

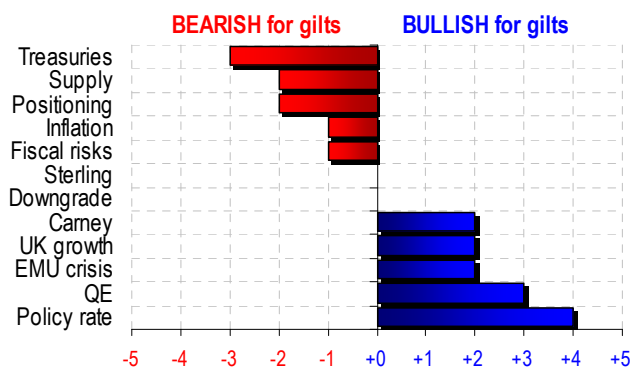
UK Rates Strategy

The Gilt 'Scorecard': Turning Bullish

- **Short- vs medium-term** – Gilt yields have surged higher as the market frets about Fed tapering and a turn in the global policy cycle. Direction in the near term will primarily depend on positioning and liquidity, in our view. However, the 'scorecard' aims to step back from volatile markets and assess the medium-term outlook for gilt yields.
- **Domestic vs international drivers** – As the 'scorecard' shows, the gilt market continues to face a range of both bullish and bearish drivers. The greatest bullish influence is likely to be domestic monetary policy (including forward guidance). The greatest bearish influence is likely to be developments in the US Treasury market. A roadmap for tapering alone has been enough to spark a rout in global bond markets over the last few weeks.
- **Overall score turning bullish** – The gilt 'scorecard' aims to assess the balance of risks compared with what is currently 'priced-in'. The overall (weighted) score has turned moderately bullish since the last update on [29 April](#) (the 'final score' is +0.7 vs -0.6 previously). This suggests that the sell-off in gilts is overdone. This owes much to our judgment that the recent rise in UK rate hike expectations is premature and will reverse, especially if forward guidance is introduced by the MPC.
- **Positioning** – In this version of the 'scorecard', we have introduced an individual score for positioning. This is to reflect the current nervousness regarding the unwinding of carry trades and the 'structural long' positions in most core rates markets (owing to safe haven buying at historically low yields levels). There is a significant risk that the speed of any 'normalisation' in core yields could be greatly accelerated by positioning.

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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*
Policy rate	An extended period of low policy rates may not prevent long-dated gilt yields from rising if Treasury yields are rising. (i.e. the curve is likely to bear steepen) Rates will eventually have to normalise. (see also US growth/Treasuries)	We expect forward guidance to be introduced after August which could imply that policy rates will be on hold for much longer than what is currently priced into the market following the sharp backup in front-end yields. Citi expects policy rates to be on hold until 2017. A rate cut or negative rates on banks reserves are policy options.	+4	25%
QE	QE on hold for now and Carney appears to prefer forward guidance as a policy option. The MPC now has a wider policy toolkit available to it. Recent MPC minutes have only discussed +£25bn. More QE could stoke inflation fears and/or weaken sterling.	QE could be used by the MPC to cap any unwelcome rise in gilt yields, such as the last few weeks. Citi forecasts +£75bn QE in total. Three members of MPC already voting for more QE (although this includes outgoing Governor King)	+3	10%
New BoE Governor	Expectations for Carney are quite high and there is a risk of disappointment in terms of 'monetary activism'. Carney only has one vote on the MPC. Carney may look at buying non-gilts assets (see also QE).	Carney takes over as Governor next week. We expect Carney to argue in favour of the introduction of forward rate guidance. (see also Policy rates). The departures of Deputy Governors Bean and Tucker over the next year could alter the policy bias of the MPC.	+2	5%
EMU crisis/ Safe haven	In the last few weeks, gilt yields have risen despite sharply higher yields in the EMU periphery. Fiscal risks+inflation+BoE policy+sterling depreciation may eventually challenge the UK's relative safe haven status.	The EMU crisis is far from over. Gilts remain a relative safe haven. The UK will continue to benefit from monetary policy independence and being non-euro. Foreigners have been net buyers of gilts in 9 out of the last 10mths.	+2	5%
UK growth	The data has improved recently and there is a risk that growth continues to beat expectations given ongoing policy accommodation.	The data may be improving, but the economy is a long way from achieving 'escape velocity'. UK growth continues to 'bounce along the bottom'. Exports are weak, productivity is low. (see also Policy rates, QE and Fiscal risks)	+2	5%
US growth/ Treasuries	The market has reacted strongly to the Fed's timetable for tapering. Gilts yields have risen with a high beta to Treasuries, highlighting their vulnerability to a sustained sell-off in the latter. US economic recovery in H2 could drag G10 yields even higher.	Gilt yields have been dragged higher by Treasuries, but this is not supported by domestic fundamentals which are likely to reassert themselves when markets calm. European growth is likely to remain very weak: G10 yields may decouple as growth de-couples.	-3	15%
Supply	Gilt issuance is historically elevated and will likely remain so for many years to come. With QE on hold, net issuance is effectively rising. (see also Fiscal risks)	Strong demand for the new 55yr gilt (2068 maturity) highlights domestic support for gilts (on any backup in yields) Gross supply will be lower in FY2013/14 than in FY2012/13 (but only thanks to the one-off APF transfer).	-2	10%
Positioning	A backup in yields could be greatly accelerated by the unwind of structural long positions in core rates (owing to safe haven buying at historically low yield levels).	The recent backup in yields has washed out carry trades and has probably made tactical positioning a lot cleaner.	-2	10%
Inflation	CPI is likely to remain above the 2% target for years to come (largely due to regulated and administered prices). The new MPC remit keeps the 2% target but allows greater tolerance for a persistent inflation overshoot. Forward guidance, if introduced, could formalise tolerance for above target inflation by including a 'knockout' at 2.5%.	Headline inflation is likely to peak in June and fall thereafter. Core inflationary pressures are muted. Global inflation expectations have been falling despite the recent rise in nominal yields. Market is well used to UK inflation overshooting. Sterling has appreciated over the last few months.	-1	5%
Fiscal risks	The UK's fiscal position remains weak and is vulnerable to any slowdown in growth. The speed of austerity has been slowed. The spending review for 2015-16 has been completed, but the cuts are tiny in the grand scheme of things. Risk of pre-election 'give-away' (election by 7 May 2015).	Markets currently driven more by CB backstops and the policy outlook 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.	-1	5%
Sterling	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 few months 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.	+0	2.5%
Downgrade	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.	+0	2.5%
FINAL SCORE		Moderately Bullish	+0.7	100%

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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