AF4 2023/2024
Asset Classes: Gilts and Bonds
Part 2: The Bond Market

The milestones for this part are to understand:

- the function of the Bond markets
- how the UK government issues Gilts
- recent trends in the Bond market

Bond markets have a primary and secondary market function:

- To enable nations and companies to borrow money for a fixed period at a fixed rate. (Primary market)
- To enable investors to buy and sell these debts (Secondary market)

We will look at the way the UK government offers new Gilts to the market

Issuing new Gilts

The issue of gilts is managed by the **Debt Management Office. (DMO)** Most new issues are carried out by auction.

The DMO on the instructions of the Treasury will issue a new Gilt and invite institutions called **Gilt Edged Market Makers (GEMM)** to bid. They can offer more or less than £100 for each £100 of debt being offered.

The DMO offers £5 billion as a new Gilt paying a coupon of 2%. The results of the auction are:

GEMM 1 offers to buy £3.5 billion at a price of £101.75
GEMM 2 offers to buy £5 billion at a price of £101.25
GEMM 3 offers to buy £3.5 billion at a price of £101.50.

As GEMM 1has offered the highest price they get their order in full
GEMM 3 is the next highest price and gets £1.5 billion of the gilt
GEMM 2 gets nothing

Note that as each offered to pay more than £100 their return would be less than 2%. This illustrates that it is the market that sets the real rate of interest. The Government must pay the coupon which in this case is 2%.

Individuals can buy new issues but this must be done through a GEMM.

The DMO issues new gilts on a regular basis and here is a selection of some of the most recent ones (July 2023)

Auction date	Coupon & redemption date	Accepted price	Initial yield
5 July 2023	3.5% 2025	£95.389	5.688%
10 May 2023	3.25% 2033	£91.41	4.351%
18 April 2023	3.75% 2053	£97.13	3.592%

Some points to note:

- In all three cases the market was only prepared to pay less than the nominal £100.
- This meant that the yield was higher than the coupon.
- The initial yields have the characteristics of an inverse curve
- The July 5 issue shows it costs the government 5.688% to borrow money for two years

What's happening in the secondary market?

Gilts are usually seen as being a low risk asset but the events of the last 15 years and particularly in the last 18 months have challenged that view. Let's go back to the performance of the July 2038 gilt with a coupon of 4.75%

Date	Clean Price	Gross Yield to Redemption
December 2008	£112.53	4.02%
June 2017	£151.76	1.81%
November 2019	£162.44	1.11%
June 2020	£172.10	0.70%
December 2022	£115.39	3.49%
July 2023	£97.83	5%

The market price rose to £172.10 with a yield of 0.70% in June 2020 but in July 2024 the price had fallen to £97.83 with a yield of 5%. Someone who bought this gilt in June 2020 would have suffered a fall of 43.16%.

To understand the reason for this volatility we need to identify both the reasons for the rise and fall in the price.

The primary reason why prices rose was the impact of **Quantitative Easing (QE)**. The Bank of England is prohibited from bidding in a primary gilt auction but can buy them in the secondary market. Following the banking crisis of 2008 the UK government instructed them to use **QE** which works as follows:

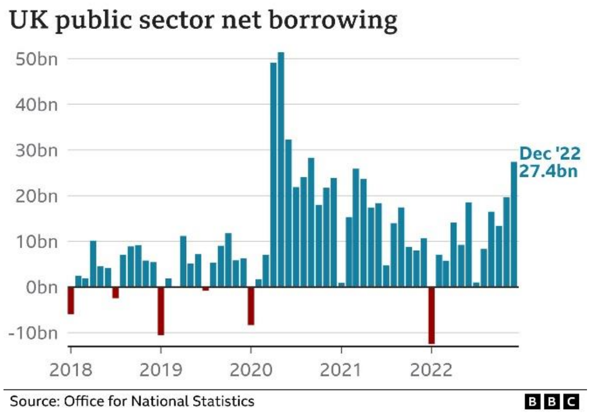
- The Government sanctions the Bank of England to create money.
- It uses this to buy up existing gilts and corporate bonds from banks and other financial institutions.
- This extra demand increases prices and lowers yields.

- The aim is to increase liquidity of institutions enabling to lend more money to business or to invest money in further assets.

The Bank buys £1 million of bonds from a pension fund. The fund now has £1 million in money and rather than hold on to it might invest in shares to get a higher return.

The main criticism of QE was that rather than institutions providing “seed investment” or lending so that firms can invest, it simply increases asset prices thus increasing the wealth gap between the richest and poorest in society.

QE was also used to lessen the financial impact of the coronavirus pandemic. To fund the costs of furlough the UK government increased its borrowings substantially in April 2020 as can be seen in this chart.



If an individual wanted to increase their borrowings by this amount it would a reasonable assumption that lenders would be reluctant to offer more credit and if they did, they would want a higher rate. The government managed to sell all this debt at a record low rate.

Indeed, in May 2020 the DMO sold £3.8 bn of a three year gilt at a negative yield of 0.003% which means if held to maturity you would get back less than the purchase price

So why were investors willing to accept such low yields?

- In uncertain times such as the start of the pandemic there was a “flight to safety” and UK gilts carry a virtually nil default risk
- Holders of the 2038 gilt would still receive £4,750 for every nominal £10,000 held so it does give investors a secure income.
- Since the 2008 banking crisis, banks, pension funds and insurance companies have increased their holdings of UK gilts as they are seen as secure assets so again demand has increased pushing up prices and reducing yields.

Let’s now look at why the price has fallen.

- At the start of 2022 it was trading at £153.93 with a YTR of 1.21%
- Shortly after the invasion of Ukraine it was still trading at £150.90/1.34%
- Half way through the year on July 1 it was trading at £131.47/2.41%. This was probably due to concerns about rising inflation primarily caused by the rise in energy prices
- The UK then had some political turmoil with a long drawn out election for a new Tory leader/PM and by September 1 the price had fallen to £118.52/3.75%
- Following the “fiscal event” of September 23, the Bond market took fright at the prospect of unfunded tax cuts and on September 26 it plummeted to £104.14/4.38%

- Liz Truss resigned and Jeremy Hunt's November mini Budget reversed most of the proposals and on the 18th November the price recovered slightly to £114.31/3.57%.
- However the rate of inflation remained high and didn't fall as quickly as anticipated. As conventional gilts have no protection against inflation demand for gilts fell.
- To try and combat inflation the Bank of England raised the bank rate which in turn led to a fall in the price of gilts.

This performance was typical of bonds during 2022 and 2023 so what can we deduce from this?

- Both the price and yield are set by the market. Increased demand for a gilt pushes up the price and lowers the yield. A low demand (more investors wanting to sell) will have the opposite effect.
- As Gilt (or any Bond) is a loan so the credit worthiness and financial strength of the borrower will be a major factor determining the price on the secondary market.
- Markets dislike political uncertainty particularly about the government's economic policy
- Inflation was rising and this made the gilt less attractive to investors

The immediate impact of this was:

- The increase in gilt yields meant the cost of future Government borrowing increased.
- It led to an increase in rates for fixed rate mortgages.
- Annuity rates increased.
- The rise in YTR meant that Gilts became more attractive to investors wishing to achieve a target yield at low risk.

The international perspective.

All governments borrow from the capital markets with the usual benchmark being a 10 year bond. In May 2019, June 2020, December 2022 and July 2023, the comparative rates were as follows (source Bloomberg):

	May 2019	June 2020	Dec 2022	July 2023
UK	1.18%	0.35%	3.17%	4.09%
Japan	-0.04%	0.4%	0.24%	0.4%
USA	2.48%	0.9%	3.56%	3.98%
Greece	3.34%	1.32%	3.95%	3.84%
Germany	-0.2%	-0.28%	1.92%	2.54%

A few points to note.

- Apart from Japan, the market is demanding a higher rate in July 2023 than in previous years.
- In 2019 and 2020 Germany's rates were negative. Investors were paying to lend money to the government.

- Currently it is costing the UK more to borrow than any of the other countries.

Events in the gilt market have been moving quickly and keeping abreast of developments should be a part of your exam prep.

That completes this part so you should now understand:

- the function of the Bond markets
- how the UK government issues Gilts
- recent trends in the Bond market