

Schroders Quickview



Gilt market heading for downgrade 4 February 2010

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- **A recovery in UK economic growth will help Britain's troubled finances, but is no panacea. The country urgently needs a credible and enforceable austerity plan**
- **Sales of gilts by the non-bank private sector were effectively matched by net buying from the banks and overseas investors in 2009. With the Bank of England now set to step away from the market, it is likely that there will be a large supply overhang this year**
- **The UK is quickly heading towards downgrade territory. As a general rule of thumb, yields rise in the order of 35-50bps for every notch of downgrade**

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A recovery in UK economic growth will help Britain's troubled finances, but is no panacea. The country urgently needs a credible and enforceable austerity plan – the worry for gilt investors is that, despite all the pre-election posturing, politicians still fail to grasp the magnitude of the problem. Repercussions could be severe – the bond vigilantes are hovering and the backdrop is ever threatening, as evidenced by the shockingly swift rise seen in Greek yields recently. The latter serves as a clear warning that markets are in the mood to punish any country that takes creditors for granted.

Politicians will, of course, retort that fiscal policy is not set for the appeasement of investors. This is a fair comment, but at this point in time the gilt market is extremely important, not least since the government needs to borrow upwards of £220 billion this year and well over £550 billion over the next three years. These are large numbers for the UK market and the task facing the Debt Management Office is daunting.

A precursory look at 2009 net gilt purchases shows that the non-bank private sector was a seller of gilts to the tune of around £35-40 billion last year. These sales were effectively matched by net buying from the banks (£15 billion) and overseas investors (£25-30 billion). It was only the Bank of England's (BoE) quantitative easing buying programme that saved the day, effectively funding the Treasury to the tune of £200 billion over the last nine months.

With the BoE now set to step away from the market, the supply/demand imbalance looks ominous. A simple back-of-the-envelope projection of issuance against the mean growth rate of the main investors over the last few years suggests £50-75 billion of supply overhang this year. Whilst banks will no doubt be cajoled by regulatory requirements into increasing their holdings, and the pension fund industry enticed by more inflation-linked bonds, equilibrium will likely only be restored with higher yields.

The situation would worsen in the event of a downgrade by any of the main rating agencies. The UK presently holds the top AAA status – it is no secret that this is under review. The main criteria used by these bodies are debt affordability, debt finance-ability and debt reversibility. It is the former that is arguably the most contentious in the case of the UK – we are quickly heading towards downgrade territory in terms of our interest payments as a percentage of tax revenues (10% plus).

The implications of a downgrade are clear – overseas investors, amongst others, will be more reluctant to support the market, and yields will certainly rise. As a general rule of thumb, research would suggest that yields rise in the order of 35-50 basis points for every notch of downgrade. This is bad news not just for gilt investors, but also for the economy, the banks and the government.

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