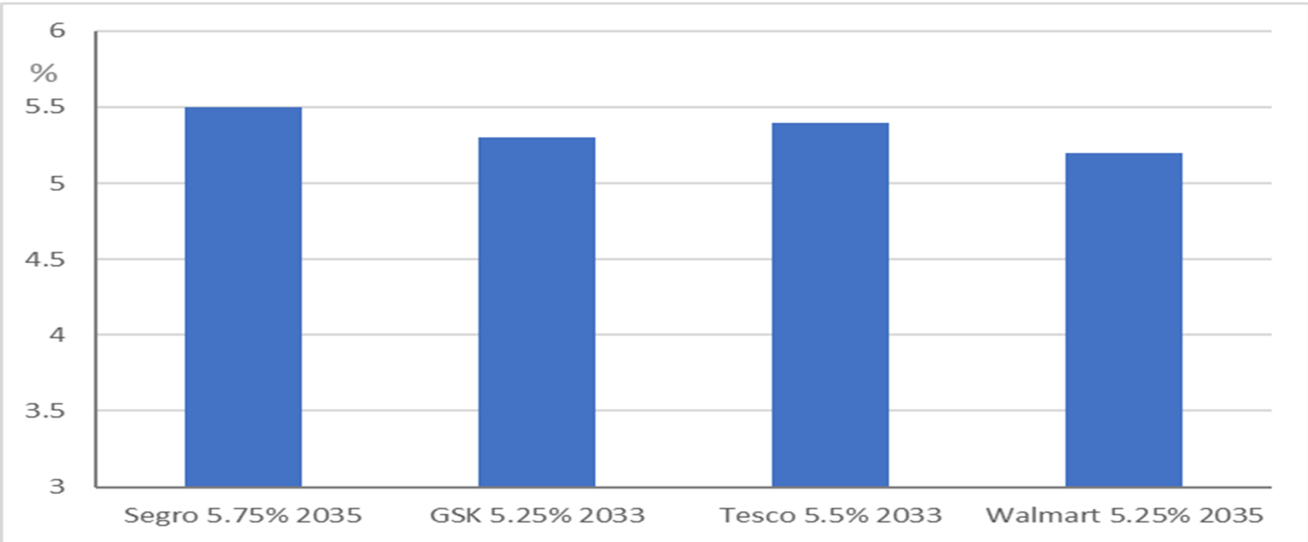
which in turn would allow the Bank of England to be more aggressive with its interest rate cuts. At present the UK economy is slowing with business confidence having taken a knock from the rise in National Insurance contributions announced in last autumn's budget. As a result, in the first half of 2025 I would expect the economy to flirt with recession. This in turn should exert some downward pressure on wage growth. So, there is a reasonable chance that rate cuts will speed up in the second half of 2025. More aggressive rate cuts would boost UK economic growth and give markets greater confidence in the trajectory of UK government debt. Although it should be noted that this scenario is contingent on a benign outcome for the global economy from Trump's tariff policies.

Are bonds attractive at current interest rates?

Over the past thirty years or so a risk premium of 3 percentage points over the Bank of England inflation target has been considered generous. This means that, assuming that inflation is roughly in line with the Bank of England target of 2%, the purchasing power of the invested money steadily rises each year. For much of the last decade 10 year gilt yields were sub two percent with corporate bond yields struggling to reach three percent. So, within the context of the last 30 years yields over 5%, on good quality 10 year corporate bonds, is very attractive. Please see below for examples of the interest rates available on longer dated bonds.

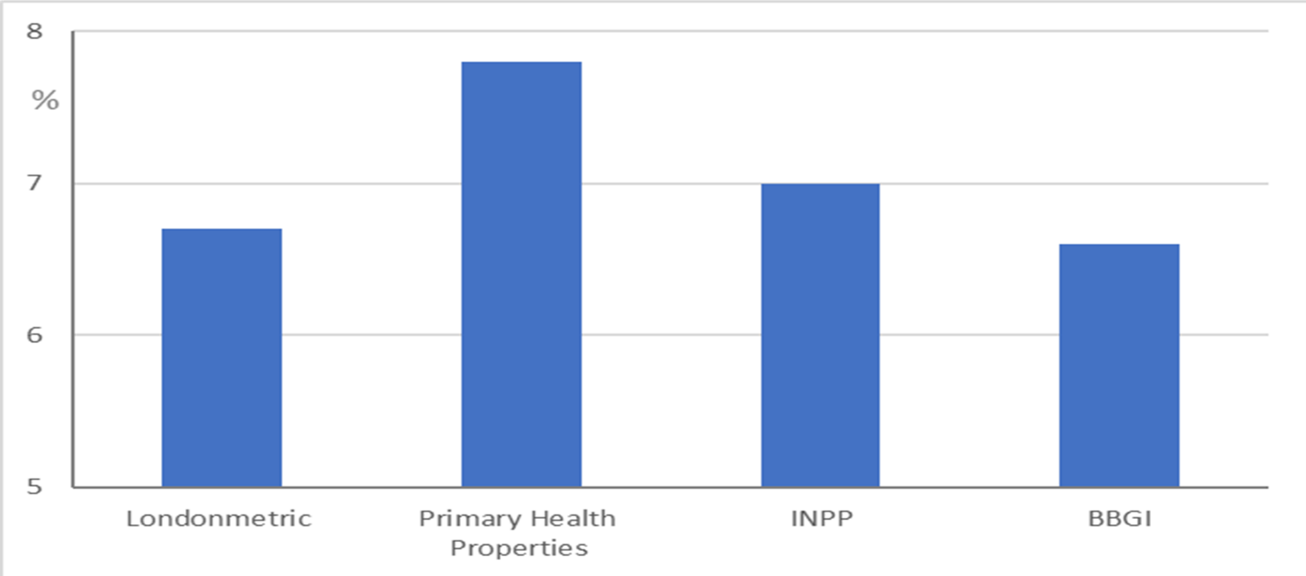
CHART 3: INTEREST RATES AVAILABLE ON LONG TERM CORPORATE BONDS



Are property and infrastructure shares currently attractive?

Property and infrastructure shares are higher risk than bonds and so have higher interest rates attached to them. Interest rates on lower risk property and infrastructure shares, where the company has a ten year track record of increasing the dividend every year, are currently around 7%. Considering the fact that there is the prospect of dividend growth as well as some capital growth these yields are very attractive. Please see below for some examples of the yields available and please note that the dividend is not guaranteed.

CHART 4 YIELDS AVAILABLE ON PROPERTY AND INFRASTRUCTURE SHARES



Conclusion

UK markets have priced in a lot of bad news associated with worries about the UK's debt trajectory and the potential inflationary nature of President Trump's policies. So, it seems sensible to buy longer dated income investments to lock in the current yields on offer. Some cash should be retained in portfolios for the situation where Trump imposes widespread tariffs on US imports. This would likely produce higher yields still.

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