Allianz Research

Gilt market meltdown – A first post mortem and key takeaways

4 October 2022

Jordi Basco Carrera
Lead Investment Expert
jordi.basco_carrera@allianz.com

Ana Boata
Head of Economic Research
ana.boata@allianz-trade.com

Roberta Fortes
Senior Economist
roberta.fortes@allianz-trade.com

Patrick Krizan
Senior Investment Strategist
patrick.krizan@allianz.com

EXECUTIVE SUMMARY

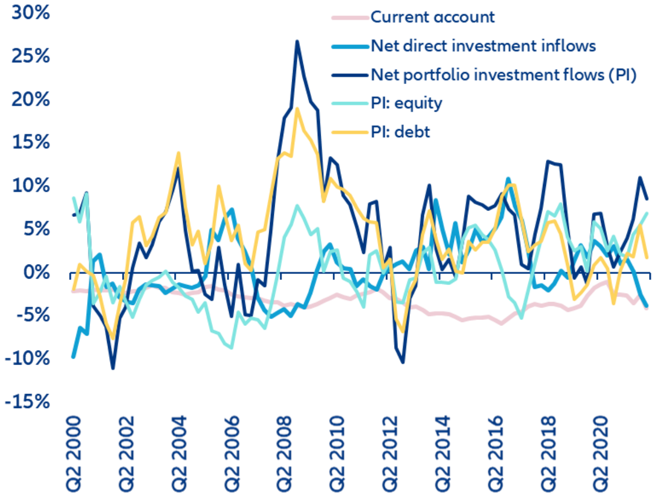
- **The gilt crash in the UK was not a repeat of the Eurozone sovereign debt crisis, but rather a liquidity-induced market accident that put financial stability at risk.** As credit-default swaps (CDS) for the UK did not follow the surge in sovereign yields, liquidity risk caused the movement in gilts, rather than credit risk. It was also not a financial dominance conflict between central banks and markets as the Bank of England acted as a backstop for and not against markets. In our view, the high risk to financial stability will make more central banks likely to exert upward pressure on short-term rates while keeping long-term rates under control.
- **Trading on the gilt market will continue to be bumpy for a while. But the UK is not an exception when it comes to liquidity risk.** It was affected first because of the unfortunate interaction of monetary (tightening) and fiscal policy (easing) signals. Similar liquidity squeezes may develop, mainly in the Eurozone but also in the US since bond-market volatility has reached levels unseen since 2008-09 and safe collateral is still scarce.
- **We believe the BoE will need to remain the 'lender of last resort' beyond end-October and delay its quantitative tightening program to restore confidence. A real fiscal policy U-turn is also still necessary, going beyond the cancellation of the top 45% tax rate (which will save GBP2.5bn).** As it stands, the fiscal package will push the UK's fiscal deficit to close to -7% of GDP in 2023 and public debt to 103% of GDP. Hence, all eyes will be the medium-term fiscal path, which the chancellor is expected to present as early as this month, given the crisis. As +100bp higher sovereign rates equal to fiscal efforts of 0.5% of GDP for debt stabilization, and as general elections approach, the risk of fiscal slippage remains very high in a context of potential growth around +1%. As a result, it seems difficult for the BoE to start gilt sale operations of GBP10bn per quarter on 31 October, as currently planned.
- **In light of the high twin deficits, further GBP depreciation cannot be ruled out.** We expect a decline of -7% against the USD if fiscal credibility is questioned again by end-November. In such a fragile environment, the BoE would be forced to hike interest rates faster (to 4% at end-2022, 150bp above previous expectations) but with limited impact on the GBP.
- **Higher financing costs could push up corporate risk.** The +150bps additional increase in rates will cut corporate margins by close to -2pp and push up corporate bank loan rates by +130bps. Cash buffers remain 35% above 2019 levels but are mainly concentrated among large companies. Hence, the potential liquidity stress coupled with the rise in energy costs will increase the share of SMEs at risk of defaulting to beyond 20% in the UK, back to pre-Covid levels. Overall, we expect business insolvencies to rise to +15% above pre-Covid levels in 2023 (to 25,400 cases).

Markets immediately challenged the UK's massive fiscal easing package, which was to be entirely financed by additional bills and bond issuance, even as the BoE was starting to sell gilts. Scrapping the tax cut for top earners is a step in the right direction, but more will be needed to get to a credible medium-term path. On 23 September, Chancellor Kwasi Kwarteng announced an ambitious spending package of around 7% of GDP (or more than GBP200bn) over the next two years to fight the energy crisis. The package included GBP45bn of tax cuts, expected to be funded by additional borrowing, and represents the biggest fiscal easing since 1972, GBP15bn larger than expected. It is equivalent to more than 50% of the total Covid-19 package and should push public debt to 103% of GDP in 2023, from 96% in 2022, creating a budget deficit of -7% of GDP.

The announcement of the fiscal stimulus when the UK already has a sizeable current account deficit (see Table 2), and when the Bank of England was set to start quantitative tightening, triggered a crisis of confidence in the markets. The pound plunged against the US dollar on 23 September (-3.5%), reaching its lowest level since 1985. While the BoE's recent announcement of engagement in targeted QE purchases of long-dated gilts has given some relief to the markets, the effect will certainly be short-lived as the reasons of the sell-off have not been fully addressed. The U-turn in the tax cuts for higher incomes has given some breathing space to the currency, but there is still a long way to go to recover fiscal and government credibility. After all, this part of the package costs the least and doubts about the financing of the fiscal deficit have yet to be clarified.

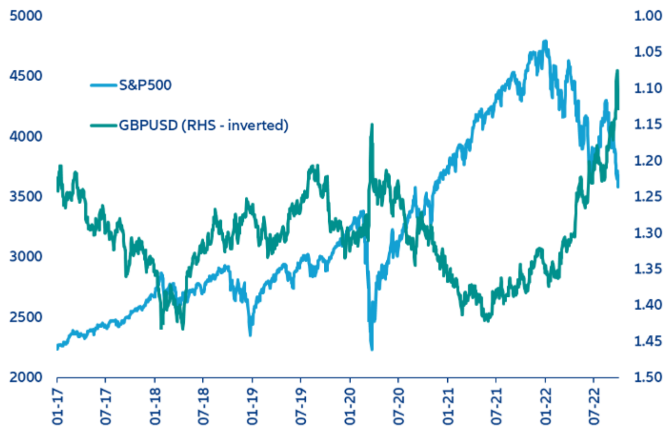
Portfolio investments have been an extremely important source of external-account funding in the UK (Figure 1), especially in recent years. However, problems can certainly arise if investors lose confidence in the country. For the GBP, this could be a major issue as the currency has been highly negatively correlated with risk aversion (Figure 2). In the case of a 'sudden stop' of capital inflows, the current account would be forced to almost immediately reverse and this would in turn trigger a (further) depreciation of the currency.

Figure 1 –Balance of payments (4q rolling sum, % GDP)



Sources: Refinitiv, Allianz Research

Figure 2 – GBP vs S&P500



Sources: Refinitiv, Allianz Research

FX valuation models[1] (Table 1) show that while the GBP is already undervalued, it is not the cheapest currency: among the G10, the Swedish krona (SEK), the Norwegian krone (NOK) and the Japanese yen (JPY) are in the worst positions. It is interesting to note that the FEER model, which considers the dynamics of the external sector, suggests that the pound is still overvalued despite the UK's significant current account deficit. Putting it all together, the models suggest that the GBP is actually not extremely cheap; as a result, further depreciation cannot be ruled out.

If we stress the assumptions of the FEER model and assume that a full adjustment of the current account is necessary, a rough estimate shows that the pound should depreciate by nearly 30% in real effective terms. A 7% depreciation would be required in the GBP vs USD, which would push the currency pair to parity. That said, monetary policy should play an important role in the story, with the BoE having to raise interest rates faster and certainly stronger than anticipated, which should give some support – although limited – to the currency. After all, higher interest rates should weigh on the already anemic growth as well as on the fiscal side. Until monetary policy plans and details of the fiscal plan are announced, we expect the pound to remain highly volatile, with news on the fiscal front setting the tone.

---

[1] *Assessing the value of a currency is not an easy task and a wide range of models is available to assess its value. One of the most widely used is Purchasing Power Parity (PPP): one of the ways to look at it is to measure the deviation of the Real Effective Exchange Rate (REER) relative to its long-term average. However, it is clear that fluctuations in the REER are primarily linked to terms of trade and also to changes in a country's relative productivity. This is why we run a Behavioral Equilibrium Exchange Rate model (BEER), which takes these variables into account. The trend in the real exchange rate is obviously linked to the dynamics of the balance of payments, which captures all financial flows and transactions among residents and non-residents. The Fundamental Equilibrium Exchange Rate (FEER) models, in particular, state that a current account balance that is too high requires an appreciation of the currency while one that is too low requires depreciation of the currency.*

Table 1 - FX valuation

	PPP	BEER	FEER	average	
CZK	35.8%	64.4%	7.7%	36.0%	Overvalued
USD	21.8%	26.5%	21.5%	23.3%	
RUB	52.4%	24.7%	-13.7%	21.1%	
HKD	5.5%	36.3%	-4.6%	12.4%	
SGD	10.9%	28.9%	-2.7%	12.3%	
PHP	11.2%	5.6%	10.6%	9.1%	
THB	3.4%	9.1%	10.4%	7.7%	
NZD	2.7%	3.1%	12.9%	6.2%	
ILS	12.5%	6.3%	-2.6%	5.4%	
CNY	23.2%	-5.0%	-3.7%	4.8%	
CHF	8.4%	9.9%	-6.0%	4.1%	
PEN	4.0%	-1.0%	5.0%	2.7%	
INR	10.5%	-2.1%	-9.8%	-0.5%	
PLN	-0.4%	-5.4%	3.2%	-0.9%	
EUR	-9.6%	0.4%	1.6%	-2.6%	
IDR	8.4%	-4.8%	-12.0%	-2.8%	
KRW	-11.0%	-0.2%	-1.9%	-4.3%	
CLP	-16.7%	-11.1%	14.6%	-4.4%	
MXN	-9.2%	-1.5%	-2.8%	-4.5%	
HUF	-10.1%	-12.0%	8.3%	-4.6%	
AUD	3.2%	0.2%	-17.6%	-4.7%	
GBP	-14.3%	-9.8%	9.7%	-4.8%	
CAD	-3.7%	-2.7%	-8.4%	-4.9%	
TWD	-5.1%	-5.0%	-8.0%	-6.0%	
BRL	-15.4%	-9.5%	-5.0%	-10.0%	
MYR	-13.7%	-16.9%	0.0%	-10.2%	
COP	-21.5%	-29.1%	14.0%	-12.2%	
SEK	-20.9%	-17.7%	-3.9%	-14.2%	
ZAR	-16.8%	-9.6%	-22.5%	-16.3%	
JPY	-39.0%	-18.2%	-1.1%	-19.4%	
NOK	-15.1%	-27.9%	-25.8%	-22.9%	
TRY	-39.7%	-45.0%	-8.5%	-31.1%	Undervalued

Sources: Refinitiv, Allianz Research.

All eyes will be on the medium-term fiscal plan, which could be presented as early as this month. Beyond the cancellation of the tax cut, which should reduce the easing package by GBP2.5bn, more will need to be done to ensure credibility. In particular, the very optimistic annual growth target of +2.5% compares to past performance of +2.1% between 2010-15, and +1.9% following the Brexit referendum and before the Covid-19 crisis. For context, since Brexit, the UK's potential real GDP growth has decreased to +1% per year.

We expect the fiscal package to provide a boost of +1.1pp after one year, which in net terms is expected to reach only +0.5pp (see Table 2). This falls short of what is needed to stabilize public debt, notably in a context of rising interest rates, which require additional fiscal adjustment (+100bps higher sovereign rates equal fiscal efforts equivalent to 0.5% of GDP).

Table 2 – Impact of fiscal easing measures in the UK

Tax cuts package (excl. tax rate cut of 45% for top earners)	GBPbn	42.5
	% of GDP	1.8%
First year tax multiplier	Exogenous tax shock of 1% of GDP	0.6
Impact on real GDP growth from fiscal easing (pp)		+1.0
Increase in key interest rates needed to offset inflation (bp)		100
Impact on real GDP growth from rising rates		-0.5
Net impact on real GDP growth		0.5

Sources: IMF, national sources, Allianz Research

Table 3 – Key economic forecasts

UK	2020	2021	2022	2023
GDP	-9.3%	7.4%	3.4%	-0.2%
Consumer Spending	-10.6%	6.2%	4.2%	0.5%
Public Spending	-5.9%	14.3%	0.7%	8.5%
Investment	-9.5%	5.9%	5.0%	2.1%
*Stocks**	*-0.8%*	*0.9%*	*2.7%*	*-1.4%*
Exports	-13.0%	-1.3%	2.3%	0.1%
Imports	-15.8%	3.8%	14.4%	2.8%
Net exports	1.0%	-1.5%	-3.5%	-0.9%
Current account (% of GDP)	-2.5%	-2.6%	-6.0%	-6.5%
Employment	-0.8%	-0.5%	2.5%	0.5%
Unemployment rate	5.1%	4.5%	3.8%	4.0%
Wages	1.8%	5.9%	5.0%	4.9%
Inflation	0.9%	2.6%	9.1%	7.5%
BoE rate	0.10%	0.25%	4.00%	4.00%
Fiscal balance (% of GDP)	-16.9%	-8.1%	-6.0%	-7.0%
Public debt (% of GDP)	103.0%	95.0%	96.0%	103.0%

*Change over the period, unless otherwise indicated: * contribution to GDP growth*

*** mds de £*

Sources: National sources, Allianz Research

In the meantime, the BoE might need to remain the 'lender of last resort' beyond mid-October and delay its quantitative tightening (QT) program to restore confidence. The BoE was harshly reminded that its challenge is not only to balance rate hikes against recession risks, but also to secure financial stability. For many investors, the combination of a sizable fiscal package and an aggressively hawkish monetary stance became a gilt-selling signal. Given already tight liquidity conditions, this led to a downward spiral, with a jump in volatility that triggered margin calls, exacerbating the liquidity squeeze until market making entirely collapsed. To prevent a systemic crisis, the BoE was compelled to delay its quantitative tightening (QT) plans and to intervene as market maker of last resort by resuming government-bond purchases (GBP5bn of purchases per day for 13 days, for a total of GBP65bn). The gilt crash was not a repeat of the sovereign debt crisis last seen in the Eurozone in 2012, but rather a liquidity-induced market accident. As credit-default swaps for the UK did not follow the surge in UK sovereign yields, the movement in gilts was caused by liquidity risk rather than credit risk. It was also not a financial dominance conflict between central banks and markets as the BoE acted as a backstop for not against markets.

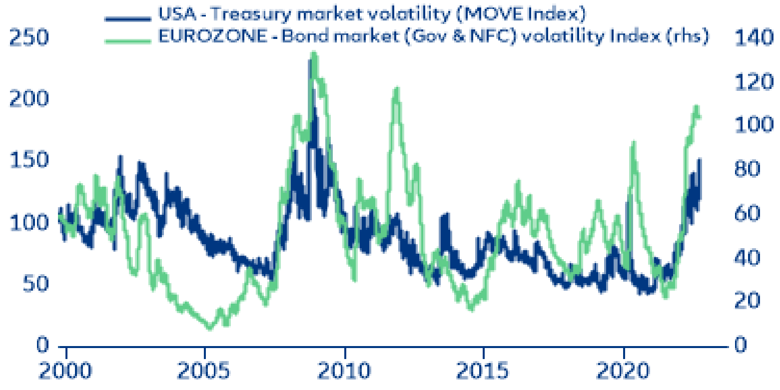
Since the budget announcements, markets are expecting UK interest rates to peak at around 6% next summer, more than twice the current levels of 2.25%. Increasing interest rates more aggressively would support an appreciation of the GBP above 1.10/USD, which is key in keeping inflation in check. In the UK, the pass-through to import prices is one of the highest in the advanced world as 55% of import prices are estimated to reflect changes in FX, compared to 10% in Germany or 5% in France. In addition, 30% of consumer expenditure is dependent on imports. Hence, looking at historical pass-through, we see that -10% depreciation would mean a close to +3pp boost to inflation after one year. On the other hand, the growth boost is limited as the GBP depreciation is estimated to translate into a change in export prices equivalent to only 40% of the exchange rate changes[2]. The pass-through could be even lower, given the weak global growth environment, with global trade set to grow at the lowest pace since 2019 (+1.2%)[3]. Hence, in order to offset the rise in inflation, we think the BoE would need to increase interest rates to 4% by end-2022, before pausing in 2023.

[2] *ECB estimates.*

[3] *Read our latest Global Economic Outlook.*

Trading on the gilt market will continue to be bumpy for a while. But the UK is not an exception when it comes to liquidity risk. It was affected first because of the unfortunate interaction of monetary and fiscal policy signals. Similar liquidity squeezes may develop in the Eurozone and the US since bond-market volatility has reached levels unseen since the 2008 financial crisis and safe collateral is still scarce. We consider Euro government bonds to be more at risk (see Figure 3).

Figure 3 – Bond market volatility close to GFC levels

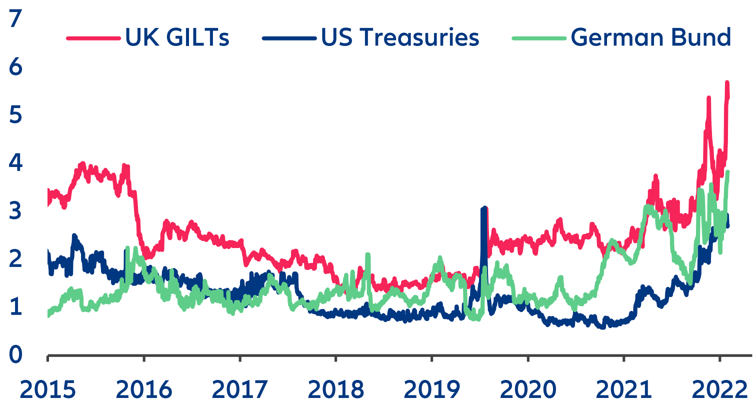


Sources: Refinitiv Datastream, Allianz Research

We draw the following lessons from the gilt crash:

- In addition to the potential of a recession, the risk to financial stability might limit interest rate increases and lead to a monetary pivot.
- The gilt crash might signify the end of QE sequencing, in which bond purchases and rate increases were viewed as mutually exclusive. The new pattern may involve central banks exerting upward pressure on the shorter end of the curve while keeping the longer end in check (flattening yield curve control).
- Comparing the current hiking cycle to the 1970s and 1980s should be avoided because the financial system is now far more vulnerable to interest-rate volatility due to the extent of financialization, leverage and derivative exposure. Managing volatility will get much more attention now in monetary policy.
- The central bank put is still there but only applies to assets that are necessary for the functioning of the financial system (safe assets, repo eligible). This will reinforce a pricing bifurcation because these assets will embody a convenience premium.

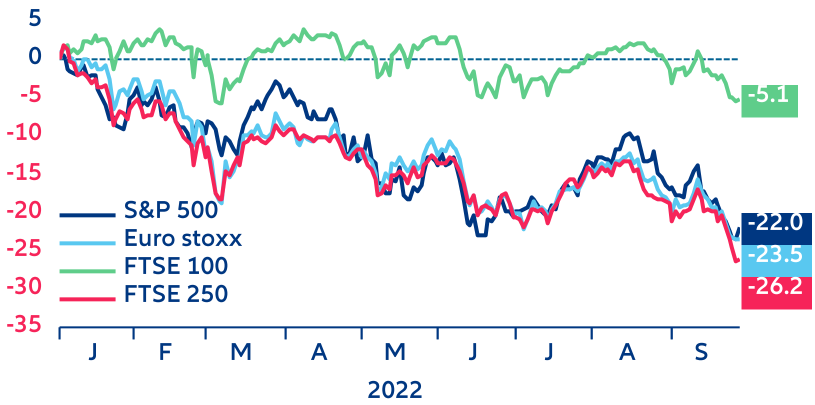
Figure 4 – Liquidity risk in UK, US and German government bond markets*



**Indices measuring aggregate bid/ask price deviations from fair value curve*
Sources: Bloomberg, Allianz Research

The FTSE 100 remains resilient despite the recent fixed income volatility, but the risk premium has increased. For most of 2022, the FTSE 100 has managed to outperform other global markets due to its intrinsic "defensive" bias and its relatively high weight of commodity-related sectors, which have enjoyed a commodity super cycle. At the same time and on the revenue side, the fact that most companies that make up the FTSE 100 tend to generate revenue outside the UK (~75%) while reporting revenues in GBPs classifies the FTSE 100 as a low UK-dependent asset, boosting or preventing a structural decline in its reported profits. Consequently, and even if the UK sovereign and corporate credit markets have been highly volatile, the FTSE 100 has remained resilient, with a continuously depreciating GBP positively compensating for the deteriorating global economic environment. This structural resilience is only applicable to 100 biggest market players. The 101 to 350 biggest companies that make up the FTSE 250 index have performed at par with other global equity markets mainly since the 250-equity universe does not possess a defensive / commodity centric tilt and its main source of revenues is the domestic British market (Figure 5).

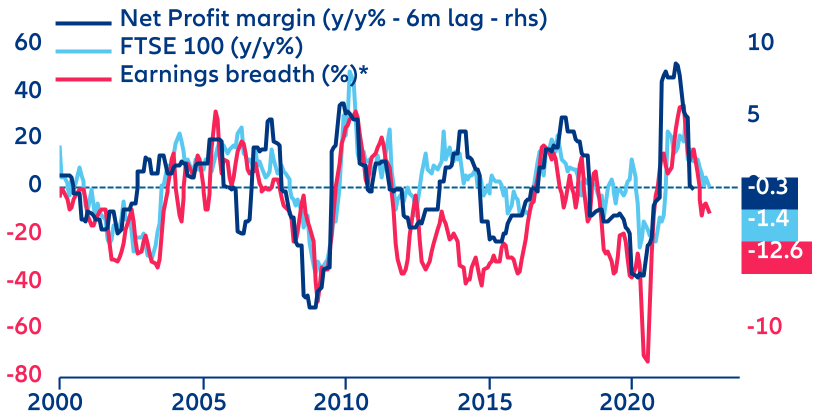
Figure 5 – Global equity markets year-to-date performance (%)



Sources: Refinitiv Datastream, Allianz Research

This market resilience will be put to the test moving forward but fundamentals still imprint a "cheap" label. Even if the FTSE 100 has shown some year-to-date resilience, the global economic slowdown is set to have structural spillover effects on UK companies' balance sheets, with the expected global demand erosion exerting a non-negligible amount of pressure, especially on commodity-dependent companies, moving forward. In this regard, analyst continue to revise down earnings estimates, accelerating expectations of a broad-based balance-sheet degradation, paired with expectations of a global demand slowdown. This should keep the index under pressure until year-end. However, and even if there is a certain level of downside consensus being priced in, the fact that the main index is trading close to the lower end of the price-earnings spectrum continues to imprint an "already cheap" label onto the index. On top of that, the relatively high dividends and share buybacks continue to provide upside pressure, especially since a non-negligible portion of the FTSE 100 dividends are sourced from USD-denominated revenues, hedging investors from a weaker sterling. Lastly, and from a composition side, the high defensive and commodity intensive market tilt paired with a high concentration of financials in the index and little exposure to "growth" stocks, which should hedge against interest-rates pressure coming from long-cash-flow duration assets, should lead to a continuous resilience for the FTSE 100 moving forward. On top of that, the fact that the BoE seems to be ready to intervene should things turn south on the liquidity front as well as the fiscal policy easing measures (which should benefit the local market, especially the FTSE 250), should allow markets to reprice a certain amount of policy put protection. This is likely to lead the FTSE 100 close to a - 2%/0% yearly performance in 2022, and a low but positive performance in 2023 (Figure 6).

Figure 6 – UK equity performance vs net profit margins and earnings breadth*

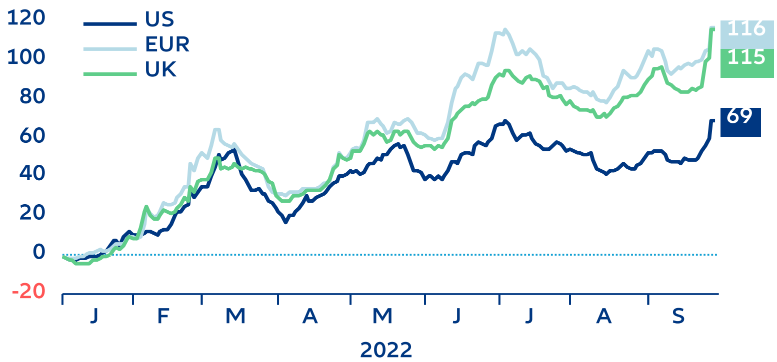


Sources: IBES, Worldscope, Refinitiv Datastream, Allianz Research

*Note: * # of EPS upward revisions - # of EPS downward revisions as a % of total # of estimations*

Corporate risk is rising under the expectations of higher financing costs. Diverging from equities, and not enjoying the resilience depicted in the FTSE 100, corporate risk has followed the same path as its European siblings. The prospects of a steeper and higher-for-longer monetary policy path paired with increasing UK-centric macro uncertainty is leading to a structural repricing of credit risk across the corporate curve. Nonetheless, and due to the low issuance volumes in sterling corporate credit, the elevation in financing costs is not yet having a significant impact in the average traded corporate debt coupon, which has remained relatively stable at around 3.6% for Investment Grade. At the same time, and mostly due to a bigger-than-expected fiscal package and the BoE's targeted purchases, sterling corporate credit has, once again, discounted a certain degree of policy put protection, effectively capping a wild increase in corporate credit risk (Figure 7).

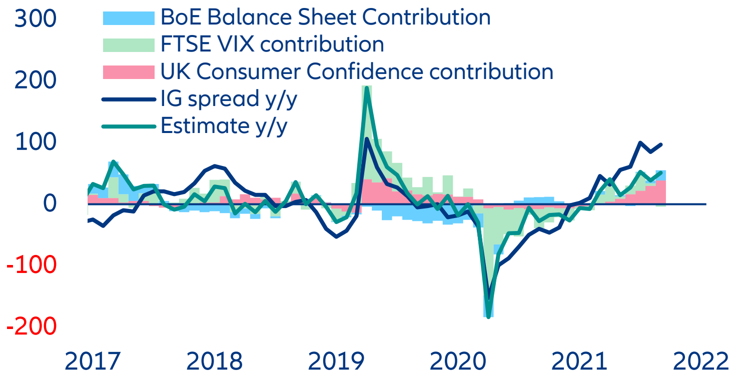
Figure 7 – Investment Grade corporate spreads (year-to-date change in bps)



Sources: BofA, Refinitiv Datastream, Allianz Research

Our corporate spread decomposition model shows that the equity volatility component of the model is not playing any significant role in the recent widening of corporate spreads. The main drivers behind the recent credit-risk repricing have been a decline in economic conditions (represented by consumer confidence) due to higher-than-expected inflation and the passive unwinding of the BoE balance sheet (BoE balance sheet contribution). The current drivers depict a highly unstable situation because the economic deterioration should still add widening pressures to credit spreads while the net effect of the balancing act between QT and QE will be a challenging (Figure 8). However, the strong fiscal push combined with the still high fundamental resilience of UK corporates, be it in terms of cash positions or debt-servicing ratios, lead us to believe that sterling corporate spreads will remain close to 200bps and 600bps for Investment grade and High Yield, respectively (vs 230bps and 660bps currently).

Figure 8 – UK Investment Grade corporate credit decomposition (y/y – bps)



Sources: Refinitiv Datastream, Allianz Research

Despite the rather resilient and benign outlook for risk-bearing assets, it is important to reaffirm the high vulnerability and volatility of the market to current endogenous and exogenous factors. Because of that, and especially if central banks continue to shifts towards a higher-for-longer hawkish stance, a cautious approach is warranted, especially for 2022.

These assessments are, as always, subject to the disclaimer provided below.

FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.

Allianz Trade is the trademark used to designate a range of services provided by Euler Hermes.