

# fundstalk-quarterly

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## Quantitative easing and the impact on gilts

Almost two years ago, we thought the government would issue a net £60 billion of gilts in the 2009 financial year. Fast forward a year to the April 2009 Budget. Then, Chancellor Alistair Darling revealed plans to issue up to £200 billion in government bonds. That's roughly equivalent to £4,000 per man, woman and child in the UK. Even for a financial sector that has become inured to bad news, this was a staggeringly large figure. Graeme Caughey, Head of Government Bonds at SWIP, looks back at the Bank of England's quantitative easing programme, the impact it's had on gilts and its legacy following the announcement that it's being halted for the time being.



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### To recap

The recent financial crisis was originally rooted in the troubled US subprime mortgage market and its fall-out cast a shadow over global financial markets, including those of the UK. But as it spread into the wider, non-financial economy, investors took fright.

In an attempt to alleviate the problems in the economy, the Bank of England began to cut interest rates savagely. At the end of August 2008 UK base rates stood at 5%. After six successive monthly rate cuts between October 2008 and March 2009, the rate stood at just 0.5%. Since then the official cost of borrowing has been at an all-time low.

Despite the rate cuts, bad news continued to assail the markets. Deflation was seen as a serious threat, the housing market remained moribund, confidence surveys were unremittingly negative and gross domestic product (GDP) continued to fall.

## Introducing quantitative easing

After the government used all the rate-cutting arrows in its quiver, it moved on to what some observers have dubbed 'unconventional methods'. Quantitative easing (QE) involves a central bank (in the UK's case the Bank of England) creating money and using it to buy existing government debt and commercial paper held by the market.

The rationale for QE is to boost inflationary pressures by pumping newly created cash into the financial system. Additionally, the Bank of England hoped to persuade investors to sell its gilts and use the proceeds to lend to the corporate market, thereby increasing activity in the economy.

Initially, the Bank committed to spending up to £125 billion in its QE programme – a figure that represented roughly 9% of the UK's GDP. But after hints that it would suspend QE, it surprised many in August 2009 by instead committing a further £50 billion to the scheme, and then announcing a further £25 billion in November. On 4 February 2010, the Bank announced that there would be no further QE for the time being, although a few days later Governor Mervyn King reiterated that further purchases would be made if necessary.

It's difficult to say what effect QE has had on the economy. Figures released by the Bank of England showed a £14.7 billion fall in bank loans to businesses outside the financial industries between April and June 2009. So if the extra money in the economy hasn't gone to businesses, where has it gone? It's entirely possible that much of it has gone to overseas-based sellers of gilts – meaning the new money hasn't been circulating in the UK economy. That said, for these investors to repatriate the proceeds of selling gilts, they will need to sell sterling to buy other currencies; the effect being a weakening of sterling, which, in the round, will itself lead to inflationary pressures.

### *The four steps of quantitative easing in theory*

1. The Bank of England creates £200 billion of extra money.
2. The Bank of England uses this money to buy gilts and high-quality debt, mainly from banks, but also from other private sector institutions.
3. The banks use this money to lend to businesses and companies, resulting in more money in the general economy.
4. Once the economy has recovered, the Bank of England sells the bonds it has bought back to the banks and institutions, or allows these bonds to mature, and destroys the cash it receives. So in the long term there isn't any extra cash in the economy.

## Quantitative easing and the gilt market

We have been in the slightly surreal situation of the government issuing bonds more rapidly than it has ever done – only for the central bank to buy many of these back. It is convenient for a cash-strapped government, issuing massive amounts of gilts, to have such a willing customer. As long as the customer buys bonds more quickly than they are sold, it should provide support for the gilt market.

It's difficult to say what effect QE has had from the point of view of the gilt investor. When the Bank of England first announced that it was planning QE, market confidence soared. Gilt prices rose and yields fell. But after gilt purchases actually started, yields rose. From a low of 2.95% in mid-March 2009, the 10-year yield went up to 3.90% by the start of June 2009. Yields remained volatile during the rest of 2009, generally falling on the announcement of QE measures and gradually rising as each tranche of purchases came to an end. In October 2009, 10-year yields fell to 3.35% but rose back to 4% as markets had already priced in the prospect of QE purchases.

Yields retreated once more in the wake of the decision to extend the programme in November 2009, and these movements provided a stark reminder of the difficulties the economy – and the gilt market – will face now that QE has been halted. A critical issue is how the volume of gilts that have come into the market will be absorbed after the Bank of England stops buying. We now expect gilt yields to rise further over the course of 2010, when we forecast 10-year yields to reach 4.4%.

The problem has partly been one of confidence. With the Bank of England as a ready and willing buyer, the simple rules of supply and demand dictated that prices would rise and yields fall. Remove that buyer and the converse will be the case.

## Is it the end of quantitative easing?

On 4 February 2010 the Bank of England's Monetary Policy Committee (MPC) decided against further QE measures.

Commenting on the decision, it said: "In the light of the Committee's latest Inflation Report projections and in order to keep inflation on track to meet the 2% inflation target over the medium term, the Committee judged that it was appropriate to maintain the Bank Rate at 0.5% and its stock of purchases of government and corporate debt financed by the issuance of central bank reserves at £200 billion. The Committee noted that this stock of past purchases, together with the low level of Bank Rate, would continue to impart a substantial monetary stimulus to the economy for some time to come. The Committee will continue to monitor the appropriate scale of the asset purchase programme and further purchases would be made should the outlook warrant them."

However, it's important to note that it hasn't completely ruled out further spending. Speaking at the Inflation Report press conference on 10 February, Mervyn King said: "Although the MPC last week announced a pause in its programme of asset purchases, it is far too soon to conclude that no more purchases will be needed. So the Committee will keep its options open, and further purchases will be made if they prove necessary to keep inflation on track to meet the target in the medium term."

So what are the reasons behind the MPC's decision to halt the programme for the time being? Well, firstly there has been a significant return of risk appetite. With investors in an increasingly confident mood, they have started to shun government bonds, moving instead into equities and corporate bonds. As a result, the effects of the Bank's purchases have been more than outweighed by investors' asset allocation decisions.

Additionally, investors have remained wary of the rise in supply. In his pre-Budget review in November 2009, the Chancellor announced a massive new supply of gilts. This measure was, he said, necessary to fund the government's plans to salvage the UK economy.

The state of the nation's finances has also been recognised by ratings agency Standard & Poor's, which has lowered its outlook on UK government debt – from 'stable' to 'negative'. It maintained its AAA rating on gilts, but cautioned that with government debt approaching 100% of national income, the rating would not be sustainable in the medium term. This is the first time the credit rating agency has lowered its outlook since it started analysing the UK's finances in 1978. That initially caused alarm in the market, although investors soon switched their attention to the US, which has much bigger deficits to deal with.

So it seems the effects of QE within the gilt market have been superseded by investors' increasingly optimistic view of the economy. Time will tell whether that optimistic view is justified, and whether the Bank of England will in fact have to make further purchases.

### More information on quantitative easing

If you're looking for more information, the Bank of England has a whole section on QE on its website, [www.bankofengland.co.uk/monetarypolicy/assetpurchases.htm](http://www.bankofengland.co.uk/monetarypolicy/assetpurchases.htm)

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