Gilt-edged opportunities

Fixed income | September 2023

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- **Gilts of two-plus years are trading cheap to US treasuries, despite a slightly higher US base rate**
- **With the UK facing unique inflationary pressures it is unlikely to support longer-term rates as high as in the US, contradicting market pricing**
- **Either the long-run neutral rate has shifted or inflationary issues will persist for several years – providing an opportunity in government bonds**

The UK and the wider world have endured many common inflationary woes. This has included surging energy and food prices following the invasion of Ukraine and Covid-induced supply chain bottlenecks pushing up the cost of input prices and final products alike. But the UK's fight against inflation has been made more challenging by country-specific problems:

- **A strained NHS with record waiting times for treatment** Since December 2019 this is contributing to an additional 412,000 adults out of the workforce due to long-term sickness[1] – 1.25% of the UK's employed population. Additionally, one in six of the UK's workforce report that they suffer from long-term health problems, which reduces productivity and hours worked[2].
- **Being one of the largest net importers of food and drink** This leaves the UK particularly exposed to rising global food prices[3].
- **Brexit-induced labour shortages** As of November 2022, 13.3% of businesses reported a shortage of workers, with a high proportion of sectors such as transportation and education citing a lack of EU applicants as the reason they are unable to fill vacancies[4].

[1] Bank of England, May 2023

[2] Bloomberg, Britain Is Rapidly Becoming a Sick Society, 17 March 2023

[3] Reuters, Explainer: Why is inflation so high in the UK?, 21 June 2023

[4] House of Commons Library, Skills and labour shortages, 10 January 2023

In light of this UK gilts are trading cheap to US treasuries: gilts with maturities of two-plus years currently give investors between 20bps-50bps of additional yield over US treasuries[5]. This is despite a slightly higher US base interest rate at 5.25%-5.50% versus 5.25% for the UK.

Market expectations

Using the UK yield curve we can calculate the implied pricing of future short-term rates. At the time of writing[6] the market expects:

- 1-year rates at 5% in a year's time
- 1-year rates at 4.5% in three years' time
- 1-year rates at 4.8% in five years' time

This is relative to one-year gilts trading at less than 1% from the financial crisis to 2022. This may reflect expectations of higher inflation for longer and would be contrary to recent Bank of England (BoE) guidance that inflation will be at 2% by early 2025[7].

Looking at implied pricing for the US yield curve[8] we get:

- 1-year rates at 4.5% in one year's time
- 1-year rates at 3.9% in three years' time
- 1-year rates at 4.2% in five years' time

Two major technical factors have contributed to higher UK yields. The first is that rising government indebtedness is leading to a higher supply of gilts and in turn higher yields. Secondly, the impact of quantitative tightening (QT). The BoE is actively selling gilt purchases into the market. Gilt holdings peaked at £875 billion in February 2022, but this is now down to £784 billion[9] and the BoE has indicated it will drop some way below the £728 billion seen in January 2021[10]. This contrasts to the passive QT approach taken by the US Federal Reserve, which simply doesn't re-invest maturing treasuries.

Where will rates go?

The theoretical answer is the neutral rate. This is the rate at which monetary policy is neither accommodative nor restrictive, a short-term rate consistent with the economy maintaining full employment with associated price stability. To get to this rate we would need inflation under control. The Fed sees the long-run neutral rate at 2.5%. Between 2016 and 2020 the UK largely had both full employment and inflation close to target but had a base rate of between 0.25% and 0.75% (Figure 1).

[5] Bloomberg, as at 20 August 2023

[6] Bloomberg, as at 20 August 2023

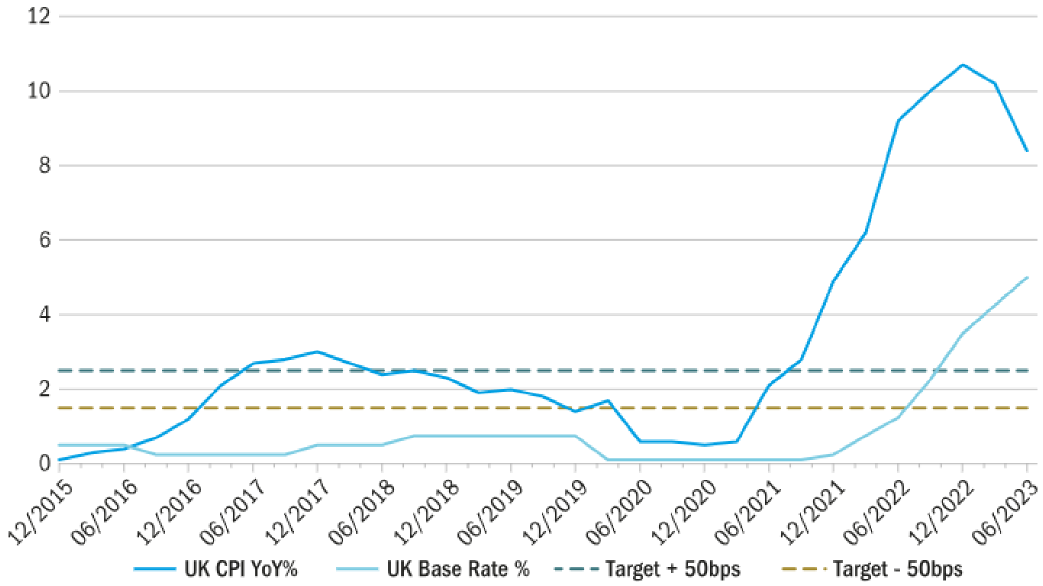
[7] Bank of England, When will inflation in the UK come down?, 3 August 2023

[8] Bloomberg, as at 20 August 2023

[9] Bank of England, as at 9 August 2023

[10] Reuters, Factbox: Giving up gilts: how the Bank of England plans to reverse QE, 1 February 2022

Figure 1: recent history of UK CPI and BoE base rate



Source: Bloomberg, as at 30 June 2023

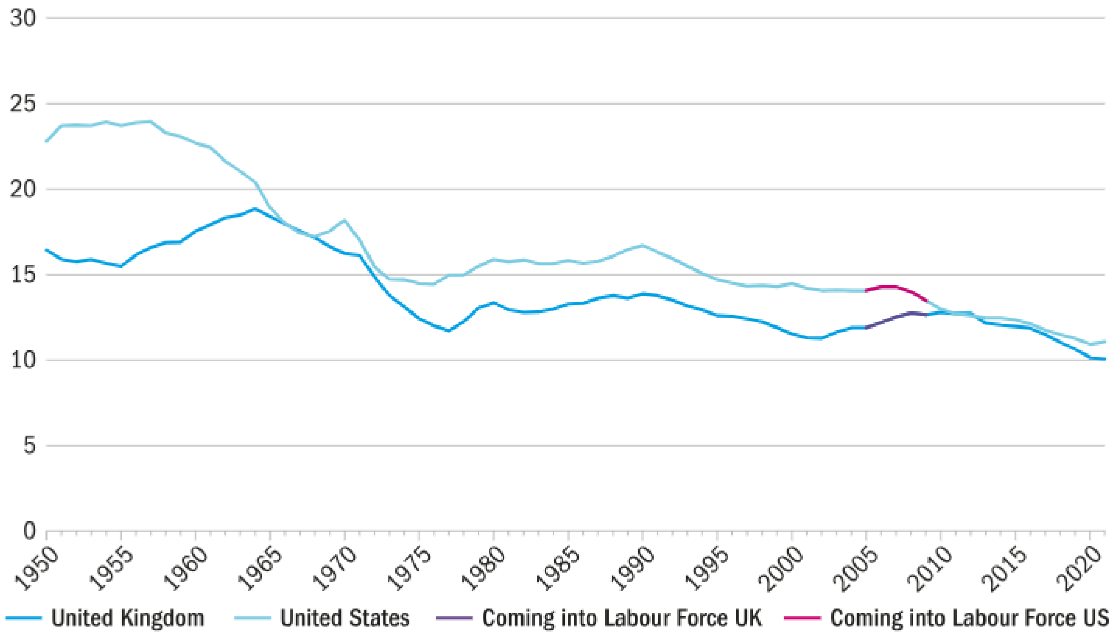
If we focus on demand-pull inflation, which is too much demand chasing limited goods, then all else being equal one economy growing faster than another (or running hotter) will require a higher interest rate to keep price pressures in check. To assess which of the UK or US economies is likely to grow faster I lean on the "labour productivity accounting equation", which says GDP growth is a result of the long-run growth in the labour force and labour productivity[11].

Labour force

While US and UK birth rates have recently converged (Figure 2), if we look at the period spanning 2005-09 the US birth rate was running at 13% above the UK. This means that from 2023-28, when this cohort turns 18, the US will have a greater boost to its home-grown labour force.

[11] CFA Institute, Economic Growth, 2023

Figure 2: UK and US births per year per 1,000



Source: Our World in Data, as at January 2022

Labour productivity

Labour productivity represents output per hour or per job, which is a measure of workforce efficiency. Productivity gains are associated with improvements to education, infrastructure and capital deepening per worker (better technology and machinery).

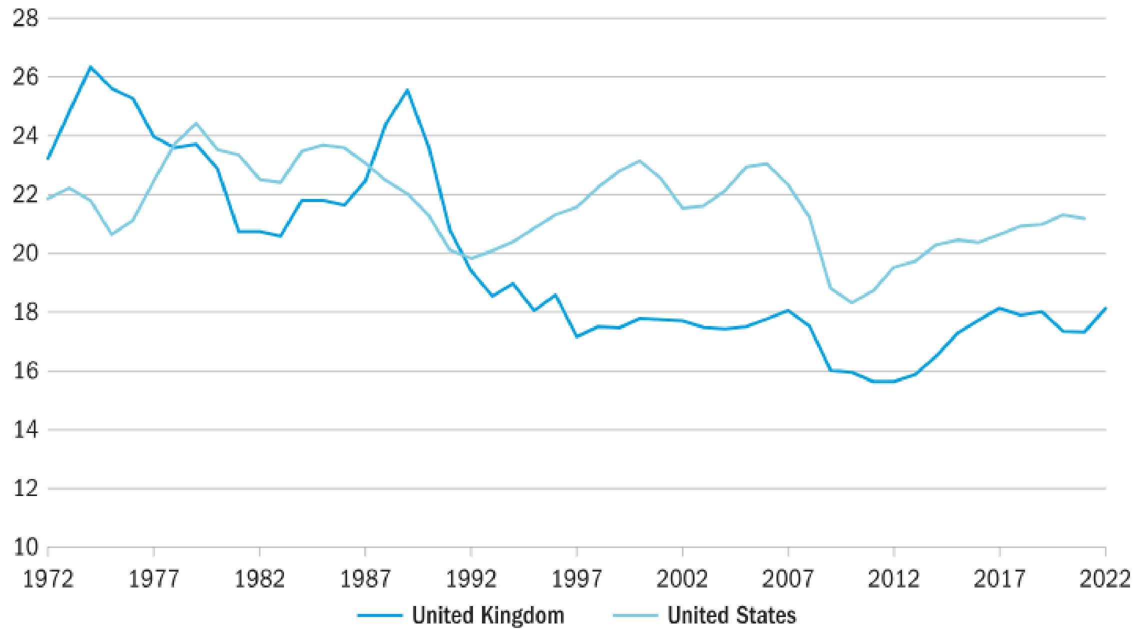
To capture investment in labour productivity we use gross fixed capital formation (GFCF[12]) which represents an estimate of net capital expenditure by both public and private sectors. US GFCF as a percentage of GDP has been running consistently higher than in the UK since the 1990s, implying greater future productivity gains (Figure 3). This is within the context of the UK having the lowest fiscal headroom since the inception of the Office for Budget Responsibility and debt-to-GDP exceeding 100% for the first time since 1961[13]. In contrast, US businesses will see the benefit of a combined $400 billion in tax credits, loans and subsidies from the CHIPS and Science Act and the Inflation Reduction Act particularly in high growth industries like semiconductors and clean energy[14].

[12] ONS, A short guide to gross fixed capital formation and business investment, 25 May 2017

[13] House of Commons Library, Public Finances: Key Economic Indicators, 21 July 2023

[14] FT.com, Inside the $220bn American cleantech project boom, 16 August 2023

Figure 3: US and UK gross fixed capital formation (% of GDP)



Source: https://data.worldbank.org/indicator/NE.GDI.FTOT.ZS?locations=US-GB

Conclusion

In conclusion, while the UK faces unique inflationary pressures and negative technicals factors, longer-run headwinds to relative GDP growth will likely mean the UK economy cannot support interest rates as high as the US in the longer term. This contradicts market pricing, indicating UK yields should be lower than that of the US in the longer term.

Market pricing in the US and UK suggests that either the long-run neutral rate has shifted dramatically or that current inflationary issues will persist five years into the future, which represents an opportunity in government bonds.

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