Have interest rates peaked?

November brought a strong bull market on the bond markets. Bond prices soared as further interest rate hikes by the central banks became increasingly unlikely. The pace of inflation has slowed recently, allowing central banks to remain in a wait-and-see mode.

An inflation rate of 2.4% was reported for November in the eurozone. Falling energy prices were the main reason for the moderation in inflation rates, although food and services are still under upward pressure. However, while the American economy is surprisingly robust, Europe has fallen into the recession. This leads optimists to conclude that interest rates in Europe will be the first to start falling next year. Nevertheless, it should not be forgotten that the United States has traditionally been seen as the pioneer and leading market in terms of interest rate trends. Furthermore, the eurozone must be careful that the common currency, the euro, does not weaken further by rushing ahead with key interest rate cuts, as this would mean imported inflation, particularly on the energy import side.

For interest rate investors, the aforementioned turnaround has the pleasant effect of better yields on existing bond exposures. After the crash year of 2022, there are signs of a return to positive yields in 2023, albeit at a modest level. The REX Index, which measures the performance of a portfolio of German government bonds with different maturities, is up 1.6% after eleven months. However, this also shows that real wealth preservation was not possible with German government bonds in 2023. And looking ahead to 2024, there is no need to be optimistic in this respect. Ten-year German government bonds currently yield around 2.4%. According to the European Central Bank, it is questionable whether the inflation rate will fall below this level in the coming year.

German government bonds also look unattractive from another perspective. If the bond price/earnings ratio is calculated by dividing 100 by the current yield mentioned above, the result is a value of around 41. In contrast, the P/E ratio of the DAX index is around 11 and therefore significantly lower. At 3.5%, the dividend yield of DAX shares is also clearly higher than the yield on ten-year German government bonds. In this respect, the main beneficiaries of an interest rate summit are likely to be on the equity side rather than the bond side. It should also be borne in mind that a large supply of new government bonds can be expected in the coming months, as government debt is soaring everywhere, including Germany, while the supply of available and new equities has been on a downward trend for years. The latter circumstance is due to many share buybacks by listed companies. In addition, the number of listed companies has been falling for years due to takeovers and delisting. At the same time, the number of new issues has been quite low in recent years.

Against this backdrop, the low cash levels in LOYS funds are likely to benefit from an improving stock market climate. Despite the tense macro situation, companies are continuing to do their homework in terms of market positions and cost structures.

Sincerely yours,

Fund managers and co-investors

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