KPMG

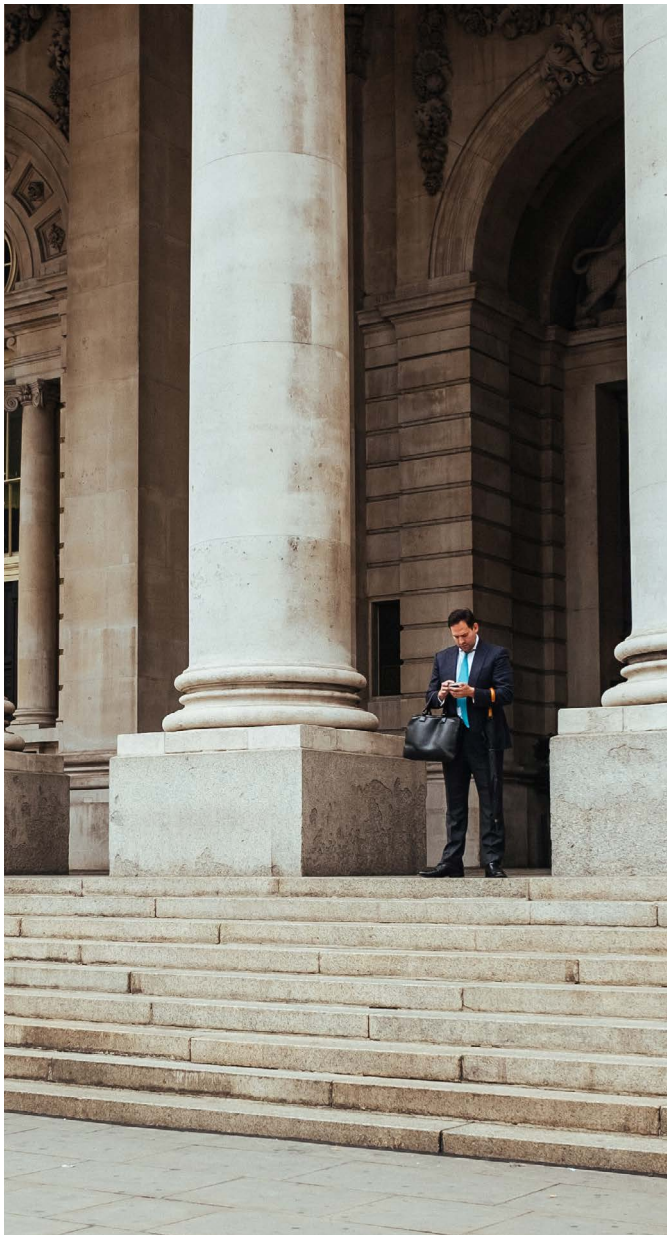
The new normal in the UK government bond market

An analysis of the outlook for the UK government bond market in anticipation of the March budget

March 2020

kpmg.com/uk/**economicoutlook**

The new normal in the UK government bond market



- The government's ambition to level-up UK economic prospects across different regions will require a sustained and significant commitment to higher public sector investment, part of which could be financed by fresh bond issues during the 2020-21 fiscal year.
- We envisage a moderate increase in 10-year government bond yields during the next five years, to 1.9% by the end of 2024; this reflects an increased supply of bonds thanks to fiscal expansion and market adjustment of expectations for future interest rates. Bond issuance will gradually regain its position as an important driver of the fixed income market, as the economy slowly recovers and market participants question the need, and merits, of keeping interest rates low for so long.
- The adjustment in yield will be heralded by the limited proportion of gilt investors who do not need to hold gilts and can trade in and out of the asset class, such as hedge funds.
- We do not envisage material issues placing the extra UK government bonds ('gilts') in the market but there will be a need for more auctions (and thus, more opportunities for demand to dwindle). There will be a greater incentive to focus on the demand coming from structural investors, who seem to favour index-linked bonds and medium-duration conventional bonds; there is also huge appetite for green bonds that can be tapped.

A new framework for levelling up

The Conservative government has stated its desire to improve the economic prospects of all UK regions so that opportunities across the country are more equally shared. Its plans are ambitious and include projects across areas such as communications, energy, climate change and transport. The intention is to narrow Britain's persistent regional imbalances – to level-up the regions by boosting economic growth and improving wellbeing. This will require a significant boost to public sector investment, part of which is likely to be announced in the Budget on 11 March, followed by a Spending Review later this year.

After a decade of austerity and with limited scope to raise taxes or cut current spending elsewhere, we expect a large part of the additional investment to be financed by an increase in public debt. Sajid Javid, the former Chancellor, proposed a new fiscal framework that should allow for at least £100bn of extra capital spending. The government's sizeable parliamentary majority should facilitate the implementation of whatever combination of expansionary policies the government deems appropriate.

The new fiscal framework is partly intended to reflect reality, since the government had been expected to breach at least three of its previous fiscal targets. But it will also seek to exploit the benefits of low interest rates. Indeed, with nominal interest rates at all-time lows, there is not much room for the use of monetary policy to stimulate the economy, a point made recently by the governors of several central banks, including the Bank of England. Fiscal policy seems to be the main tool to deal with both cyclical and structural shocks to the economy.

Moreover, the departure of Mr Javid – and his replacement by Rishi Sunak – opens up the possibility of amending the fiscal rules once more, allowing for an even more generous fiscal package.

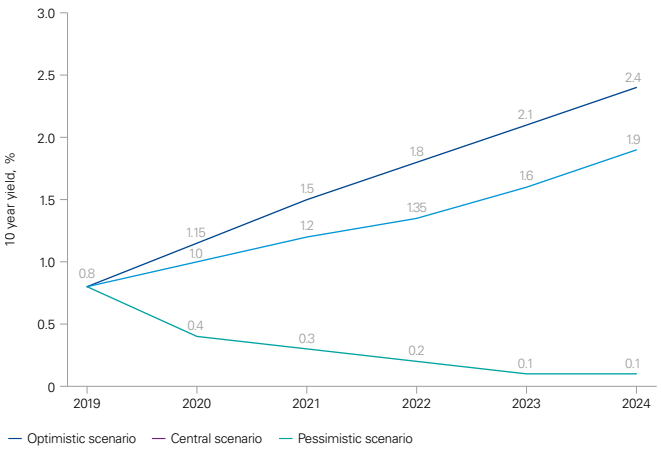
In this report, we consider the likely evolution of bond yields over the next five years, taking into account the expected rise in borrowing associated with the fiscal expansion to be announced on 11 March. We expect yields to rise as a result of the new bond issuance, which will finance around £100bn in extra spending. We present three different scenarios for yields and consider the operational aspects of the extra issuance.

Our forecast for sovereign bonds

Fixed income markets have been distorted by quantitative easing (QE), to a point where gilt prices do not only respond to expectations about fundamentals (or future bond issuance) but also reflect the likelihood of further asset purchases by the Bank of England (BoE). The central bank's balance sheet expansion has possibly created a scarcity of bonds of certain maturities, which has further muffled market responsiveness to economic and political developments.

However, while bond issuance is no longer such an important driver of the fixed income market, we believe this will change to some degree in the future. Normality will gradually return as the BoE reiterates the limits of monetary policy, the economy slowly recovers and market participants question the need to keep interest rates low indefinitely.

Chart 1: Expected 10-year yields on gilts under different scenarios



Source: *Haver, KPMG forecasts.*

Our central scenario

We remain moderately optimistic about the UK's growth prospects and therefore believe there will be no further monetary easing in the medium term. During this period, we do not expect any active unwinding of the bonds bought by the BoE as part of QE; it is likely these bonds will simply continue to mature and that the BoE will become a less significant owner of gilts over time (see Chart 3). However, full unwinding will take a considerable amount of time since c.46% of the bonds within the BoE's asset purchasing facility have a maturity of more than 10 years.

The more successful government's plans in stirring growth, the higher is the likelihood of an increase in expected inflation and therefore in interest rates (and yields) in the medium term. The fiscal expansion comprises several measures aimed at boosting productivity, which could stimulate long-term growth and increase economic capacity.

The scenario assumes that the impact of the coronavirus epidemic is contained and global markets start to recover in Q2 2020, easing potential pressures on bond prices.

We expect a small increase in yields to 1% by the end of 2020, and further increases to 1.35% by end-2022 and to 1.9% by end-2024. These will primarily be caused by the rise in government spending, the subsequent increase in the supply of government bonds and moderate increases in expected inflation, as well as a gradual readjustment of the market's expectations about future monetary policy.

We envisage a reasonable performance from the government and other UK institutions in terms of managing, developing and implementing policies that do not lead to further credit downgrades. We believe the UK's monetary policy stance (comprising QE, interest rate setting and forward guidance) will remain essentially unchanged until the end of 2023, when we expect rates to start increasing again. Markets may need some time to adjust to the arrival of the new Governor of the Bank of England, Andrew Bailey, in March 2020, as he sets out his views on monetary policy tools and his modus operandi.

Investors who are more sensitive to price movements and can choose whether to hold gilts may need some time to be convinced that further rate cuts are not on the short-term agenda and that the BoE will take a back seat in terms of managing the business cycle. This realisation could also generate upward pressures on yields if these investors sell their holdings amid dissatisfaction that the price increases and rate cuts they expected never took place.

Our optimistic scenario

In our optimistic scenario, there is a gradual and sustained improvement in capacity, productivity and potential growth due to the successful structural measures implemented by the government; this triggers renewed economic momentum and supports broader economic sentiment, in turn boosting activity further. There is a substantial improvement in the US-China relationship and a strong pick up of the US economy. Equity markets outperform expectations.

Inflation expectations in the UK rise. The BoE increases its base rate in late 2022 with the market factoring in the beginning of a new interest rate cycle. There is a sustained increase in yields, which reach 2.4% by the end of 2024.

Our pessimistic scenario

In our pessimistic scenario, the fiscal package increases government borrowing and the debt-to-GDP ratio but has a negligible impact on capacity and medium-term growth. Inflation remains low for a prolonged period, the economy stagnates, the government loses credibility, and poor economic performance, together with unsuccessful Brexit negotiations, generate further pessimism and a lack of trust in the institutions. There are further credit downgrades. The coronavirus epidemic becomes a pandemic and has a significant negative impact on markets worldwide. The currency depreciates and the economy enters a recession.

Quantitative easing is perceived as ineffectual at supporting economic activity. Although domestic demand has grown rather insensitive to interest rate cuts, the BoE reluctantly reduces rates by 50 basis points, in a desperate attempt to stimulate growth. The UK economy becomes liquidity 'insensitive' in the medium term, in the sense that the extra liquidity does not have any impact on the real economy and consumers prefer to hold cash, in similar fashion to the problems experienced by the Japanese economy. The yield curve remains rather flat during the whole period. There is talk of negative interest rates.

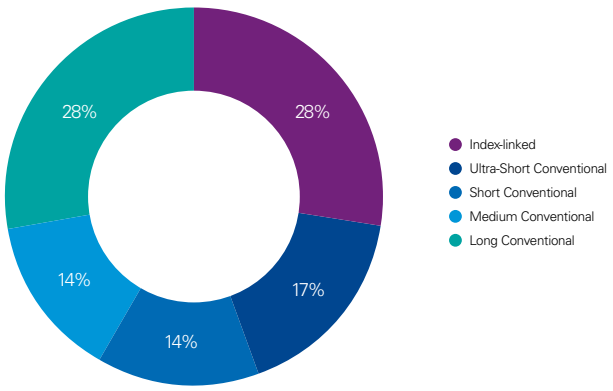
The financial remit

The government will soon decide on the structure of its financing remit, in accordance with its debt management objective, the debt management framework and wider policy considerations. For the 2020-21 round, these decisions will be taken in the context of an already high debt-to-GDP ratio and high and increasing government borrowing in a period of no fiscal consolidation.

The remit specifies the annual total of gilt sales planned for the financial year and how this breaks down between index-linked and conventional gilts (plus, within conventional gilts, the maturity split between short, medium and long maturities). It reflects a debt management strategy that weighs five key risks: interest rate risk, refinancing risk, inflation risk, liquidity risk and execution risk.

The weight placed on each risk can change over time, though governments tend to attach particularly high importance to minimising near-term exposure to refinancing risk. This risk is managed by avoiding concentrating redemptions in particular years, thus spreading gilt debt issuance along the maturity spectrum. The average maturity of the UK's debt stock is relatively high compared to other G7 countries: in December 2018, it stood at 15.2 years compared to fewer than eight years in Canada, France, Germany, Japan and the US. This may look unnecessary at a time when short-term real interest rates are negative, but the Debt Management Office (DMO) also has to encourage the development of a liquid and efficient gilt market, which demands issuance across the maturity spectrum.

Chart 2: Composition of government debt (February 2020)



Source: *DMO*.

Chart 2 shows the composition of central government sterling debt by instruments and over time. In February 2020, 56% of the debt portfolio consisted of index-linked and long conventional gilts.

This includes a stock of index-linked debt that accounts for about 28% of the government portfolio (considerably higher than in other G7 countries). This reflects, to some extent, the strong demand for index-linked gilts in the UK, especially from institutional investors, such as domestic pension funds and insurance companies. Meeting this demand has brought clear cost advantages, though this relatively large stock of index-linked debt also increases the sensitivity of the public finances to inflation shocks. The previous government committed to reducing the proportion of index-linked issuance in a measured fashion in the context of fiscal consolidation. We believe this commitment could be broken by the current government and that a significant proportion of the fresh extra debt will still be funded with index-linked government bonds (possibly long dated), which will increase government exposure to inflation risk. The structure of the retail price index may also change following the joint consultation between the government and UK Statistics Authority.

Execution risk poses an interesting challenge. There is an operational aspect to consider since while the DMO is both efficient and competent, there are some basic capacity issues to deal with when government borrowing increases. Usually, most of the planned issuance is placed via auctions (75.2% in 2019-20), followed by syndication (18.4%, especially for long-dated conventional bonds) and unallocated issue. The number of auctions and their average size are likely to increase in 2020-21 to cope with the larger amount of gilts issuance. It may also be convenient to allow for a large amount of gilts to be placed in an unallocated form, which increases flexibility. More auctions create more opportunities for demand to dwindle. In addition, the DMO has been updating its systems for deal input, settlement, risk management and accounting. There is an added pressure in increasing gilt issuance while implementing a relatively new operational framework.

The bids to cover ratio at auctions are strong, averaging 2.2 times over the 12 months to mid-February 2020. The two auctions with the lowest ratio (1.7 and 1.8) were of bonds with a relatively long maturity (30 years) while index-linked and 10-year maturities were more in demand (with ratios of up to 2.6 for both types). The latter become more popular during periods of uncertainty because they are typically used to hedge risk or as benchmarks in contracts.

These are healthy figures, but they are mostly lower than the average cover ratio at gilts auctions in 2017-18, which was 2.30. Since the DMO tends to front load issuance along its issuance calendar, it will be interesting to monitor whether there is any gradual change in these ratios once the government has unveiled its Budget and we enter the new fiscal year in April 2020. The presence of a deep and well-functioning gilt market remains critical to the DMO's ability to successfully deliver its debt management objective.

We do not envisage significant problems in placing the extra debt in the short term (especially judging by the results of recent European sovereign bond placements), but the reputational risk attached to waning demand is possibly too high to run. For this reason, we believe there is a strong incentive to meet demands from institutional investors, who lately seem to favour index-linked and medium-duration gilts. Issuance of short and ultra-short bonds are a given, considering the cash management responsibilities of the DMO.

This may also be a good time to reassess the benefits of issuing green bonds, which have become more popular amongst UK and international investors. However, Robert Stheeman, the head of the DMO, has expressed some caution about green bonds due to the expected higher costs attached to their issuance.

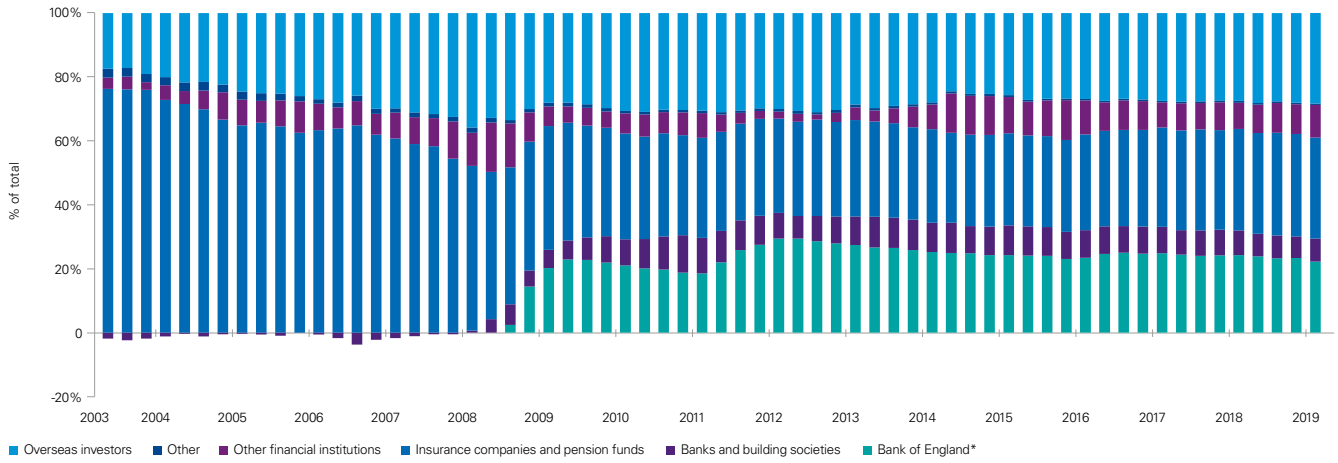
Demand for gilts

The three largest groups of investors in gilts are insurance companies and pension funds (holding 32% of stocks), overseas investors (28%), and the Bank of England's Asset Purchase Facility (23%).

The UK government is relatively fortunate in that it enjoys strong structural demand for bonds from domestic institutional investors (pension funds and insurance companies), which need to buy gilts to match their liabilities and mirror their policies as part of their business-as-usual activities. By matching the duration of their liabilities against the duration of a fixed income portfolio, these groups protect themselves against interest rate risk and acquire assets that increase or decrease in value inversely to their liabilities.

In addition, banks and building societies (which hold about 7% of the stock of gilts) need to buy a constant flow of bonds in order to meet their ongoing regulatory capital and liquidity needs. We note that from January 2022, the Basel IV regulation will come into force and the expectation is that capital requirements will increase. This should also help sustain an increasing demand for gilts prior to January 2022 and subsequently. Although this is a European requirement and Brexit will determine the specifics surrounding Basel IV implementation in the UK, if the BoE's objective is to aim for regulatory equivalence, the UK will be expected to fulfil the minimum implementation timeline.

Chart 3: Gilts holding by sector (% of total)



*BoE data for Q3 2019 is an estimate.

Source: *DMO, BoE.*

In addition, there is structural demand for UK government bonds from international investors, though these are traditionally perceived as less 'sticky' than domestic buyers. There is no publicly available data on overseas gilts investors, but all central banks which manage their exchange rates need to hold reserves and will buy and hold gilts (examples include China, Norway and Switzerland). These institutions may need to readjust their sterling-denominated holdings if the pound depreciates so that the value on their balance sheet remains reasonably stable; this would partially offset the drop in demand that would typically follow a depreciation of the pound. Such investors seem to favour short-dated bonds; in December 2018 overseas investors held 49% of Treasury bills according to the DMO.

In aggregate, there are many buyers both domestically and abroad who need to buy gilts, but also some gilts holders for whom the asset class is optional; they could, for example, choose to hold UK equities or US bonds instead, which offer a higher return. For investors searching for yield, such as international investment funds, UK bonds are still attractive, especially when compared to some European bonds with negative returns, with investors paying puzzling prices for risky debt.

However, overseas investors such as hedge funds from G7 countries are far more price and FX sensitive, and can sell their stock quickly if, for example, their expectations about the likelihood of further monetary easing change. The supply of gilts within the market will also be affected by whether these price-sensitive investors consider the government to be more or less capable of delivering growth. Such investors will, therefore, play an important role in the adjustment towards higher yields in the medium and long term, and in shaping the risk premium as the political situation evolves.

So how many gilts are too many gilts?

The price of gilts can plummet if the perception is that the government is issuing too many.

For as long as nominal GDP growth remains above interest rates, it is possible that the UK's debt-to-GDP ratio can continue to increase at a relatively limited pace without generating alarm.

The relevant interest rate in the case of the UK is not the 10-year bond yield that markets usually consider; rather, the 15-year yield is more significant since this is closer to the average maturity of the existing debt stock. This return tends to be higher than the 10-year bond yield. Nominal GDP growth in the second half of 2019 was 3.0% (a figure that would also be compatible with an inflation rate between 1.5% and 2%, and a potential real growth rate of between 1.5% and 1%). The 15-year nominal forward curve tends to be between 1.9% and 2%. In other words, there is a cushion of more than a percentage point. While rates remain low, it is difficult to envisage a situation where paying the interest on accumulated debt would become significantly burdensome.

If flows are not the immediate issue, what about the stock? The rise in borrowing associated with the proposed fiscal package (and the recent £14bn increase of extra funds during the current fiscal year) will translate into an increase in the government debt-to-GDP ratio since there is not much appetite to raise taxes in the short term. The ratio is already comparatively high at 85.7% and could go over 90%. This is a threshold which, according to Reinhart and Rogoff[1], could have a negative impact on growth. The Reinhart and Rogoff paper offers one benchmark, others believe the threshold for developed countries could be higher if you look at countries like Italy with 135% debt-to-GDP ratio and Japan with 238% debt-to-GDP ratio.

Future governments are likely to have to undertake sustained fiscal tightening in order to address the costs of an ageing population and upward pressures on health spending. Eventually, tax increases may be needed to balance the accounts, even when allowing for stronger productivity growth in the future. However, a responsible government can move towards an unsustainable fiscal path (for example due to an ageing population and upward pressure on health spending), without ever coming close to default, if it adopts economic policies that generate a meaningful primary surplus.

Once the UK economy is on a stronger path, the international environment has become more supportive of growth, and interest rates have moved well above current levels, the UK will need to engage, yet again, in discussions about fiscal discipline. This will require more than five years, but nonetheless, as we head into the new normal, we should be mindful that history will repeat itself.

[1] See Reinhart, Carmen M.; Rogoff, Kenneth S. (2010). "*Growth in a Time of Debt*". *American Economic Review.* 100 (2): 573–78.

Contact details

Yael Selfin
Chief Economist, KPMG in the UK
T +44 (0)20 7311 2074
E yael.selfin@kpmg.co.uk

Susana Cervero
Economist, KPMG in the UK
T +44 (0)7557 256 992
E susana.cervero@kpmg.co.uk

CREATE | CRT124765 | March 2020