GCG

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UK 10-Year Gilt Investment Thesis

Current Landscape
The UK 10-year gilt yield is currently hovering around 4.9% (equivalent to a bond price of £95.18) after increasing by 100 basis points in recent months. This rise has been driven by:

- A weak budget from the UK government, with increased spending and borrowing.
- Inflationary fears stemming from global and domestic factors.
- Reduced expectations for Bank of England (BoE) rate cuts, as markets anticipate tighter policy for longer.
- A weaker pound, increasing import costs and inflation risks.
- Knock-on effects from rising US Treasury yields, pushing global bond yields higher.
- Diminished trust in the UK government, exacerbating investor concerns about fiscal discipline.
- Despite these headwinds, we believe the current yield level offers a compelling opportunity to buy 10 year UK gilts (short the yield).

Key Arguments for the Trade
1. **Fiscal Policy and Disinflationary Impact**
    - Rachel Reeves, the UK Chancellor, has effectively lost the £9 billion in fiscal headroom outlined in her budget due to higher borrowing costs.
    - Given the lack of growth in the UK economy, we expect the government to cut spending rather than implement inflationary measures (e.g., raising taxes).
    - Spending cuts are inherently disinflationary, likely prompting a market reaction and reducing gilt yields.
2. **Weak Economic Growth**
    - UK GDP is projected to grow by just 1.2% in 2025, significantly below trend.
    - Low growth typically leads to:
        - Reduced inflationary pressures.
        - Increased likelihood of BoE interest rate cuts.
        - Lower overall demand for borrowing.
        - Increased investor preference for safe-haven assets, such as government bonds.
    - These factors should support higher gilt prices (lower yields) over time.
3. **Inflation Expectations and Interest Rate Cuts**
    - Goldman Sachs has forecasted a significant easing in inflation for 2025.
    - A downside surprise on inflation could lead markets to rapidly price in additional BoE rate cuts, beyond the current expectations of 50bps, given the policy rate is still at 4.75%.
    - A more aggressive easing cycle would be highly supportive of lower gilt yields.
4. **Demand from Gilt Auctions**
    - Recent UK gilt auctions have been oversubscribed, demonstrating robust demand from investors.

- Locking in yields of 4.9% (10-year) or 5.5% (30-year) offers attractive risk-adjusted returns, particularly for investors using tax-efficient structures.
- This reflects significant investor appetite at these levels, further supporting the case for a rebound in gilt prices.

Our View
The current market sentiment is shaped by short-term fears about inflation and fiscal mismanagement, which have driven yields higher. However, we see these concerns as overstated, given the weak economic fundamentals, slowing inflation, and a likely dovish pivot by the BoE.

- Entry Strategy:

Gradually build positions to take advantage of potential temporary spikes in gilt yields caused by economic news or market events.

- Risk/Reward:

The upside potential in gilt prices significantly outweighs downside risks, particularly in the context of slowing economic growth and easing inflationary pressures.

Hedging Strategy
While we are confident in the long UK gilt trade, we acknowledge risks to capital appreciation, such as persistent inflationary pressures, strong correlations with US Treasuries, and broader market uncertainty surrounding the UK economy.

To mitigate these risks, we propose buying put options on US 10-year Treasury futures. The rationale is as follows:

- UK gilt and US Treasury yields are historically correlated. If UK gilt prices fall (yields rise) due to adverse economic conditions, US Treasury prices are likely to decline as well, increasing the value of the put options.
- Factors such as strong US economic growth, inflationary policies under Trump, and concerns about rising US national debt could shrink the yield gap between the US and UK, amplifying the effectiveness of this hedge.
- In the event UK gilt yields rise, there is a strong probability that US bond prices will fall faster, potentially putting our options in the money and offsetting losses in our gilt trade.

This hedge balances the risks of the trade while preserving potential upside from favorable movements in UK gilt yields.

Conclusion
Our view is anchored in the UK's weak economic outlook, shifting market sentiment on interest rates, and the structural demand for government bonds globally. With the 10-year gilt yield at 4.9%, a level not seen since early 2008, we believe current conditions present a compelling opportunity to invest in UK gilts.

By gradually increasing our exposure during periods of temporary yield spikes, we aim to capitalize on potential mispricing in the market. This strategy is built on our strong conviction that as inflationary pressures ease and economic growth remains weak, market dynamics will recalibrate in favor of lower yields and higher gilt prices.

In addition to potential capital appreciation, UK gilts offer the stability of a guaranteed 4.9% nominal return, backed by the full faith and credit of the UK government. To manage downside risks, we incorporate a hedging strategy designed to hedge against unexpected market developments. This balanced approach reinforces our conviction that UK gilts represent a compelling and prudent investment opportunity in today's macroeconomic environment.

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