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Fiscal policy is driving up bond yields

US yields rose again this month, with the 10-year ending at 4.8% and the 30-year at 5.3%. We see this as a fiscal rather than a monetary reaction. The US is running a deficit of around 6% of GDP at full employment, and net interest is now the fastest-growing item in the budget.

The last time US debt was this high, after the Second World War, it was worked down by holding interest rates below inflation for a number of years: the Fed pegged bond yields, deposit-rate ceilings kept banks' funding costs low, and a burst of post-war inflation eroded the real value of debt that was almost entirely owned by Americans. That approach needs captive domestic lenders and a central bank willing to tolerate the inflation that produces negative real returns. Today, a large share of US debt is foreign-held and Fed Chair Warsh's firm recommitment to the 2% inflation target at Jackson Hole closes the door on reducing the debt through inflation.

Warsh also made clear that current financial conditions are not restrictive. With the labour market at full employment and economic growth at around trend, inflation is likely to prove sticky. The bond market has already shown him the cost of hesitating: when the Fed held rates in July and markets read the decision as too dovish, the 30-year yield rose to its highest level since 2007. We expect long term rates to rise further from here, unless inflation moderates faster than expected.

Bond yields have historically settled close to an economy's trend nominal growth - real growth plus inflation. For the US that is 4 - 5%, and yields now sit at the top of that range, without the quantitative easing or China-driven disinflation that held them below it for most of the past decade. Economies whose debt already worries the market trade well above their own trend growth: UK gilts yield around 5.1% against trend nominal growth of roughly 3.5%, while French and Italian yields of 4.2% sit against trend growth of around 3%. The US does not yet carry that premium. We expect the gap to close through some combination of higher long yields and a weaker dollar as foreign appetite for Treasuries and dollar cash wanes.

Barring extreme changes, monetary policy will move yields around this upward trend but will not change it. July showed what too little hawkishness does - the long end sells off on credibility. Essentially, fiscal consolidation changes the trend, and we don't expect that until higher yields inflict real market pain or the growth outlook is downgraded from a slowdown in Tech capex spend.

Equities: AI capital spend remains a key driver

The same AI capex that is pressuring long yields is underwriting US earnings revisions. For now, the earnings growth associated with the AI capex is offsetting the valuation headwind from higher long dated yields.



Positioning

We maintain reasonable exposures toward financials which still offer 6% plus dividend yields and high single-digit earnings growth. While the retail sector has significantly underperformed over the last year and valuations are optically cheap, we remain concerned about the ability of these companies to grow their earnings in the face of some of the structural challenges. We have continued to add to our positions in Naspers and Prosus given the significant discount to their stack up value and the record cheap underlying multiple of Tencent. Recent results highlighted the quality of the portfolio despite the additional capex allocated to AI.

We continue to hold sizable positions in Bidcorp, Anheuser-Busch and British America Tobacco where valuations remain reasonable with expected returns in the mid-teens for each of these names. Within the resources complex we still like the long-term prospects for copper and maintain a large overweight position in Glencore and to a lesser extent Anglo American. Within the precious metals we continue to prefer PGM stocks over the gold stocks as we think PGM miners are more geared to higher prices than the gold miners. PGM basket prices are also not as high in real terms as gold.

While the gold price is high in real terms, we think the price is increasingly driven by dollar and debt considerations rather than interest rates. A sustained rise in real yields could test that view in the short-term, but overall, we retain reasonable exposures to the precious metals complex.



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