

Citywire

UK fixed income a 'one way bet to lose money'

by **Ian Williams** on Feb 16, 2011 at 08:33



Since global bond markets peaked last Autumn the price of a 10-year gilt has fallen some 8.5% while a 50-year gilt has dropped circa 12.5%.

These dramatic falls have occurred in less than six months in what is supposed to be the low risk element of a balanced portfolio. Corporate bonds which are obviously priced off the gilt have also shown similar dramatic losses. So is it now safe to go into the gilt market or is there a realistic prospect of further losses?

One interesting point over the last six months is the number of bond fund managers rushing to stress that all is well with no reason to panic, and that bonds offer good long term value. To suggest a 50-year gilt on 4.4% gross redemption yield offers good value when UK Inflation is running between 4 % and 5% is of course unmitigated self interested drivel.

The facts are quite simple and quite stark. UK Interest rates and UK bond yields are now on a rising multi-year trend that will restore gilt yields at the very least to the average yields of the last 25 years or so.

Base rates of 0.5% are not some form of 'new normal', they are an overhang to the worst banking crisis since the second world War, and as such are certain to return to 'old normal' as the banking crisis of 2008 disappears further and further into the rear view mirror. This means within the next three years or so base rates will be back to 4% or above and 10-year gilt yields back to around 5.5%.

The long term average (25 years) of ultra long gilts is around 7% from today's level of 4.4%. The capital losses implied by a move of this magnitude are horrendous. A 50-year gilt stands to lose 36% in capital on top of the 12% odd already lost in the last six months alone, while a 10-year gilt stands to lose a further 12% on top of the 8% loss already seen.

These are the numbers if yields return to their 25-year average, in reality there is no reason to assume that at some stage yields will not go above the average of the last 25 years in which case the losses will be even greater.

Meanwhile, the news background offers no encouragement at all. The UK public sector deficit which in 2010 stood at circa £175 billion while the projection for 2011 is for a deficit of similar proportions. UK Public spending is forecast to be £696 billion in 2010/2011, £701 billion in 2011/2012, £713 billion in 2012/2013, £724 billion in 2013/2014.

So far from seeing 'savage' cuts etc government spending is scheduled to carry on rising for every year of the coalition government. The National Debt Office has to somehow finance these gargantuan sums against a background of falling gilts and rising Interest rates, a completely different kettle of fish to selling gilts in a bull market.

Furthermore as the penny has now dropped that this is the cyclical low in the bond cycle every Tom, Dick and Harry wants to issue bonds. This is adding to the supply of bonds coming on to the market and this source of supply could prove to be equal that from the government.

The conclusion of all this is that UK fixed Income is a one way bet to lose money. In the UK Gilt Fund that I run (the City Financial Gilt Fund) we took virtually all risk off the table last July by selling out of 10-year gilts and re-investing in one-year gilts to protect our Investors capital.

We have no desire to lengthen again any time soon as in our view the risks still heavily outweigh the rewards.