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# Gilt market outlook

## Gilt yields set to rise sharply as the APF winds down

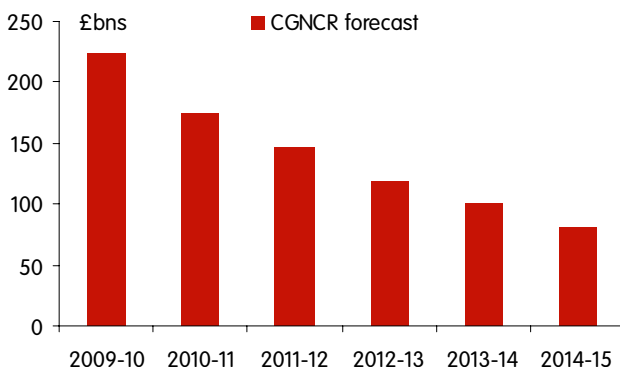
### Introduction

The decision of the Monetary Policy Committee (MPC) to suspend the Asset Purchase Facility (APF) last week has raised fears that, in the absence of central bank buying, UK government bond yields could be prone to a substantial upward correction over the coming months. Since the Bank of England established the APF in March 2009 it has bought, through the creation of central bank reserves, £200bn of financial assets, almost all of which (£198bn) have been gilts. Indeed, as a result of these purchases the Bank of England has almost fully funded the central government's 2009/10 borrowing requirement of around £220bn, and taken its share of ownership of the gilt market to around 30 per cent. With the central government's net borrowing requirement projected to remain historically high, two questions arise: where are the extra funds going to come from to meet the government's deficit requirement? And what yield premium is likely to be required to ensure sufficient demand?

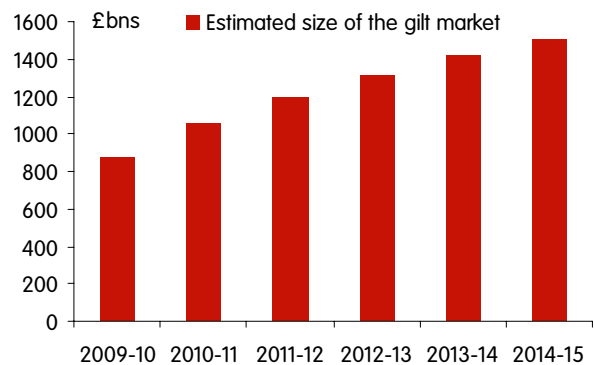
### Gilt market set to almost double in size in over the next five years

The scale of the government's funding needs and the implications for the size of the gilt market are shown in charts a and b. Currently, the market value of the total amount of gilts outstanding is around £800bn. Assuming the central government's net cash requirement (CGNCR) is fully funded through gilt issuance, the size of the gilt market should broadly rise in line with the CGNCR over the coming years. Chart a shows the government's CGNCR projections contained in the 2009 Pre-Budget Report. In the current fiscal year (ending next month), the CGNCR is projected to total £223.3bn. It is expected to fall steadily over the next five years, as the government embarks on a substantial fiscal tightening. Nevertheless, given the extent of the deterioration in the government's finances, the CGNCR is not expected to fall below £100bn until FY2014-15. As chart b shows, based on the government's current fiscal projections, the amount of gilts outstanding looks set to almost double to around £1.5trn over the next five years.

**Chart a: Central government borrowing requirement, the majority of which will be financed through gilt issuance**



**Chart b: Estimated size of the gilt market**



Source: DMO

Source: DMO, LTSB Corporate Market Economic Research

Over the past year, the government has had little problem funding its borrowing requirement as the Bank of England has absorbed nearly £200bn of gilts. Last week's decision by the Bank to suspend the APF, however, means that the gilt market can no longer rely on central bank purchases. Indeed, at some stage, the Bank will seek to sell its APF gilt holdings back to the market as it seeks to reverse its policy of quantitative easing. The prospect of a double whammy of elevated government bond issuance and future central bank gilt sales pose a upside clear risk to the future path of UK government bond yields.

### Sources of potential demand

To meet the planned increase in supply, the appetite to hold gilts by the private sector will need to rise sharply. The extent to which gilt yields will need to rise to generate this increase in demand will depend on trends in domestic saving and the asset allocation choices investors make over the coming years.

Over the past two years, saving by the UK private sector has risen sharply, as both households and corporates have sought to repair their balance sheets and pay down debt. Indeed, as chart c shows, the UK household and corporate sectors are now both generating financial surpluses (positive cash position). These surpluses, coupled with that of the financial sector, and the inflow of foreign capital to finance the current account deficit, have provided the funding for the UK's rising public sector borrowing requirement. Over the coming years, we expect these trends to continue, as the household, corporate and financial sectors continue to repair their balance sheets, which have deteriorated dramatically in the last 10 years, see chart d.

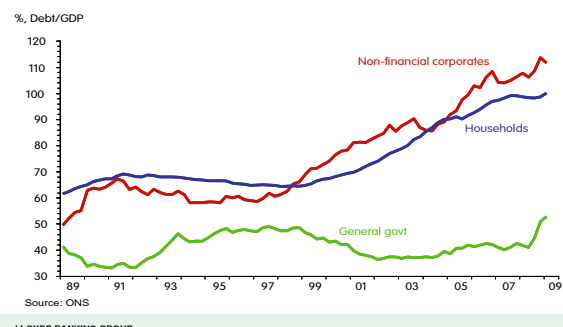
Chart c: Financial surpluses (£bn)



Source: National Statistics

Chart d: Balance sheets have deteriorated

The UK needs to deleverage



Source: National Statistics, LTSB Corporate Markets Economic Research

Nevertheless, it is highly doubtful that domestic private sector saving will rise sufficiently to absorb the additional gilt issuance over the coming years; even if it did, the likelihood is that most of the saving would be held in cash. To put the requirement in perspective, at end-Q3 2009, the market value of gilts held by the domestic private sector was just under £400bn, or just over 50% of the total value of outstanding gilts. The remainder was held by overseas investors (£217bn) and the Bank of England (£151bn) – see table a.

Table a: Distribution of gilt holdings (Q3-2009)

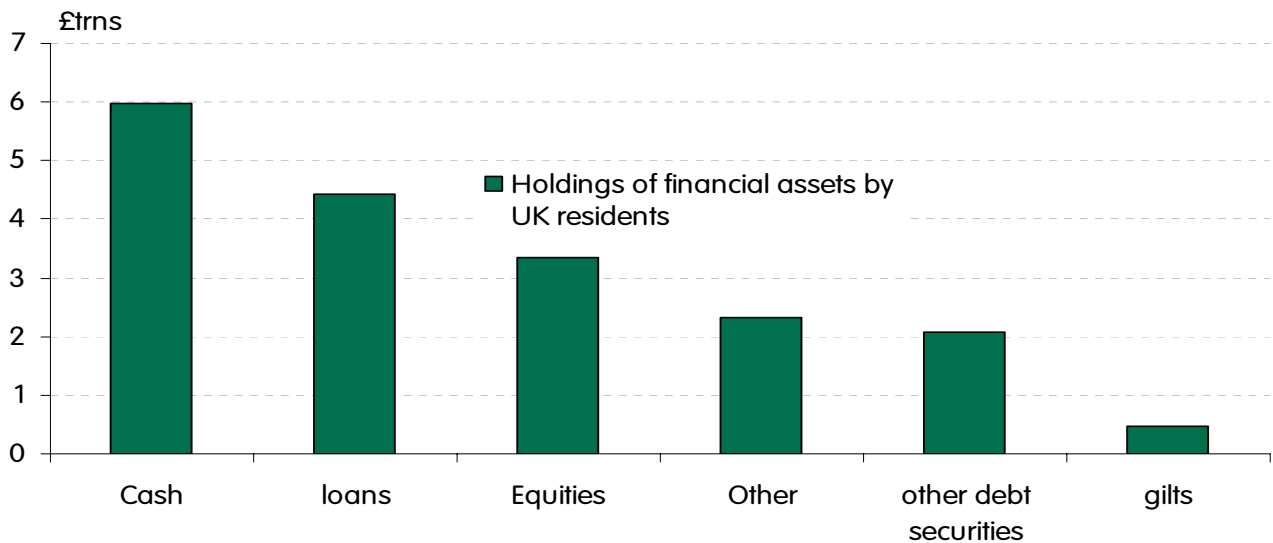
£bn	Q2 09	Q3 09
Insurance co's and pension funds	233.3	248.4
Overseas	207.5	216.9
Other financial institutions	104.9	97.1
Households	7.1	5.6
Building societies	10.0	12.9
Local authorities & public corporations	1.5	1.5
Banks (ex BoE)	26.6	33.1
Bank of England	96.4	151.8
<b>Total</b>	<b>687.2</b>	<b>767.2</b>

Source: DMO, Bank of England

To make up for the potential shortfall, either overseas investment in the UK gilt market may need to rise sharply or, more likely, there will need to be a substantial shift out of cash and equities within the UK into government bonds. Given that foreign investors already hold around 30% of the gilt market, a substantial increase in their holdings is unlikely - at least in the absence of a marked fall in sterling's exchange rate and/or a sharp rise in gilt yields.

A substitution of funds out of other asset classes into government bonds by UK private sector investors, however, is possible. Chart e shows the current breakdown of financial assets held by UK residents. Compared with cash holdings of around £6trn and equity holdings of over £3trn, UK resident holdings of gilts, at around £400bn, are relatively small. There may be some scope, therefore, for the government's borrowing requirement to be financed by internally generated funds – either through increased domestic savings, or through a substitution by resident investors out of other asset classes into UK government bonds.

Chart e: Current holdings of UK financial assets by UK residents (Q2-2009), £trns

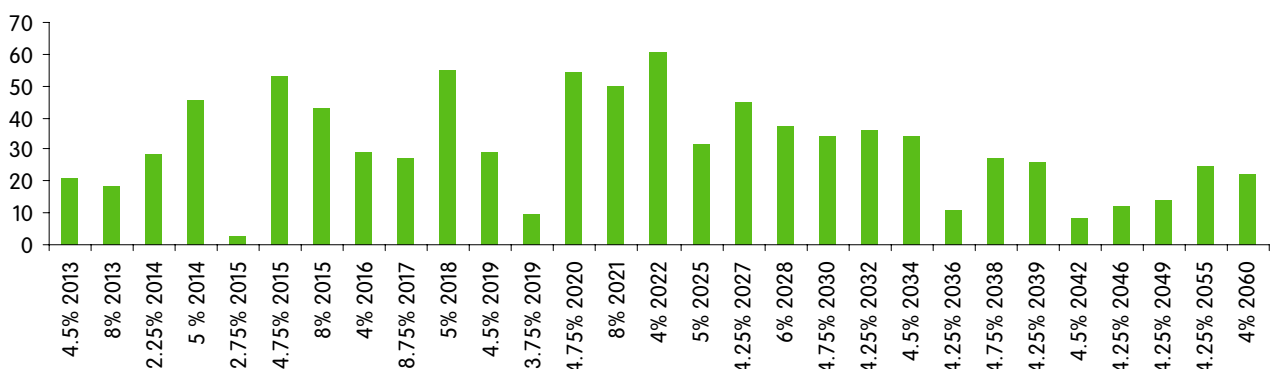


Source: National Statistics

In theory, this substitution could occur without an increase in gilt yields. A renewed downturn in the UK economy, a marked fall in inflation expectations, or a sharp drop in equity markets and an accompanying rise in risk aversion could all generate an increase in demand to help absorb the extra gilt supply at prevailing yields. Indeed, given the uncertain economic environment, and the likelihood that UK inflation weakens over the medium term, we believe the UK economic outlook is likely to be conducive to some increase in gilt demand over the coming years. Furthermore, changes in the regulatory environment requiring banks to hold more gilts to bolster their liquidity ratios are also likely to provide an additional source of demand.

Nevertheless, given the scale of the future funding requirement, and the prospect of a reversal of QE at some stage, we doubt an increase in demand for gilts can be achieved without a sharp increase in gilt yields – particularly at the medium to long end of the yield curve where the Bank of England's asset purchases have been concentrated to date – see chart f.

Chart f: Percentage of gilt issue owned by the Bank of England



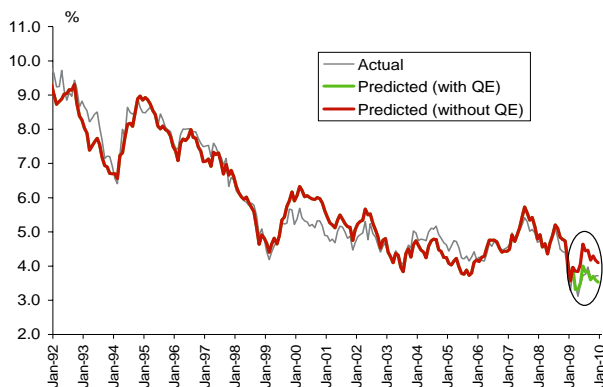
### What is the likely impact on gilt yields?

In order to estimate the impact on gilt yields of the additional supply over the coming years, first we need to quantify the impact of quantitative easing (QE). To do this, we estimate a long-run econometric equation for benchmark 10-year gilt yields, controlling for a number of macroeconomic variables that theory suggests should impact upon them. These macroeconomic variables include: inflation expectations, 3m libor, public sector debt/GDP ratio, 10yr US treasury yields and 10yr German bund yields. The impact of QE on gilt yields is estimated by the inclusion of a dummy variable in the equation. The list of variables and their rationale are provided below.

Macroeconomic variable	Rationale
Inflation expectations	Higher inflation will reduce demand for nominal gilts. Inflation expectations are measured as RPIX one-year ahead.
3m libor	Higher short-term interest rates will reflect higher growth and/or inflation.
Public sector debt/GDP ratio	A high debt/GDP ratio will raise gilt yields.
US 10yr treasury yields	In a global bond market dominated by the US treasury market, movements in treasury yields will affect gilt yields.
German 10yr bund yields	Movements in bund yields will also affect gilt yields.
Dummy variable for QE	The dummy variable will quantify the impact of QE on gilt yields.

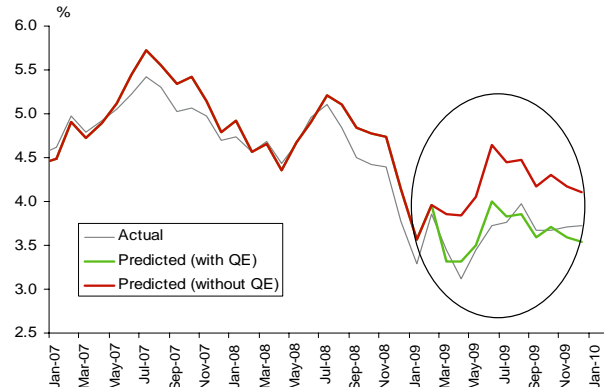
The econometric model does an effective job of modelling 10-year gilt yields over a long period, as chart g shows. Interestingly, the model successfully captures the impact of QE on gilt yields versus the counterfactual (i.e. without QE). According to the model estimates, gilt yields are 40-80bps lower than they would have been without QE (see chart h). Therefore, other things being equal, the reversal of the Bank of England's quantitative easing programme could be expected to push medium-term gilt yields from 4.0% currently up towards 4.5%-5.0%. This, however, ignores the impact of the projected increase in the public sector debt/gdp ratio over the coming years. If this is entered into our model, the rise in 10-yr gilt yields is estimated to be far higher (6.5% by end 2011).

**Chart g: The econometric model successfully captures movements in gilt yields over a long period**



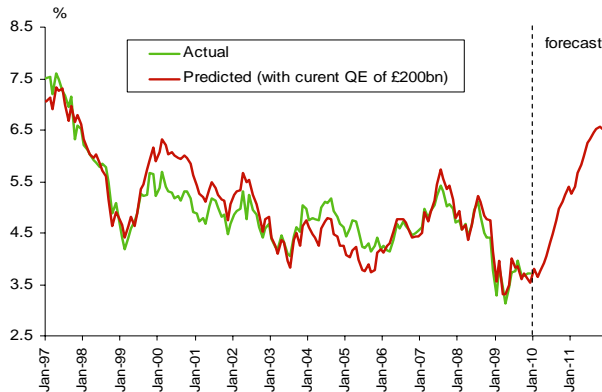
Source: Datastream, LTSB Corporate Markets Economic Research

**Chart h: The Bank of England's quantitative easing policy is estimated to have reduced 10-year gilt yields by 40-80bps**



Source: Datastream, LTSB Corporate Markets Economic Research

**Chart i: Gilt yields are set to rise sharply in the next two years, but a further expansion of QE would lower the pace of increase**



Source: Datastream, LTSB Corporate Markets Economic Research

It should be stressed that these estimates provide only an indication of the likely impact on the gilt market of the reversal of the APF and the increase in public sector debt. Clearly, this impact would be far less pronounced if gdp or inflation expectations dropped sharply and/or the Bank of England decided to extend the APF again later this year. As BoE Governor King noted at the Inflation Report Press Conference earlier this week, *“it is far too soon to conclude that further bond purchases will not be needed”*. Nevertheless, given the scale of the government’s funding requirement, it seems reasonable to expect gilt yields to rise over the medium term.

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