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## Gilt buying 'lunacy' fuelling the next bubble

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Gilts along with other major bond markets, including US Treasuries and German Bunds, have seen yields fall to levels never seen before during the lifetime of the average investor.

For example, Two-year US T-bonds now yield 0.46% per annum, five-year German Bunds yield 1.2%, while 50-year gilts are yielding 3.8%.

The lunacy is not restricted to the conventional market. Three-year UK index-linked gilts are on a negative real yield of -1.6%, while inflation, as measured by the CPI, is currently around 3% per annum or 5% using RPI. Taking an average of the two gives a UK inflation rate of 4%, which places the three-year gilt on a negative real yield of 3.2%.

Furthermore UK inflation is displaying distinctly sticky tendencies with a marked reluctance to come down to the Bank of England's target of 2% CPI. Governor King has already had to write eight separate letters explaining why inflation is so high. With Russian wheat rises, January VAT increases and 6% plus rail fare increases on the way a ninth and tenth letter could be on the cards.

The mania to own government bonds stems from a desire to allocate away from perceived risk assets, but exactly how risk-free are gilts? Over the last 50 years or so, the long-term yield on long gilts has averaged around 8% against the current yield of 3.8%. If or when the interest rate cycle moves back to the long-term average yield, this will involve a capital loss of 50%. As an example a UK Treasury with a 4% coupon maturing in 2060 currently priced at 103 would have to fall to a price of 51 to yield 8%. To clarify the point – a move back to the average (never mind above average) yield levels wipes out 50% of the investors' capital in nominal terms. Obviously that becomes 54% after year one and 58% in year two in real terms once inflation reduces the return even further.

Other types of analysis also suggest a bubble. The gilt market is technically at it's most overbought since the Asian currency crisis of 1998 - excluding the Lehman crisis - having risen for eight consecutive months.

It would need a global recession bordering on global depression to validate these yields, but globally no such thing is on the horizon. The debtor nations, such as the US and UK, are experiencing low growth (not even recession) as a hangover from the previous property boom and crash, while the creditor nations, China India and Germany, are showing strong growth. Indeed the world, excluding countries suffering from 'property hangovers', is doing quite well at present. This explains the buoyant price of commodities, which is another reason why inflation will not fall in the West).

The only conclusion one can draw is that gilts have been puffed up to levels that will be impossible to sustain for any period of time and are therefore not a risk-free asset at all. For the City Financial Strategic Gilt fund that I run we have taken the decision to reduce the risk in our fund to the absolute minimum in order to protect our investors' capital to the fullest extent possible.

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