

A better year ahead for gilts



With a recession looming, UK government bonds (gilts) should deliver positive returns in 2023 following a challenging year of performance. Here's why.

One of the main ways a government can raise money to pay for its spending programme is to issue bonds, which in the UK are known as gilts. In effect, the buyer of a gilt is lending the UK government money for a specific period of time, which can be anything from a few months to decades.

Investors receive interest in the form of regular coupon payments throughout the gilt's life and get back their initial investment at the end when it matures. Gilts play an important role in a balanced portfolio due to this guaranteed income stream, and because they tend to do well when stock markets are underperforming.

Gilts are considered to be among the safest investments as they are backed by the UK government. Investors are reassured that UK government is stable and that no matter what happens, they'll continue to receive their periodic interest payments (the coupons), as well as their initial capital back when the gilt matures.

Gilts and recessions

During a recession there is often a surge in demand for gilts from investors looking to protect their portfolios – sometimes called the 'flight to safety'. With the increase in demand, their price rises. So if you have gilts in your portfolio their value should increase in a recession.

Meanwhile, recessions tend to be associated with lower share prices because there's more uncertainty about company profits. So the appreciation of the value of your gilt investments should help to offset any fall in value of your share holdings.

Gilts also do better as central banks often respond to recessions by lowering interest rates to stimulate the economy. Gilt prices tend to have an inverse relationship to expectations of interest rates, so when interest rates go down, gilt prices go up. This means that older bonds with higher coupons are more attractive to investors than the newer ones with lower coupons.

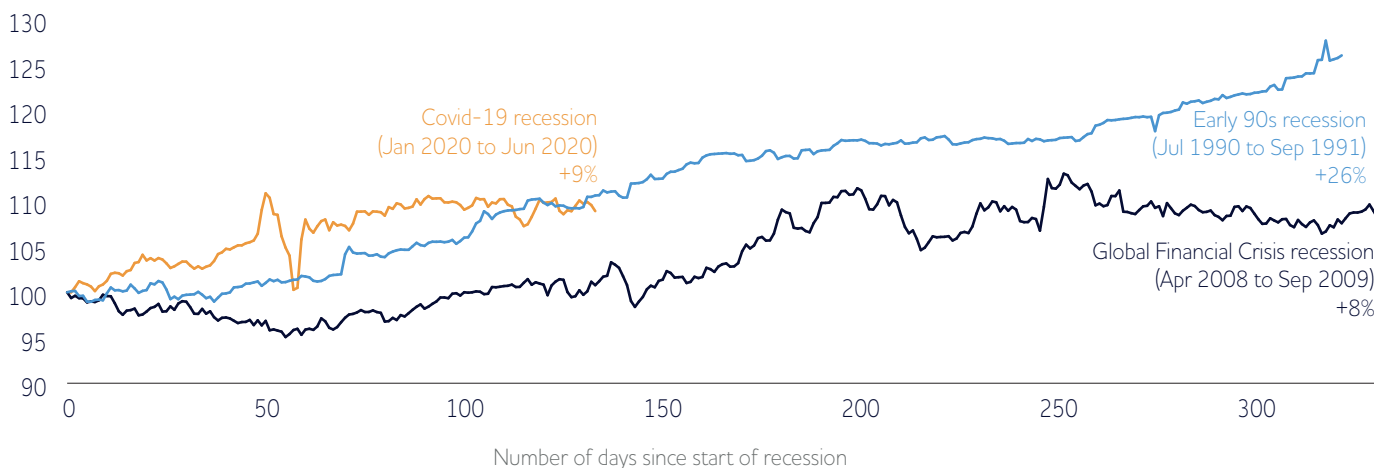
Looking back

If we look back over previous decades, we can see that gilts have tended to deliver positive returns during recessions. For example, figure 1 shows how during the recession of the early 1990s the price of UK gilts went up by 26% from July 1990 to September 1991. It was also a similar story for the recessions during the financial crisis (gilts up 8%) and the beginning of the Covid-19 pandemic (gilts up 26%).

The past year has been challenging for gilt investors. However, history tells us that as we head into a recession they should deliver better returns for portfolios, and we expect gilts to recover during 2023.

Figure 1: Gilts deliver positive returns through recessions but don't move in a straight line

This chart shows UK gilt returns from the day before the UK entered a recession (indexed to 100) until the day after the recession ended.



Source: ICE BofA UK Gilt Index from Bloomberg.

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