

# UK Rates Strategy

## The Gilt 'Scorecard' Reloaded

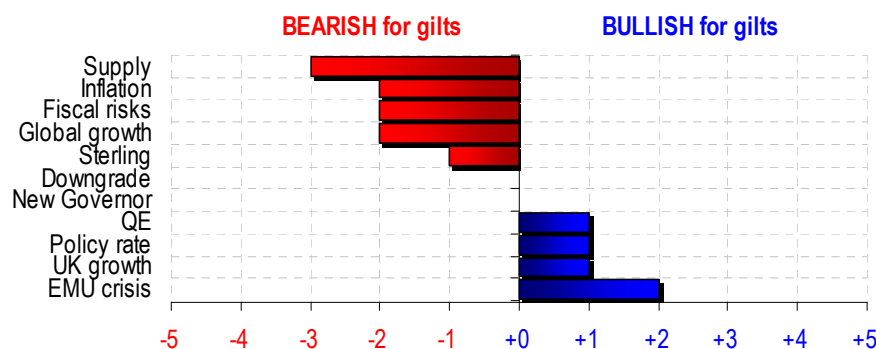
- We update the gilt 'scorecard' for developments since the last update on [27 March](#). The idea of the scorecard is to assess the balance of bullish and bearish risks facing the gilt market compared with what is currently 'priced-in'.
- The recent newsflow has predominantly added to the bearish risks for gilts. However, the scorecard also acknowledges that inflation/fiscal risks in particular are, for now, being overwhelmed by global central bank liquidity, positioning and yield-grab.
- Overall, the scorecard continues to suggest that the medium-term risks facing long-end gilts are, on balance, moderately bearish (the 'final score' is -0.6).
- The main developments since we last updated the scorecard include:
  - The Funding for Lending Scheme has been extended to end-2014 with greater incentives to lend to SMEs;
  - The gilt issuance remit for FY2013-14 was revised higher by £4.7bn following the publication of the CGNCR outturn for FY2012-13;
  - Fitch downgraded the UK's credit rating from AAA to AA+ (stable outlook). In contrast, S&P affirmed the AAA rating, but kept the negative outlook;
  - UK GDP was stronger-than-expected in Q1 at +0.3% QoQ (median +0.1%);
  - The BoJ announced more aggressive plans for monetary easing.
  - The EMU periphery has performed well, aided by the perception that near-term risks (mainly related to Cyprus and Italy) have receded;
  - Brent oil prices have fallen 6% in GBP terms over the last month.

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Figure 1. Summary of the Citi Gilt Scorecard



Source: Citi Research

**See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.**

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## The gilt 'scorecard' (for the medium-term)

Figure 2. Citi Gilt Scorecard (for the medium-term outlook)

Driver	BEARISH case for gilts	BULLISH case for gilts	Net Score -5 BEAR-BULL +5	Weight*
<b>Inflation</b>	<b>Realised inflation likely to head higher in the coming months.</b> The new MPC remit keeps the 2% target but allows greater tolerance for a persistent inflation overshoot. Regulated and administered prices to keep inflation above target. Sterling depreciation, should it resume, is inflationary.	<b>Inflation risks are being reflected in break-even inflation spreads, but are still not impacting nominal gilt yields.</b> Market is well used to UK inflation overshooting. <b>Brent oil prices have fallen sharply over the last 2mths.</b> Sterling has appreciated over the last month.	<b>-2</b>	15%
<b>Fiscal risks</b>	<b>The 2013 Budget was neutral, but the medium-term fiscal outlook continues to deteriorate.</b> Weak growth weighing on tax receipts. Growing risk of pre-election 'give-away' (election by 7 May 2015).	<b>Markets currently driven more by CB backstops than fiscal risks.</b> 10yr Gilt-OAT spreads already near the 2yrs lows (fiscal risks in France arguably greater than in the UK). 10s30s gilt curve already steeper than 10s30s UST/Bund.	<b>-2</b>	15%
<b>Supply</b>	Gilt issuance is historically elevated and will likely remain so for many years to come. <b>The borrowing requirement for FY2013/14 has already been revised higher since the Budget and probably will be again.</b> (see also Fiscal risks)	Gross supply will be lower in FY2013/14 than in FY2012/13 (but only thanks to the one-off APF transfer).	<b>-3</b>	15%
<b>QE</b>	<b>The extended FLS, strong Q1 GDP and the low level of gilt yields arguably makes QE less likely in the coming months.</b> The MPC now has a wider policy toolkit available to it. Recent MPC minutes only discussed +£25bn. More QE could stoke inflation fears and/or weaken sterling.	<b>QE could be used by the MPC to cap any rise in gilt yields.</b> Citi forecasts +£75bn QE in total. Latest Reuters survey suggests just 60% probability of more QE. MPC open to more QE. King voted in favour for the last 3 meetings.	<b>+1</b>	15%
<b>EMU crisis/ Safe haven</b>	The euro crisis has eased over the last 6 months and the market has shown signs of "bad news fatigue". Fiscal risks+inflation+BoE policy+sterling depreciation may eventually challenge the UK's relative safe haven status.	<b>The EMU crisis is far from over, and gilts remain a relative safe haven.</b> The UK will continue to benefit from monetary policy independence and being non-euro. Sterling remains a global reserve currency. BoE data shows that overseas investors are still net buyers of gilts.	<b>+2</b>	15%
<b>Policy rate</b>	An extended period of low policy rates is unlikely to prevent long-dated yields from rising in the face of inflation/fiscal risks (i.e. the curve is likely to bear steepen) Rates will eventually have to normalise.	<b>Citi expects policy rates to be on hold until 2017.</b> The MPC will report on the merits of rate guidance in the August Inflation Report. A rate cut or negative rates on banks reserves are policy options.	<b>+1</b>	10%
<b>Global growth</b>	US economic recovery in H2 could drag G10 yields higher.	European growth likely to remain very weak: G10 yields may decouple as growth de-couples.	<b>-2</b>	5%
<b>Sterling</b>	Sterling depreciation may resume if Carney encourages full use of the MPC's toolkit. Inflation impact via higher imported food and energy prices (see also Inflation). Tail risk that sterling depreciation snowballs	Sterling has appreciated over the last month since Governor King said GBP is close to fair value. Long-term relationship between gilt yields and sterling is poor. As is relationship between sterling and overseas holdings of gilts.	<b>-1</b>	2.5%
<b>UK growth</b>	UK growth may surprise given ongoing and expanded policy accommodation. This has proven to be the case in Q1 2013.	UK growth continues to 'bounce along the bottom'. Exports are weak, productivity is low. (see also Policy rates, QE and Fiscal risks)	<b>+1</b>	2.5%
<b>Downgrade</b>	The UK has now lost its AAA-rating from both Moody's and Fitch. S&P affirmed the AAA-rating on 5 April, but kept the negative outlook. Downgrades may have political implications over the longer-term. (see also Fiscal risks, Safe haven).	The loss of the UK's AAA-rating had been well anticipated by the gilt market, as evident from the lack of reaction to the downgrades from both Moody's and now Fitch.	<b>+0</b>	2.5%
<b>New BoE Governor</b>	Carney likely to encourage the use of a wider range of policy tools explicitly permitted under the new MPC remit. Carney may look at buying non-gilts assets (see also QE).	New Governor may introduce forward rate guidance (the BoE will report on the merits of guidance in the August Inflation Report) (see also Policy rates).	<b>+0</b>	2.5%

<b>FINAL SCORE</b>	<b>Moderately Bearish</b>	<b>-0.6</b>	100%
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Source: Citi Research

\*The weights are adjusted to avoid double counting and do not necessarily reflect the importance of the driver in isolation

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