

ANDREW J. BELSHAW
Head of Investment Management, London



Outlook for the UK—Inflation and the Gilts Market

Executive Summary

- A high-debt burden will slow growth and limit fiscal policy flexibility.
- Monetary policy will have to become more accommodative in the short term.
- In the long term, the inflation risk premium will rise.
- The Bank of England will require an exit strategy to unwind its asset purchase programme.
- Four exit strategies are explored and one considered most likely.
- Gilts remain vulnerable to an inflation shock.

The European economy, including both the eurozone and the UK, continues to face major structural challenges that will take several years to resolve. The central issue faced by the majority of European countries is that of high levels of debt (Exhibit 1). The resolution of this debt burden will continue to act as a brake on growth in the short term. Over the medium and long terms, it will pose inflationary risks, at least in those countries that have control of their currencies. Contrary to previous cycles, the confluence of over-indebtedness in both public and private sectors and the resultant adherence to “austerity” programmes has meant that fiscal policy has been inhibited as a stabiliser. Monetary policy has by necessity been the sole provider of stimulus, and will continue to be so for the foreseeable future. However, the differing institutional frameworks within which monetary policy operates have different implications for eurozone and non-eurozone economies.

Exhibit 1 Total Economy Debt (%GDP)

	1995	2012	Difference
United Kingdom	277%	556%	+279
Sweden	360%	500%	+140
Switzerland	305%	369%	+64
Germany	230%	338%	+108
France	280%	500%	+220
Italy	246%	390%	+144
Spain	207%	488%	+281
Belgium	345%	483%	+238
Austria	229%	360%	+131
Portugal	217%	433%	+216

Source: Haver Analytics, Western Asset

United Kingdom

Clearly, of the major European economies, the UK is by far the most indebted. The debt burden is split almost equally (excluding financial corporations) across the major sectors (Exhibit 2). With all sectors of the economy deleveraging, it is little surprise that the UK economy has performed as poorly as it has, both in absolute and relative terms.

Exhibit 2 Debt Burden

	Household	PNFC*	Government	Financial Corp	Total
Debt (%GDP)	99%	118%	100%	239%	556%

Source: Haver Analytics, Western Asset. *Private non-financial corporations

Before we see any meaningful improvement in economic activity, this debt burden has to be further reduced. Fortunately, unlike those eurozone countries in a similar position (e.g., France and Spain), the UK has recourse to its own monetary policy. This enables it to pursue both conventional measures, such as interest rates, and unconventional measures, such as quantitative easing (QE), and to tolerate a higher and more volatile level of inflation. In fact, long-term inflation is the major risk we see to the gilt market.

With growth so anaemic, policy stimulus has to resume. The Bank of England (BoE) is clearly tolerant of higher inflation, taking the view that it is better to have higher long-term inflation than to run the risk of Japan-style deflation. Policy has effectively been on hold awaiting the transition to the new BoE Governor Mark Carney. We expect the BoE to resume easing monetary policy when he takes over and after the budget-inspired review of monetary policy is completed in mid-August. Whether a more accommodative monetary policy will take the form of more QE or other non-standard measures—credit targeting, nominal GDP targeting, real economy triggers (e.g., unemployment) or negative interest rates—we will wait to see. All will increase long-term inflation risks.

According to the latest BoE inflation survey, long-term inflation expectations have been stable at 2% for the consumer price index (equivalent to 2.75% to 3.00% for the retail price index). Of course the BoE defines “long-term” as up to 2016! Using market pricing, the gilt market is currently discounting nominal gilt yields and breakeven inflation rates as shown in Exhibit 3.

These expectations are too pessimistic in the short term as nominal rates are too low, and too optimistic in the long term as inflation expectations are also too low. Ultimately, if one is going to rely on monetary policy to stimulate an economy, one is relying on the real rate of interest. To stimulate growth, one needs a lower real interest rate, at least at the short end of the government bond yield curve. This can be achieved by standard and non-standard measures but should, in the short to medium term, be positive for both conventional and inflation index-linked government bonds with a maturity of 10 years or less. However, the long-term consequence of such a policy has to be both higher inflation expectations and a correspondingly higher risk premium for long-dated gilts.

Exhibit 3
Forward Yields

	Now*	2014	2016	2023
Nominal Gilts				
2-year	0.32%	0.38%	1.59%	3.91%
5-year	0.82%	1.33%	2.42%	4.15%
10-year	1.88%	2.33%	3.08%	4.33%
30-year	3.19%	3.40%	3.69%	3.85%
Breakeven Inflation Rates				
10-year	3.34%	3.42%	3.69%	3.92%
30-year		3.72%		3.75%

Source: Western Asset. *14 May 2013

Consequently, the market expectation for short-dated and intermediate gilt yields is too pessimistic, given the economic and policy backdrop in the medium term. However, we also believe that inflation expectations, as indicated by breakeven inflation rates, are too sanguine. As can be seen, the breakeven inflation profile is virtually unchanged over 10 years for 30-year gilts and only marginally positive for shorter-dated gilts. Exhibit 4 highlights Western Asset’s nominal gilt yield and breakeven inflation expectations.

**Exhibit 4
Breakeven Inflation Profile**

	Medium Term	Long Term
Nominal Gilts		
10-year	1.25%–1.75%	2.50%–3.00%
30-year	3.00%–3.50%	4.50%–5.00%
Breakeven Inflation		
10-year	2.75%–3.25%	3.75%–4.25%
30-year	3.25%–3.75%	4.25%–4.75%

Longer-term expectations are, by their nature, more susceptible to error. Aside from the immediate impact of any further BoE policy measures, the biggest factor that will determine yield levels is the strategy that the BoE will adopt when the UK economy does eventually respond and the deleveraging cycle ends. Specifically, what will the BoE's strategy be when it wishes to reduce the size of its balance sheet?

Before addressing the valid options available to the BoE in unwinding its asset purchase programme, it is important to address a solution that has garnered much news coverage in recent months, namely, the cancellation of the BoE's gilt holdings. Superficially, this appears to be a neat and cost-free solution. Both the BoE (buyer of gilts) and Her Majesty's Treasury (issuer of gilts) are wholly-owned public sector bodies but the former has an asset and the latter a liability; by netting one off against the other, there is no change to the net public sector balance sheet position (Exhibit 5).

**Exhibit 5
Stylized UK Public Sector Balance Sheet (£ Billion)**

Assets		Liabilities	
Non-Financial Assets		Financial Liabilities	
Residential Buildings	9.3	Currency	59.2
Other Buildings	704.2	Gilts	894.8 ← 1,269.8
Plant & Machinery	32.0	of which BoE	375.0
Other Assets	77.1	Other Liabilities	47.1
	822.6		1,001.1 ← 1,376.1
Financial Assets			
Official Reserves	19.2		
Bank Deposits	97.8		
BoE Gilt Holdings	375.0		
Other Assets	61.5		
	553.5		
	1,001.1 ← 1,376.1		

However, this simple solution ignores the interaction of the BoE with the private sector. To analyse the implications of cancelling the BoE's gilt holding, it is first necessary to understand how that holding sits within the BoE's balance sheet (Exhibit 6).

Exhibit 6
Bank of England Balance Sheet (£ Billion)

<u>Assets</u>		<u>Liabilities</u>	
Net Foreign Assets	0.00	Currency in Circulation	59.24
Net Domestic Assets		Reserves of Banks & BS	289.88
Market Operations	13.77		
Ways & Means	0.37	BoE Securities	3.88
Other Assets*	<u>388.83</u>		
		Other Liabilities	49.83
		Bank (Equity) Capital	<u>0.14</u>
	402.97		402.97

* The loan to the Asset Purchase Facility to fund gilt purchases under the QE programme.

The Asset Purchase Facility (APF) is a wholly-owned subsidiary of the BoE and is the vehicle by which the BoE conducts its purchase of gilts in the secondary market. The BoE loans the APF the funds to purchase gilts, as directed by the BoE’s Monetary Policy Committee, through the creation of central bank money. The loan to the APF matches exactly the cost of the gilts purchase so, for the sake of simplicity, we assume the APF to be the BoE in what follows.

When the BoE purchases gilts in the secondary market, two things occur. First, the asset side of the BoE’s balance sheet expands to reflect the increase in gilt holdings. Second, the liability side of the balance sheet expands to reflect the creation of new cash. In terms of the liability side of balance sheet, this usually shows up in “Reserves of Banks and Building Societies” (RBBS). When gilts are purchased in the secondary market, electronic cash is credited to the selling institution. If a bank or building society is the seller, the “cash” will show up directly in RBBS. If the seller is a non-bank it will ultimately appear there as well, as the selling institution will typically deposit the proceeds of the sale with their custodian bank.

From the above, it is obvious that if the government cancels the BoE gilt holdings, the BoE will, in fact, become insolvent: liabilities will far exceed assets. Is this a problem? Technically not, as a central bank is not a commercial bank and its liabilities are its own “fiat” money that never has to be redeemed. However, from a market and economic signalling perspective, it is highly unorthodox and would indicate explicitly that the BoE was content to undertake money financing of deficits. This may not be the straight road to the hyperinflation of the Weimar Republic, but the implications would be clear. Inflationary expectations would soar.

Could the BoE cancel its gilt holdings and remain solvent? Yes, if it pursued one of or some combination of the following. First, it could correspondingly reduce the liability side of its balance sheet, either by reducing the amount of physical cash outstanding or by charging a punitive rate of interest on reserve deposits to deter money holdings. Either would be economically disastrous, engendering a severe deflationary shock to the economy. Second, the BoE could rebuild its asset side via an injection of assets from the government. As this would most likely take the form of depositing gilts with the BoE, the whole process becomes rather circular and pointless.

Cancelling the BoE’s gilt holdings is thus clearly not practicable or desirable. In assessing potential exit strategies, one always has to remember that they will have implications both for the BoE’s balance sheet and for

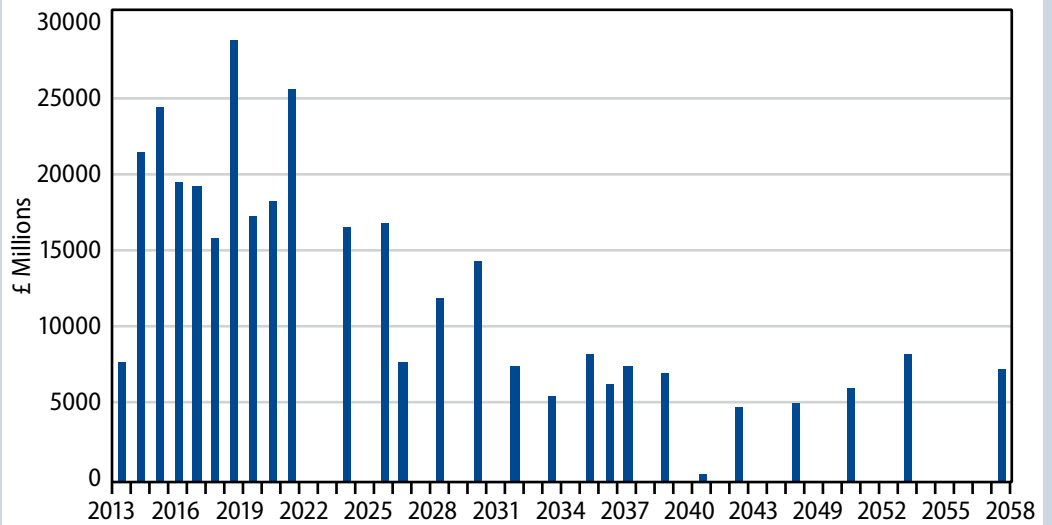
the government's. When the APF was established, the government indemnified the BoE against any losses it would make on its gilt purchases. Given that the vast majority of the APF purchases have been above par, de facto, if the gilts are held to maturity, the APF will be locking in a loss. To be fair to the BoE, it does know this, but it has taken the view that the coupon payments that accrued over the period would offset the capital value losses. Unfortunately, the Chancellor decided late last year that any coupons net of expenses should be paid over to the Treasury as a dividend in order to facilitate short-term fiscal management. As the accumulated coupon inflow was £35 billion, this was a substantial dividend that had to be paid across and that will have to be reversed at some point. This will mean the Treasury will have to inject capital into the APF to cover losses. Of course, this can be viewed as a cash flow management exercise, using idle cash now to "help" the economy, with the prospect of repayment later when the good times return. The risk of this approach is that the good times don't return or, rather, that they are not sufficiently good to generate a significant improvement in the UK's fiscal position and that more gilts have to be issued to make good the losses on the "old" gilts! This could pose an interesting dilemma for the BoE when evaluating its choice of exit strategy.

We see four potential exit strategies:

1) No Active Gilt Sales / Gilts Mature and Run Off

This removes the risk of disrupting the gilt market by selling gilts and gradually reduces the BoE's balance as gilts mature and cash is paid back to the BoE (and destroyed). The risk of this approach is that inflation expectations may rise, because the bank has to maintain a large balance sheet for longer (Exhibit 7). In terms of the government's indemnity, the smoothing aspect would in all probability be easier to manage under this scenario.

Exhibit 7
BoE Gilt Holdings (Nominal Amount Maturing Annually)



Source: Bank of England

2) Active Gilt Sales

Assuming the economy recovers sustainably, the BoE could move to actively reduce the size of its balance sheet to keep inflation expectations in check. This would reverse the depressant effect of 100 basis points or more that the BoE believes QE has imparted to the UK interest rate structure. It may cause the economy to

stall and the increased financing costs may put further pressure on government finances. The APF indemnity would be called in to use, which would put further pressure on government finances.

3) No Active Gilt Sales / Increase in Interest Rates

Rather than pursue an active gilt sales policy, the BoE could allow gilts to mature as in (1) and, in order to prevent inflation expectations from rising, increase short-term interest rates. This would smooth the shock to the interest rate structure and not force the BoE to “dump” a large volume of gilts on the market. It would also allow a smoother adjustment for the government in terms of its indemnity financing.

4) Active Gilt Sales / Increase in Interest Rates

This is the “nuclear” option that would probably only be contemplated when inflation pressures were out of control and sterling were under severe pressure. The negative monetary shock would quell any economic activity and do immense damage to the government’s fiscal position.

Of the four options, we would assume, *ceteris paribus*, the third as the most likely exit strategy.

In conclusion, we believe the UK gilt market remains vulnerable to an inflation shock. The UK economy has disappointed all reasonable forecasts over the past six years. The need to generate a sustained recovery is acute. This raises the prospect of a policy mistake. Adding a new BoE Governor who may wish to try different and untried non-conventional monetary measures to this mix naturally leads investors to the conclusion that the risk premium of long-dated gilts has to rise.

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