

UK Rates Strategy

Introducing a 'scorecard' for gilts

- Only two months into 2013, the MPC has communicated a new reaction function (to tolerate a longer inflation overshoot), the probability of more QE has risen, trade-weighted sterling has depreciated 6%, the UK has lost its AAA-rating from Moody's and the Italian election result has reminded us that the euro crisis is far from over.
- But what does all this mean for gilt yields?
- In this note we introduce a 'scorecard' for the gilt market over the medium term. The idea is to provide a guide to the most important drivers of gilts and assess the balance of bullish and bearish risks compared with what is currently 'priced-in'.
- The 'final score' is moderately bearish at -0.8 (on a scale of -5 to +5). This is consistent with our view that gilts yields are likely to move into a moderately higher trading range in 2013, but an aggressive sell-off seems unlikely (see [European Rates Weekly](#)).
- The scores (and weights) are highly subjective. Your feedback and opinions are always welcome.

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

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Introducing a 'scorecard' for gilts

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The gilt market faces many potential drivers over the medium term

Some of the drivers are, to varying extents, already 'in the price'

The 'scorecard' aims to evaluate the balance of bearish/bullish risks

The scores are highly subjective and are intended purely as a guide to the risks

Weights are used to reflect the importance of the driver and avoid double counting

The scorecard currently suggests a moderately bearish stance on gilts over the medium-term

Only two months into 2013, the MPC has communicated a new reaction function (to tolerate a longer inflation overshoot), the probability of more QE has risen, trade-weighted sterling has depreciated 6%, the UK has lost its AAA-rating from Moody's and the Italian election has reminded us that the euro crisis is far from over. But what does all this mean for gilt yields? In this article we introduce a 'scorecard' for the gilt market over the medium term. The idea is to provide a guide to the most important drivers of gilts and assess the balance of risks compared with what is currently 'priced-in'.

How the scorecard works

The gilt market faces a multitude of potentially bearish drivers in 2013, including higher inflation, weaker sterling and fiscal slippage. There are also potential bullish drivers such as a resumption of QE and continued economic stagnation. There are also drivers – such as the EMU crisis – that could pull yields in either direction.

But, of course, these risks, both bearish and bullish, are well understood by financial markets and, to varying extents, are already 'in the price'. The gilt market's shrug in response to the recent downgrade by Moody's is testament to that.

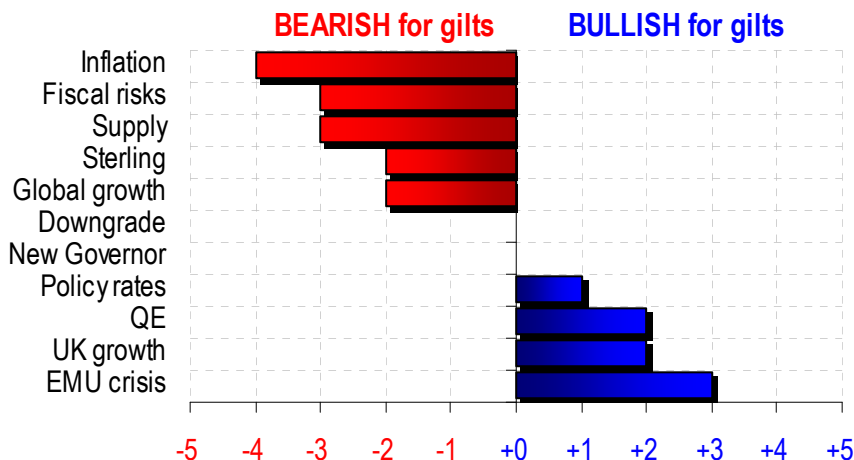
The 'scorecard' (see next page) aims to assess the balance of bearish and bullish risks for different drivers in the context of what is currently being anticipated by the gilt market. The most extreme bearish/bullish score is -5/+5, suggesting a risk that is not currently priced by the gilt market. A score of zero would suggest that the risk is, in our judgment, fully reflected in valuations at this moment in time.

The scores are, of course, highly subjective and we prefer to use it as a guide to the risks rather than to directly inform our forecasting process, especially in the short term when more transient drivers will normally dominate. In short, this is not intended to be a forecasting 'model', but is more a reality check.

The 'final score' is a simple weighted average. There is inevitably some overlap between categories which we attempt to address with the weights in order to avoid double counting (N.B the weights do not necessarily reflect the importance of the driver in isolation). A summary of the individual scores is shown in Figure 1.

The 'final (weighted) score' is currently -0.8 (see next page). This is consistent with our view that gilts yields are likely to move into a higher trading range in 2013, but an aggressive sell-off seems unlikely at the moment.

Figure 1. Summary of the Citi Gilt Scorecard



Source: Citi Research

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*
Inflation	MPC have communicated a greater tolerance for a sustained inflation overshoot. Regulated and administered prices to keep inflation above target. Sterling depreciation is likely to raise inflation further (market won't be slow to price it in given the experience of the last few years).	10yr break-evens have already risen 50bp this year (but 40bp of this was post CPAC). Market is well used to UK inflation overshooting. Oil prices range-trading.	-4	20%
QE	Greater focus on FLS. Diminishing impact of QE. Carney may consider buying assets other than gilts. January MPC minutes only discussed +£25bn. More QE could stoke inflation fears.	QE could be used by the MPC to cap a rise in gilt yields. Citi forecasts +£75bn QE (with +£25bn in March) Latest Reuters survey suggests just 60% probability of more QE. MPC open to more QE. King voted in favour in January.	+2	20%
Fiscal risks	Risk of fiscal slippage at the 20 March Budget (austerity getting pushed back). Weak growth weighing on tax receipts. Risk of pre-election 'give-away' (election by 7 May 2015). Likelihood of Labour victory (as indicated by polls).	Markets currently driven more by CB backstops than fiscal risks. 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.	-3	10%
EMU crisis/ Safe haven	The euro crisis has eased over the last 6mths, at least until the Italian elections. Fiscal risks+inflation+BoE policy+sterling depreciation all raising question marks about the UK's safe haven status.	EMU crisis could resurface at any moment. 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.	+3	10%
Global growth	US economic recovery could drag G10 yields higher.	European growth likely to remain very weak: G10 yields may de-couple as growth de-couples.	-2	10%
Supply	Gilt issuance will remain elevated for many years to come. Gross supply in FY2013/14 likely to be similar to FY2012/13. (see also <i>Fiscal risks</i>)	DMO could skew supply even more towards IL where demand is still very strong.	-3	10%
Policy rate	Rates will eventually have to normalise.	Citi expects policy rates to be on hold until 2017. Governor-designate Carney may introduce rate guidance. Rate cut still possible. MPC member Tucker has recently raised the idea of negative rates on banks reserves, but this seems very unlikely any time soon.	+1	10%
UK growth	UK growth may surprise.	UK in danger of triple-dip recession. Exports are weak, productivity is low. (see also <i>Policy rates, QE and Fiscal risks</i>)	+2	2.5%
Sterling	BoE encouraging GBP depreciation via verbal intervention. Inflation impact via higher imported food and energy prices (see also <i>Inflation</i>). Could prompt selling of gilts by overseas holders (see also <i>Safe haven</i>). Tail risk that sterling depreciation gets out of control.	Long-term relationship between gilt yields and sterling is poor. As is relationship between sterling and overseas holdings of gilts.	-2	2.5%
Downgrade	Moody's downgrade (and possible downgrades from other agencies) may have political implications over the longer-term. (see also <i>Fiscal risks, Safe haven</i>).	The loss of the UK's AAA-rating has been well anticipated by the gilt market, as evident from the lack of reaction to Moody's downgrade.	+0	2.5%
New BoE Governor	Any change to the inflation target may destabilise inflation expectations. Carney may look at buying non-gilts assets (see also <i>QE</i>).	New Governor may introduce forward rate guidance (see also <i>Policy rates</i>).	+0	2.5%

FINAL SCORE	Moderately Bearish	-0.8	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

Appendix A-1

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