

Schroders Talking Point



Who is buying UK gilts?

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In brief:

The UK gilt market is growing at an unprecedented rate. While the dominance of insurance companies and pension funds is clearly waning, there is no reason to suppose that the structural demand from these investors will fall. Of more concern is the recent foreign selling: the latest Bank of England figures show net selling from overseas investors of around £19 billion in the last three months.

UK banks are stepping up purchases of gilts, partly an attempt to strengthen the quality of their balance sheets, but banks are also positioning ahead of the impending FSA announcement. The latter is widely expected to force the UK banking sector to increase its holdings of gilts by upwards of £150-200 billion. Such a development would mean that the banks will be the biggest buyers of gilts for many years ahead.

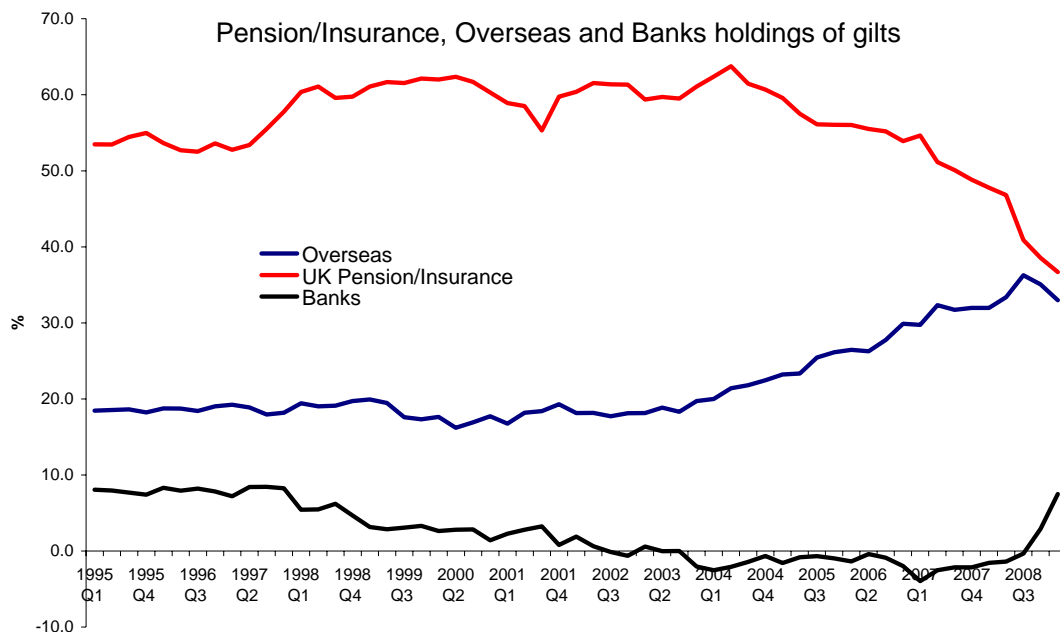
The joker in the pack remains the Bank of England, which has now purchased over £100 billion of gilts since March as part of its quantitative easing programme. The initial size of the programme is £125 billion, but it is most likely that the Bank will decide to extend the programme.

At some point, other investors will be needed to support the market – the obvious enticement would be that of higher yields.

Whereas it took the UK gilt market over 300 years to reach £200 billion in total size (which it did in the mid-1990s), the next £200 billion took a mere decade – and recent years have seen a dramatic acceleration in the pace of borrowing. Thus, a market that was measured at £479 billion at the end of Financial Year 2007/08 had grown to £713 billion a year later. Given the dramatic deterioration in the government's finances, it seems reasonable to forecast a continuation in this trend, with issuance likely to be in the order of £200-250 billion per year for the foreseeable future.

This raises the obvious issue as to who will buy all these gilts. Historically, the market has been dominated by the UK insurance companies and pension funds – this fact has been acknowledged by the government, with the composition of the debt portfolio focused on long-dated gilts (maturities over 15 years), which represent 27.5% of the market, and index-linked gilts (22.5% of the total market). The last few years have also seen a strong growth in purchases by overseas investors, predominantly foreign central banks and sovereign wealth funds. By contrast, the banking sector (including building societies) held few gilts (see chart on the next page).



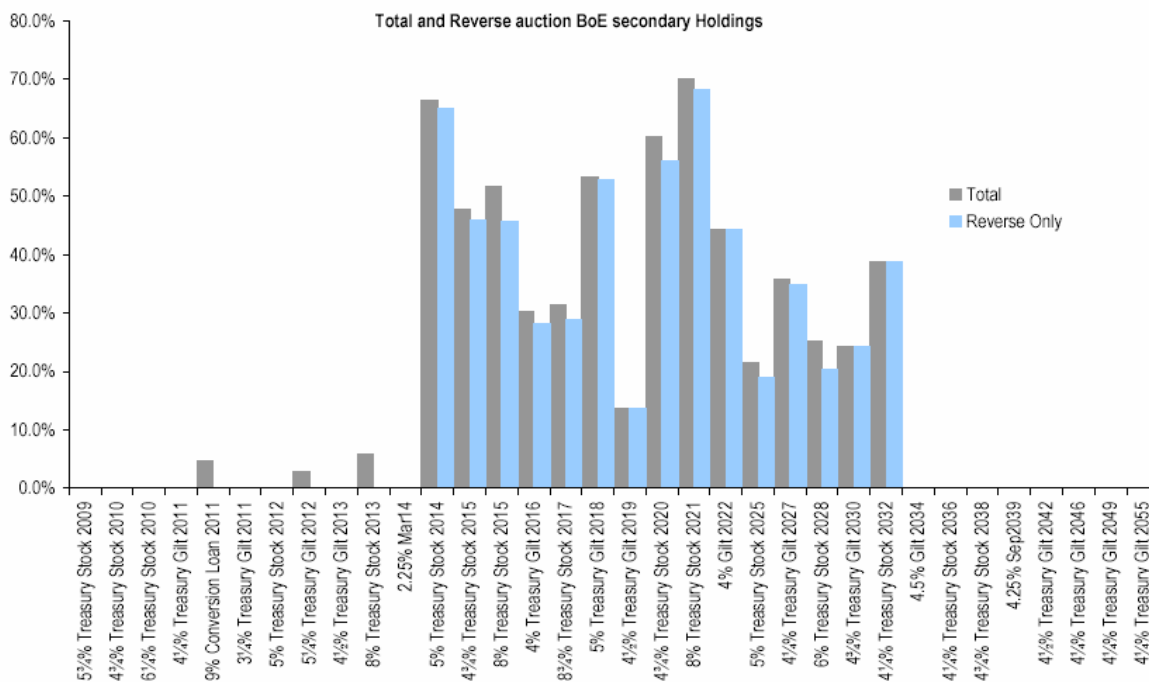


Source: Office for National Statistics (ONS): data up to the end of March.

Whilst the dominance of the insurance companies and pension funds is clearly waning, there is no reason to suppose that the structural demand from these investors will fall. Indeed, most surveys suggest that these funds are looking to increase their exposure to gilts, but consider yields at present to be too low (on both an outright basis and versus swaps and equities). Of more concern is the recent foreign selling – the latest Bank of England figures show net selling from overseas investors of around £19 billion during the last three months. It is probably too early to talk of a significant detectable loss of appetite, but many abroad fear that UK government debt could be downgraded by the rating agencies unless fiscal tightening is forthcoming. It should be noted that, although the public finances are worsening at an alarming rate (public sector net borrowing rose by £19.9 billion in May alone), similar concerns exist for the US and a number of other countries.

On a more positive front, the UK banks are stepping-up their purchases of gilts, with net buying of over £30 billion in the first three months of the year. This is partly an attempt to strengthen the quality of their balance sheets, but it is also positioning ahead of the impending FSA (Financial Services Authority) announcement on Bank Capital Requirements. The latter is widely expected to force the UK banking sector to increase its holdings of gilts by upwards of £150-200 billion. Such a development would mean that the banks will be the biggest buyers of gilts for many years ahead. This has already been recognised by the Debt Management Office, which is raising significantly the issuance of short-dated maturities – the sector most favoured by the banks.

The joker in the pack remains the Bank of England, which has now purchased over £100 billion of gilts since March as part of its quantitative easing programme – a method of pumping money into the banking system to revive lending and demand, and thus stimulate the wider economy. This means that the Bank now owns 15% of the entire gilt market, making it by far the most aggressive of the leading central banks (by comparison, the US Federal Reserve has bought 3%, while the European Central Bank has not purchased any eurozone government bonds). To date, this buying has been restricted to gilts with maturities of between 5 and 25 years. As a result, the Bank of England now owns almost 40% of this sector, and the next chart shows the percentage of holdings in individual issues.



Source: Bank of England

The initial size of the Bank of England programme is £125 billion. With the downward revision to first quarter GDP growth, and no evident improvement in lending to households and private non-financial companies, it is most likely that the Bank will decide to extend the programme. This should be viewed, however, as an emergency measure, which is not sustainable in the medium term. At some point, other investors will be needed to support the market – the obvious enticement would be that of higher yields.

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