

# The Outlook for the Gilt Market

January 2010

PENSIONS

## Factors that could cause gilt yields to rise substantially

**Gilts are bonds issued by the UK Government to help meet its spending requirements.**

**As the UK Government needs to borrow significantly to meet increased spending plans, the gilt market is set to double in size over the next 4 years providing substantial upward pressure on gilt yields.**

**When gilt yields rise, the price falls. This will mean low/negative returns from gilts, although pension scheme liabilities would also fall at the same time (a benefit).**

## The scale of UK borrowing

Due to the current economic crisis, the UK Government expects to issue a significant amount of gilts in order to maintain public spending plans and to meet the cost of initiatives to boost the UK economy.

The national debt is therefore expected to go from less than 40 percent of GDP pre-credit crunch to around 80 percent of GDP by 2014, with some projections saying that it could reach 100 percent of GDP.

In particular, in the current financial year the UK is forecast to issue £220 billion of gilts – more than 4 times the average in the 5 years prior to the collapse of Lehman brothers. Even allowing for maturing gilts, this will mean a significant net supply into the market.

## The effects of this borrowing

We have already seen nominal gilt yields start to rise, with the 10 year yield rising from 3.5 percent in early October to 4.2 Percent by the end of December. Real yields, whilst volatile, have not seen the same directional shift.

Further upward pressure can be expected on gilt yields for two reasons:

- The sheer volume of gilts that will need to be absorbed into the market will make public sector net debt (which is predominantly the gilt market) more than double in size from £608 billion at the end of 2008/09 financial year to almost £1.4 trillion by 2014. It seems highly unlikely that new investors can absorb this additional supply without yields increasing.
- As the UK balance sheet becomes weaker, it may lose its AAA rating and cause investors to look elsewhere for 'risk-free' bonds, therefore reducing demand at a time when supply has increased dramatically.

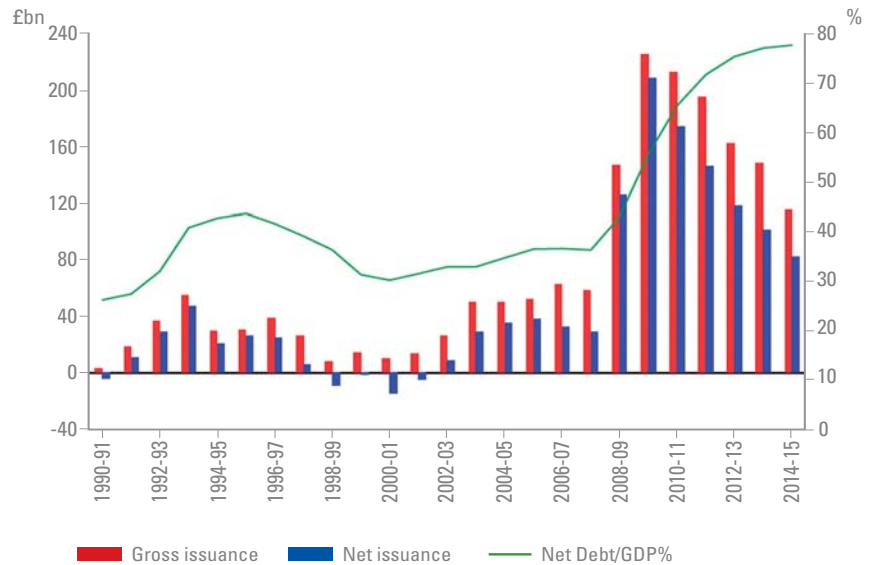
An increase in future inflation is another risk faced by UK pension schemes. Whilst higher future inflation is likely to lead to higher gilt yields, the focus of this paper is on factors that are likely to lead to both higher real yields and higher nominal yields, meaning that we can apply the rationale to both Fixed Interest Gilts and Index-Linked Gilts.

However there are two factors we discuss in the following page which offset some of this upward pressure on gilts:

- In the short term the Bank of England's policy of Quantitative Easing (QE) has created a huge source of demand for gilts.
- Pensions funds and banks are likely to be a significant source of demand for gilts, for reasons discussed on the following page.

The key question is whether these sources of demand will be sufficient to offset the unprecedented level of gilt issuance expected over the next few years.

### Historic and projected UK gilt issuance

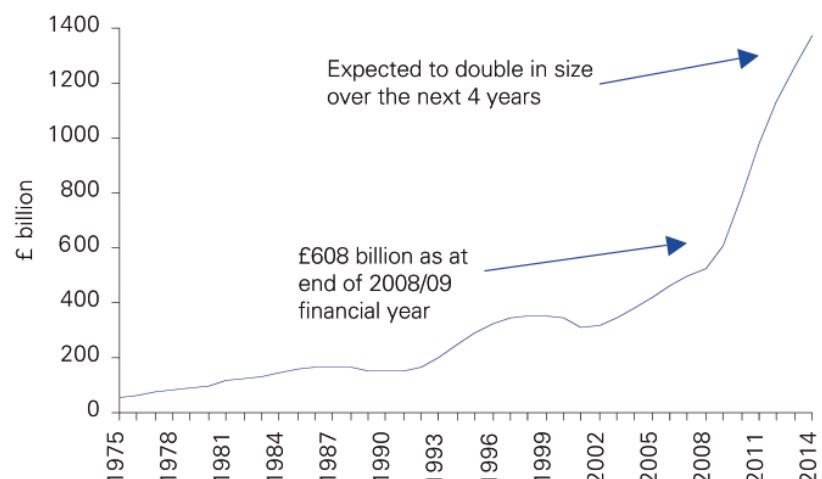


1. Data from the current financial year onwards are projections, while the earlier data are actual historical figures  
 2. Net Debt/GDP figures are published by HM Treasury  
 Source: HM Treasury

### KPMG Investment Advisory View

- We believe that it is likely that gilt yields will rise over the next 3 years, leading to weak returns from gilts.
- Trustees can achieve additional benefit by moving (some of) their gilt exposure into other asset classes – the most appropriate option will need to be considered on a scheme specific basis but could add significant extra value to Scheme arrangements.

### Size of the UK public sector net debt



Source: HM Treasury

## Factors that could limit the extent to which gilt yields could rise

Thus far QE has soaked up much of the additional supply of gilts, and pension schemes are likely to be a longer term source of additional demand.

But will this additional demand be enough to stop yields rising dramatically?

Trustees will benefit on the liability side if gilt yields rise but additional benefit can be gained by switching gilt exposure into other asset classes.

Which ones are appropriate will be a scheme specific decision as risk and return will need to be considered carefully.

### Quantitative easing (QE)

The additional supply of gilts issued in the current financial year has been soaked up by the Bank of England's policy of QE, with 99 percent of the £190 billion that has been spent through QE used to buy gilts.

The pace of QE has slowed recently, and the end of QE is currently planned for the end of January. It is a possibility that QE continues throughout 2010, although many commentators do not expect it to do so (or not at a significant level).

The Bank of England do not plan on holding all the gilts they have bought to maturity. Selling these back into the market will provide additional pressure on gilt yields to rise.

### Where the demand is going to come from once QE ends?

Pension schemes could be a huge source of potential demand for gilts (which match liabilities and as such are a "low risk" investment). Rising yields will allow schemes to de-risk and increase their allocation to gilts. However, virtually all the £700 billion UK DB pension fund assets that are not already invested in gilts would have to

be invested to provide the additional demand. We do not see this as a likely scenario.

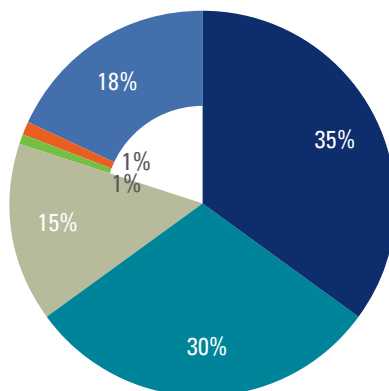
Over the 12 months to June 2009, banks increased their aggregate holdings in gilts from a slight negative holding to £120 billion. This is mainly due to additional requirements introduced by the FSA in 2009. UK banks are now required to strengthen their liquidity buffers by holding more assets that are high quality and have high liquidity. This could mean

that banks are likely to increase their holdings in gilts even further:

- The Institute for Fiscal Studies, in a combined report with Morgan Stanley, estimate that this could mean the top 10 UK banks increasing their holdings in gilts by £55-£210 billion.

Continuing demand from overseas investors will be important in supporting gilts. If the loss of the UK's AAA rating where to feed through to a loss of investor confidence in Sterling as a currency, this demand could start to fade.

### Current ownership profile of gilts



Data as at 30 June 2009  
Source: DMO

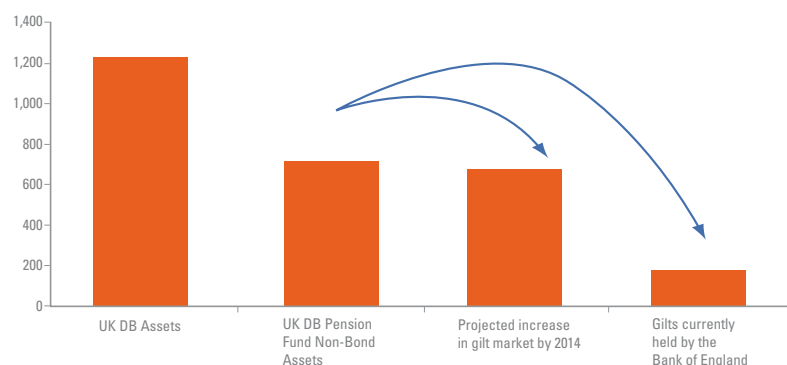
### The Japan effect

Finally, we note that high national debt to GDP ratio and the loss of a AAA credit rating does not necessarily lead to high government bond yields.

Japan, with government borrowing at 180 percent of GDP and a credit rating of AA for its long-dated borrowing, has had 10 year government bond yields of less than 1.5 percent or most of 2009.

### Pension funds and gilts

UK pension funds do not seem to have the capacity to buy all the gilts likely to be issued by the Treasury or sold back into the market by the Bank of England



Data for UK DB Pension Fund assets as at 31 December 2008.  
Source: KPMG, UBS, BNY Mellon Asset Servicing, Bank of England

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