

UK Rates Strategy

What's going on with 30yr gilt swap spreads?

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- This has taken 30yr gilt swap spreads towards their cheapest levels for the last two years. In this article, we consider what has driven the cheapening and whether it is more likely to continue, or reverse.
- We also discuss any possible implications from the 3 December Autumn Statement.

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What's going on with 30yr gilt ASWs?

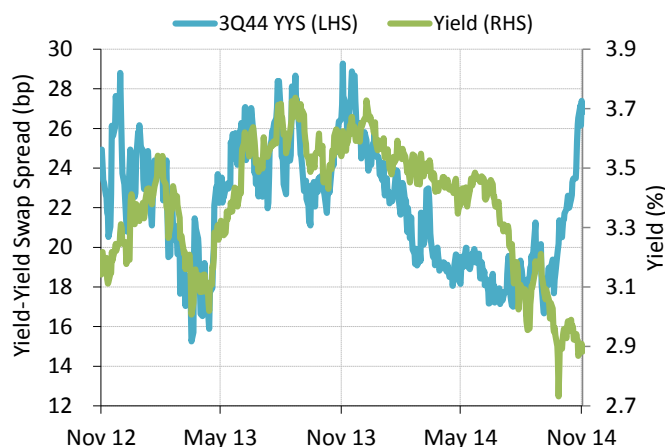
In just over a month, 30yr gilt swap spreads have cheapened by almost 10bp. To put this into context, the trading range for the previous six months was around 3bp. This has taken 30yr spreads towards their cheapest levels for the last two years. In this article, we consider what has driven the cheapening and whether it is more likely to continue, or reverse. We also discuss any possible implications from the 3 December Autumn Statement.

Why have 30yr swap spreads cheapened by so much?

There are several possible explanations for the cheapening in 30yr gilt swap spreads. All have probably contributed, but to varying degrees. Some are more technical, others more fundamental in their nature.

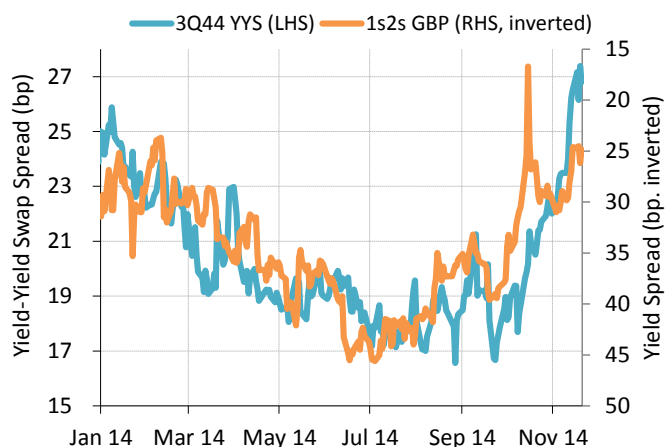
- **On the technical side, the proximity to year-end, balance sheet constraints and financing costs have all contributed.** Relatedly, LDI-related demand appears to have been more concentrated on swap receiving than gilt buying.
- **The cheapening may have been exacerbated by positioning.** There may have been some expectations that 30yr spreads would richen following the 2068 gilt syndication on 28 October. When this didn't materialize, the stopping out of long positions probably helped to propel the cheapening.
- **On the fundamental side, attention is growing on political and fiscal risks in the UK.** The May 2015 general election is now just six months away and the latest polls point to a messy outcome, with perhaps a three-party coalition. This may hinder the progress on fiscal consolidation, which is anyway being challenged. As our economists team have highlighted, the recent fiscal slippage can be associated with the fact that much of the job growth in this recovery has been in low-paid sectors (see for example [The UK's Achilles Heel](#), 7 November). The Autumn Statement on 3 December will put the fiscal challenge firmly in the spotlight. In this context, it could be argued that political/fiscal concerns are weighing on long-end swap spreads.
- **The cheapening in swap spreads may also be related to the pricing out of rate hike expectations.** A hiking cycle is normally associated with richer swap spreads. Swap spreads do appear to have become less directional (Figure 1) and more sensitive to policy rate expectations in 2014 (Figure 2), but the recent cheapening of 30s looks disproportionate to moves in shorter tenors.

Figure 1. 30yr swap spreads have lost their yield directionality...



Source: Citi Research, Bloomberg.

Figure 2. ...but have become more sensitive to policy rate pricing



Source: Citi Research, Bloomberg.

Why 30yr swap spreads may begin to perform

Of the drivers outlined above, we suspect that those of a technical nature may have played a greater role than the fundamental considerations.

■ **Markets more broadly are not overly sensitive to fiscal risks at the moment.**

EMU spreads offer a case in point. Political uncertainty is also likely to linger for many months, but only fully priced-in when it becomes a more immediate concern. Any cheapening of gilts related to these concerns is also likely to be limited by demand for yield from international investors and structural interest from liability hedgers. As we have discussed previously, we expect these demand trends to encourage a lower-for-longer yield environment in the long-end.

■ **The Autumn Statement is also unlikely to be overly negative for gilts.**

While it is likely to highlight fiscal slippage, this has been well anticipated by the market. The gilt issuance remit may also be left broadly unchanged. Any changes to the financing requirement within the fiscal year have been met in recent years with an alternation to the planned sales of Treasury bills. This allows continuity in the gilt remit. An overshoot in this year's deficit will also be partially offset by the announcement by the ONS in mid-October that the CGNCR for the last three years has been overestimated by a cumulative £9.7bn. **Our base case is that the gilt remit is left unchanged at £127.2bn.**

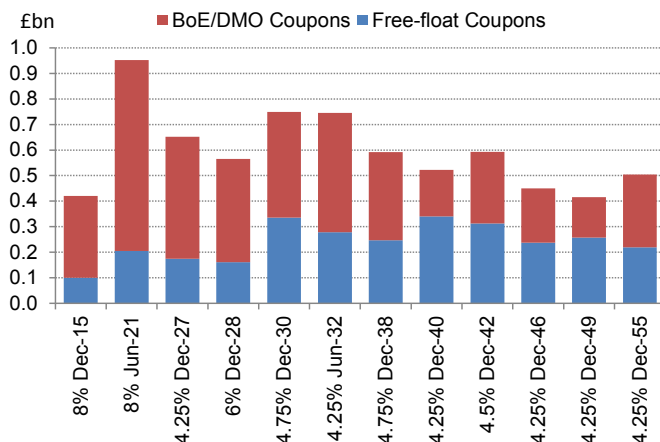
■ **Gilt coupon payments supportive for the long-end.** The coupons due on 7 December total £7.2bn, falling to £2.9bn when DMO/BoE holdings are excluded. Of this, a large proportion - £2.2bn - is in longs (15yr+) - Figure 3.

■ **30yr swap spreads also cheapened sharply in late 2012 and 2013, and then reversed.** The peaks – which were close to current levels – were 18 December and 21 November, respectively (Figure 4). There is, then, a precedent for underperformance towards year-end to reverse.

In our minds, the recent cheapening in swap spreads is more likely to be technical than fundamental. This makes us more inclined to fade the move and **scale into a long position in 30yr swap spreads**, especially given coupon support.

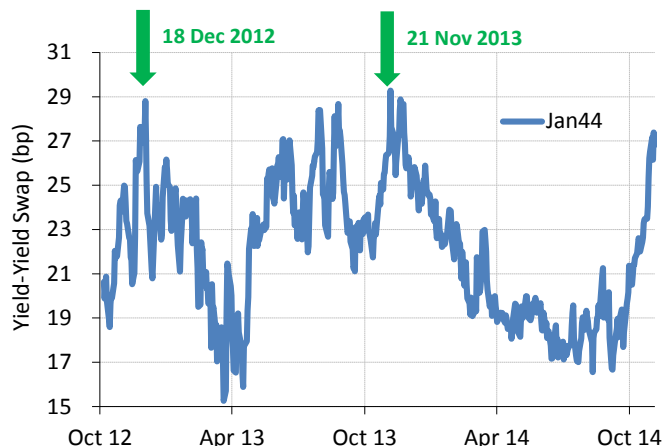
■ **Trade details:** buy gilt 3.25% Jan44 yield-yield swap. Current level = 27bp, target = 20bp, stop 30.5bp.

Figure 3. Breakdown of 7 December coupon payments



Source: Citi Research, DMO, BoE.

Figure 4. Year-end cheapening/reversal of 30yr swap spreads



Source: Citi Research

Appendix A-1

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