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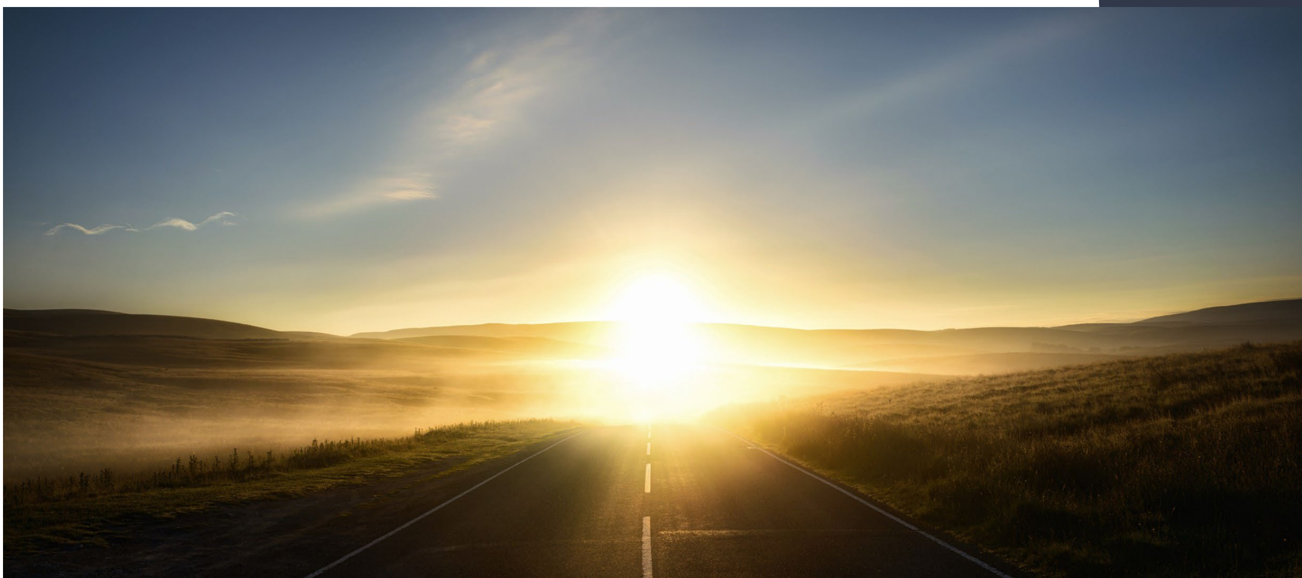
G(u)ilty



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Welcome to the first Weekly Digest of the year, and I'll warn you now that it's a bit longer than usual as we need to address the Gilt market malaise in some detail. Investors seem to have got out of bed on the wrong side in 2025. Bonds have continued to sell off and equities are feeling the strain too. The pound has been particularly weak. President-elect Trump has been rattling his sabre at Greenland. The Canadian Prime Minister was forced to resign. And, in a story with real human impact, large areas of Los Angeles have been razed by fire. The New Year has hardly been a happy one.

In the UK, the domestic financial headlines have been dominated by the bond and currency markets. It's easy to get panicked by headlines suggesting some sort of sterling crisis and a repeat of the Truss debacle, and the situation is not helped by opposition politicians stoking the fires of discontent, even if we all know that's the game that they play. Not to mention unhelpful and misinformed interventions from the other side of the Atlantic. This is a time for calm heads to prevail, although it's not easy to sugar-coat the moves we have seen.

Nobody can deny that there are fundamental reasons for the sell-off in Gilts, especially at the longer end of the curve, and they are a toxic combination of global and domestic influences. Taking the bigger picture first, we have seen sharp rises in US Treasury yields, and that's usually a difficult tide for global bonds to row against. Even Germany, where the economy is flirting with recession, has seen yields rise by almost 60bps since early December.

US 10-year Treasury yields have risen by more than 100bps since September and are, for now, holding in what looks like a new higher range. That still feels a bit unreal and unsustainable to many, following the post-financial crisis period of rate suppression and subsequent post-Covid zero-interest rate policy. But looking further back, we have only returned to levels that were commonplace in the decade leading up to the GFC and we are still well below what prevailed in the 1990s.

There have been several driving forces. First of all, there was probably an element of mean reversion to begin with. A 3.6% yield in mid-September felt low relative to reasonable long-term nominal growth expectations of 4.25%, especially with no sense of an imminent recession. Then we had the double whammy of an aggressive 50bps Federal Reserve (Fed) rate cut, which some investors thought was unnecessarily large, at about the same time as Donald Trump's star began to rise again in the opinion polls. His policies were deemed to be potentially more inflationary than Vice President Harris's. Since then, we have had Trump's actual victory, a few higher-than-expected inflation prints and an ominous rise in natural gas and oil prices.

And that's just the inflation impact. Then there is the supply side of the market to consider. Trump's underlying policies are not expected to reduce the fiscal deficit and potentially to increase it, tariff income and efficiency-led cuts to government spending notwithstanding. Indeed, in the latter case, it's hard to know where the mooted $2 trillion of cuts could come from given the level of unavoidable interest and entitlement payments, which already account for 95% of government revenue. That all suggests that the stock of bonds will continue to expand.

Next witness in the dock is the Treasury maturity schedule, which sees a big spike in 2025, partly owing to the huge amount of short-dated bills that have been issued by the Treasury in the last year or so. Indeed, it was the pivot towards issuance at the short end of the curve that helped to turn the yield tide in Q4 2023. The situation might be exacerbated by the fact that the prospective new Treasury Secretary, Scott Bessent, has said he intends to lengthen the maturity profile, which suggests more pressure on the long end of the curve.

Unsurprisingly, all this has taken its toll on the long end of the Treasury market, with the widely quoted I-Shares 20-year+ Treasury ETF down 15.5% since September and approaching its 2023 cycle lows. The cumulative loss from the 2020 peak is once again more than 50%! This trend is also playing out at the short end of the curve, with investors pricing out any chance of further Fed rate reductions before the summer.

Then there is just the sheer amount of existing debt. Global debt-to-GDP has risen by a hundred percentage points in the last quarter of a century to around 320%. With so much debt having been created, it's harder to find buyers to take up the slack. When governments were deleveraging after World War II, the private sector had very limited debt and could easily take more on. When the private sector blew up in the financial crisis, it was governments who responded. And while the aggregate private sector is not in such bad shape now, there is a big gap between the haves and the have nots, which, in turn, informs some of the political trends we are seeing today in favour of the redistribution of wealth. Put another way, given an average global debt maturity of around five years, there is around $70 trillion of debt that has to be refinanced every year, which creates great risks for the financial system if liquidity dries up and debts cannot be rolled over. Given past lessons learned and the actions of central banks when faced with such a possibility (as in the Silicon Valley Bank bankruptcy and LDI crisis), we think there is less chance of this happening, but it's not zero and things would have to get scary before the central banks were forced into action.

Now down to the local nitty gritty. First, the wider context. If we look back over the last six months, there really is not much difference in performance between the US and UK 10-year benchmark government bonds. The peak premium yield of UK over US (0.25%) came just after the Budget at the end of October as the market priced in higher Gilt issuance, but we are below that level now (0.08%).

Next we can look at the difference between now and 2022 and the Truss/Kwarteng mini-Budget fallout. From the beginning of 2022, the 10-year Gilt yield was already up 230bps before the proverbial hit the fan, and then it rose another 120bps in just a few days before the Bank of England stepped in to provide support. In the current episode, the yield is up some 100bps since last September before which it had risen around 30bps during 2024. Thus, a cumulative 130bps vs 350bps in 2022. Put another way, the biggest percentage capital loss experienced by a holder of a generic 10-year Gilt in 2022 was around 25% vs 8% over the last year and 6% since September. Of course, the numbers are bigger at the 30-year maturity and amounted to more than a 50% capital loss in 2022 vs "just" 15% since September 2024.

And this is where we have to remind ourselves what the driver was behind the final sell-off in 2022 and why it's different today – LDI, or Liability Driven Investing. This is the strategy by which the sponsors of defined benefit pension funds invest on a leveraged basis to close the gap between their pension fund assets and liabilities. It worked fantastically well when funding costs were next to nothing and yields were trending lower but fell apart when those factors reversed and bond volatility spiked higher. Capital losses on a leveraged base triggered margin calls and forced selling. The good news today is threefold: 1) leverage is much reduced; 2) capital reserves are substantially higher; and 3) the net move in yields (and thus capital losses) are far less. Nobody who knows what they are talking about seems to be suggesting a second LDI-driven crisis.

The bad news, though, is that investors seem to be taking fright at something more than mere shadows. This can be seen in the fall of sterling, which has lost 2.7% of its trade-weighted value since December. However, a lot of this is a function of the strong dollar, against which the pound has fallen from $1.34 to $1.21 since the end of September. But against the euro it has lost little more than a cent, and that only in the last week. Still, that hasn't stopped people describing the UK as an "emerging market economy" owing to its twin fiscal and trade deficits, and there is no doubt that shorting anything to do with the UK has become a "pile on" momentum trade in the short term.

I should also note the sort of alarming headlines we are seeing. This one is from Bloomberg: "Pound traders are ready for another 8% slump after market rout". Sounds ominous, until you read that it is "some traders" who are betting on sterling falling below $1.12. No doubt some are buying put options at that strike price which would produce a big payoff if sterling collapsed, or maybe it is, in fact, somebody who is long of sterling assets putting on a tail risk hedge. But this sort of inflammatory journalism fans the flames in the short term. Even so, it's hard to contradict the fund manager who claims in the same article that "the path of least resistance is lower at this juncture".

The UK's moment under scrutiny comes courtesy of worries about the country's fiscal sustainability. Growth is weak following the unpopular Budget and the long-term effects of higher interest rates. Sticky inflation is tying the hands of the Bank of England when it comes to cutting rates. The global bond market sell-off was the final straw, leading to concerns that Chancellor Reeves's fiscal rules are on the verge of being broken. We were not alone in highlighting how little fiscal headroom she had following the Budget, which the OBR calculated to be £9.9bn. Capital Economics, amongst others, suggests that this is now down to around £1bn, and the OBR will update its figure in March. None of the options open to the Chancellor to bolster the finances look appealing, as, realistically, they range from less government spending to higher taxes, neither of which help growth.

Is there a solution? Probably some kind of kicking the can down the road again and some bending of the rules. It feels premature to call for an intervention from the Bank of England. There is no sense of an actual financial crisis and no real forced selling to mop up – this is generally investment allocation led. The first stop might be for the Bank of England to curtail its Quantitative Tightening programme, although there are only £13bn of active sales scheduled this year. There is also the possibility of reinvesting maturing bonds which are currently being allowed to roll off, and that amounts to a bulkier £87bn in 2025. In the end, though, much of any yield rise will be self-correcting as higher and higher rates will weigh more on economic growth, eventually triggering recessions and rate cuts.

The final factor to mention is the nebulous concept of the "term premium", the extra yield demanded by buyers of longer term government bonds to account for uncertainty relating to growth, inflation and general government incompetence. One widely quoted model (Adrian, Crump & Moench) runs back to 1961, and it's instructive to look at it over that period for the US 10-year Treasury. It rises from zero at the start to around 1% a decade later as the US government began to expand its spending again having reduced debt-to-GDP post-WWII. The space race and the Vietnam War joined with President Lyndon Johnson's Great Society to create the initial inflation, and that went into overdrive in the 1970s driven by energy shortages and powerful labour unions. The early-to-mid 1980s peak was over 500bps as inflation peaked and Paul Volcker increased interest rates to tame inflation. It took years to break the inflationary mindset, with investors continually looking back over their shoulders. But increasing central bank credibility, a boom in global trade, the post-Cold War peace dividend and technology-led productivity growth finally did the trick.

The madness started after the financial crisis as the private sector deleveraged, baby boomers and trade surplus countries needed a home for savings and regulators created price-insensitive buyers of bonds. Throw in Quantitative Easing, a policy that was taken to extremes during Covid, and the term premium collapsed to a low of -1.67% in 2020. The fact that it is a positive 63bps today looks peaky compared to that trough, but not so much in the longer term. To be clear, we are not calling for a return to 1970s-style inflation on a sustained basis nor a 5% term premium, but it's not really clear where exactly this measure should settle. Certainly above zero, one would have thought, barring more intervention, which would, itself, only occur in extremely negative circumstances or outright financial repression.

Looking back at past Fed rate-cutting cycles, we can see that, on average, the 10-year Treasury yield has fallen by around 20bps one hundred days after the first cut, which is where we are now. But in this cycle the yield has risen by 100bps. Given that we know that a lot of trading is a function of algorithms which rely on past trends, what has happened since September breaks the mould and will have delivered substantial trading losses, one suspects, as reality did not meet model-based expectations.

There is a lot to get one's teeth into here, hence the longer-than-usual piece. And we haven't even gone into what it all means for equities and other assets. However, the key message to take away for now is that there are good reasons for the movements in bond and equity prices and currencies, but that we do not see them as a harbinger of some sort of crisis. Sensibly diversified portfolios should be able to bear the strain, even if it would be healthy to see some froth blown off the top of more extreme valuations. I shall follow up with more on the subject next week.

Economic Commentary

FTSE 100 weekly winners

Antofagasta plc	6.7%
International Consolidated Airlines Group SA	5.7%
RELX PLC	4.4%
DS Smith Plc	4.4%
BP p.l.c.	4.2%
Melrose Industries PLC	3.7%
AstraZeneca PLC	3.7%

FTSE 100 weekly losers

Ocado Group PLC	-13.9%
B&M European Value Retail SA	-12.2%
WPP Plc	-10.6%
J Sainsbury plc	-8.8%
United Utilities Group PLC	-8.1%
Taylor Wimpey plc	-8.0%
Entain PLC	-7.7%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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