The Investment Podcast

Episode 33: The Investment Podcast: Dissecting the fallout from the gilt crisis
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Speaker 1: The *Investment Podcast*, brought to you by M&G.

Speaker 2: This podcast is for investment professionals only.

Harry Bullamore: Hello and welcome back to another episode of the *Investment Podcast* brought to you by M&G Investments. My name is Harry Bullamore. Today, I'm in the studio with Miles Tim, senior government bond portfolio manager. Great to have you with us, Miles.

Miles Tym: Hello, Harry. Great to join everyone.

Harry: Now, it's been just over a year since the gilt market turmoil of September 2022. The fallout from the crisis prompted an emergency intervention by the Bank of England on financial stability grounds to restore orderly market conditions according to the IMF. We'll come back to what may still linger around in a second, but Miles, first, could you paint us a picture of what's gone on in the last 18 months and how the macroeconomic backdrop for fixed income has shifted significantly?

Miles: We'll begin the story probably in early 2022 when you already had inflation starting to get out of control, accelerating more than central banks were comfortable with. That was then greatly exacerbated by the outbreak of war in the Ukraine, which created a lot of scarcity in a lot of key commodities for the world.

The initial part of the story was inflation spiking very, very high. That was then followed by significant pricing of higher interest rates by central banks across the world. Not just the UK, the US, Europe as well. That was the first phase of the move if you like. Since then, inflation has not fully come back under control, but certainly looks like it's turned a corner. We've perhaps in more recent weeks had concerns about the sheer amount of government bond supply coming our way. That's become the latest fear to stalk financial markets, really.

Although the pricing of short rate expectations has not gone any higher and indeed actually come down over the last few months, you've actually had yields on longer-dated bonds across the world, not just the UK, rising quite significantly over the last three or four months. That's become the dominant theme within fixed-income markets globally. That's where we sit at the moment on this.

Harry: Absolutely. Quite a significant shift that we've seen there. After the Truss-Kwarteng government announced £45 billion in unfunded tax cuts, there was a substantial selloff in gilts as UK pension schemes sought to meet collateral calls for their LDI mandates. Now, have gilts recovered from this episode? To bring it back to the introduction, where are we today? Are the factors that contributed to the crisis still there?

Miles: Yes and no I think really is the answer. Gilts have recovered to the extent that they're not so much the global outlier anymore. If you look at what was happening during that LDI crisis that you described, you had the yield of long-dated gilts spiking dramatically versus US. The borrowing cost that the UK was having to pay to issue bonds went a lot, lot higher than it did, for example, compared to the US.

That was what you were seeing during the LDI crisis. Now, that has now passed. You're no longer seeing gilts specifically cheap relative to other markets. That forced selling from pension funds has definitely not been seen more recently. There's no UK LDI-specific crisis going on anymore, but the costs that are associated with those much higher government bond yields are very definitely something that the government is grappling with, not just in the UK.

Nevertheless, it's still an issue for the UK that if they're having to issue gilt with much higher interest rates, which they are, and in fact even higher now than during the height of that LDI crisis. That's very much a real problem that the UK is dealing with. It's just that it's perhaps not a UK-specific problem anymore. It's a global issue, but it is a higher cost of funding that we have to face.

I think the second part of this is that panic has passed for the moment in terms of UK-specific nature, but I think the UK is very much on walks from global investors if you like. As in, if there was a brief foray into unfunded fiscal policies, which caused a bit of a scare, that was then immediately corrected by the new administration. Investors are happy with that, but I think the UK remains on watch from the international community in terms of we need to continue to implement what's seen as a fiscally responsive framework, otherwise, investors would probably take pride.

Harry: It's interesting. Obviously, the summary there being that, generally, interest rates are substantially higher today. What does this mean specifically for the government borrowing that you mentioned and that forecast gilt issuance within the UK market?

Miles: There are multiple legs to how these impacts on the cost for the government. Firstly, just in terms of the issuance, if they're issuing new gilts with much higher coupons, which they are. You're seeing the gilts that have been issued in recent months have got 4.5% towards 5% coupons on them compared to much, much lower coupons from gilts that were issued two, three years ago.

Obviously, they're locking in that level of finance for the full term of the gilt. Just the rate of interest that the government is now having to pay is much higher, which carries a cost in of itself. If you're having to spend more just funding your existing debt, you've got much less scope for other fiscal programs elsewhere. That's the first leg of this. That's not specific to the UK. That applies to the US to European governments as well. They're all faced with higher borrowing costs on the new issuance. An issue that's perhaps a bit more acute in the UK is the UK has a very high proportion of index-linked debt as a way of funding itself. Getting on for 25% which is much, much higher than in other markets. The problem with that for the UK government is that because it's linked to inflation, you can't inflate it away. As inflation goes up, so does the cost of servicing that debt in line with inflation.

A fair bit of the ramp-up in the UK government's debt servicing costs is related to the fact that they're just paying inflation-linked cash flows to investors. There's no getting away from that. Now those bonds have been issued. It is treasury policy to issue a smaller percentage going forward in index-linked gilts. To be fair, they have been doing that for a number of years. It's just that they the outstanding stock that was built up over multiple decades is still the minority of it, in index-linked, but quite a lot more than in other countries is in index-linked. That's a bit of an issue for the UK.

Harry: Interesting. I think in terms of the biggest impacts that we see as a result of these rising gilts, specifically towards UK pension schemes where their funding positions have improved substantially since the UK LDI crisis and many schemes are now looking for a path to buy out. This can take time. As schemes de-risk, can active management be used to generate alpha for their government bond allocations during this transition?

Miles: Absolutely. I think you can see that we have been successfully implementing active management strategies in government securities for over 15 years now. Almost a percent of alpha per annum generated. I think it's worth bearing in mind that a lot of that was during periods when there wasn't much of an interest rate cycle. You had interest rates only just above zero for a prolonged period of time, not that much volatility in the bond markets. Whereas what we've seen obviously in the last couple of years is a move to definitely a pretty violent interest rate cycle and quite a lot of volatility in bond markets.

That has presented some opportunities for active management. I think it's fair to say that broadly speaking, the more volatile the market is, the more opportunities there are for active management to add some value to portfolio. Very definitely, I think we've put behind us the environment of very stable bond markets. We're in an environment where investors probably need some active management to really get the best out of their portfolios.

Harry: Before we go, how is the UK fairing compared to its global counterparts in your view?

Miles: A lot of the issues that the UK is grappling with are universal. They had the violent overshoot in inflation, the need to swing from very low stable interest rates to really quite sharply rising interest rates is across the board, across all countries. I think you could probably make the case that-- Undoubtedly the US has had less of a spike in inflation and it has turned the corner sooner and come closer to the two-ish percent target that central banks are hoping to achieve. The US definitely has been ahead of the UK in terms of getting inflation back under control.

You could possibly make the case that this Federal Reserve started to move rates aggressively higher sooner than the Bank of England and therefore has got their inflation under control sooner as well. To be fair to the Bank of England, you could probably argue their job was harder in that UK inflation was just stickier. Also, the spike in inflation was far sharper in the UK because what the US has is energy independence and the UK is not so fortunate in that respect. The huge spikes in natural gas prices, for example, last year, which exacerbated inflation around the world were particularly acute in Europe, less so in the US.

The UK in many ways has had the same problems as everyone else, but perhaps a little bit more acutely. Some of that you could maybe suggest was due to the response of the central bank, but a lot of it, to be fair to the central bank is just the nature of the UK economy and how it's structured. I think they're universalish-type problems, but the level of how difficult they've been to solve has been different in different countries.

Harry: That's very interesting. Now, unfortunately, that's all we have time for in today's episode of the *Investment Podcast*. We hope you enjoyed the episode. Miles, thank you for expertly dissecting the gilt crisis with us today.

Miles: Thanks, Harry. Enjoyed speaking with you.

Harry: Thank you to you too our audience as always for tuning in. We look forward to you joining us next time. Goodbye, for now.

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Speaker 2: For further information, please view the notes which accompany this episode. This podcast is for investment professionals only. The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice, or forecast.

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