



Fixed Income Focus.

How low can gilt yields go?

Throughout 2016, the Active Liability Solutions team has had a bias towards being overweight duration across the active LDI portfolios, expecting UK government yields to continue their move lower. Admittedly, we had expected the move to be more of a grind than a lurch, but the combination of Brexit – and now the Bank of England's (BoE) aggressive response – has caused gilt yields to surge to new record lows.



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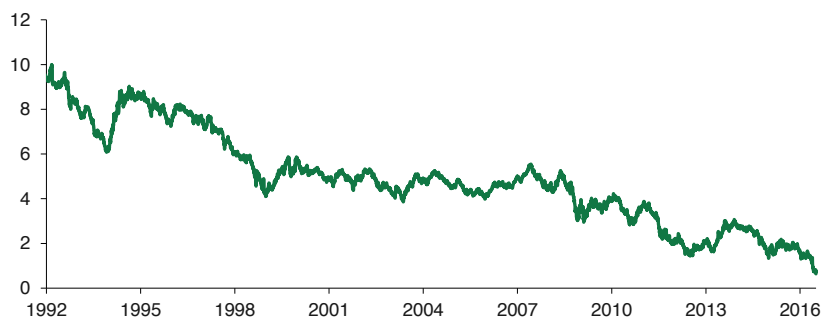
The Monetary Policy Committee (MPC) has delivered a bigger monetary policy response to Brexit than expected by many market commentators. It cut the base rate by 25bps and gave guidance that rates could be "near zero" by year end. Meanwhile, the MPC also announced a £60bn increase in gilt purchases (quantitative easing) and £10bn of corporate bond purchases, as well as revealing a new "Term Funding Scheme" for banks.

With 10-year gilt yields dropping towards 60bps in the immediate aftermath of the BoE's announcement, where can we go from here?

We now face a bit of a wait before the post-Brexit hard data readings (such as industrial production and retail sales) are released. We will be watching closely to see whether they back up the gloomy picture that has been painted by recent sentiment surveys taken in the immediate aftermath of the Brexit vote.

If the hard data is as poor as surveys suggest, uncertainty really is weighing on firms' investment and hiring decisions, and consumers are spending less, then this confirmation of a slowdown in growth is likely to prompt the Bank of England to do even more. After all, Governor Mark Carney has demonstrated a clear willingness to ease further in the coming months in order to support economic activity in the UK. The prospect of further action from the Bank of England could ultimately send gilt yields even lower.

Figure 1: UK 10-year gilt yield at all-time lows (%)



Source: Bloomberg L.P.

Notably, it's unlikely that UK economic activity will receive an immediate boost from the bank's latest actions. Base rates were at very low levels even before the 25bp cut. Gilt purchases simply add to an existing large pile of central bank assets, and the corporate bond market already provided very cheap funding for UK corporates. The resultant fall in sterling could lead to some imported inflation, but such a temporary effect is unlikely to change Carney's medium-term outlook. His hope will be that monetary support will boost economic activity in the longer term, but as my colleague Ben Bennett has written about previously, the over-indebtedness weighing on global growth is unlikely to be solved with more debt.

And while it is very easy to become consumed by what is going on in the UK alone, it is also important to remember that the global macro environment remains very challenging. This means the UK faces an added headwind at a time when it is already fighting a macroeconomic shock.

For now, with this backdrop, we face a nervous wait to see whether it is going to be as bad as the pessimistic picture being painted by the gilt market. As we head through summer, we will get clarity over the real impact of Brexit on the economy, as well as the shape of future fiscal policy (with particular interest on any potential fiscal loosening). At this stage, we feel inclined to retain our overweight duration bias.

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