Market Musings

Global Rates, FX & Commodities Strategy

5 June 2018

▶ UK ▶ RATES ▶ GLOBAL MARKETS

Gilts: Outperformance No More

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- With 10y Gilt yields hovering around the 1.30% mark, we are currently trading close to the lows seen since the beginning of the year. Weekly changes in core rates vs 10y Gilt yields suggest that Gilts have outperformed both USTs and Bunds when rates have declined over the last couple of months. Even during sell-offs, Gilts have seen more support than USTs.
- With the BoE's underlying bias for tightening of monetary policy remaining intact, we hold a bearish view for the Aug-18/ Sep-18 MPC dated contracts. Meanwhile, we still consider being outright short 10y Gilts as relatively risky with supply still favorable in near term. Thus, we prefer curve/spread trades, which can work better given different BoE scenarios.
- With risk-on momentum again starting to pick up, we would expect some of the flight to quality premium embedded in Gilt to decline. Thus, we favour a tightening move in 10y Gilts swap spreads.

Trade Ideas

We sell £25k DV01 of the 5s10s30s Gilt fly at -18bp, targeting 10bp with a stop of -25bp.

Mysterious support for Gilts?

Political uncertainty in Italy, as well as the resurfacing of trade disputes, have been driving global risk sentiment over the last couple of weeks. 10y Gilts have rallied nearly 20bp since mid-May, outperforming the 15bp rally in Bunds and the 10bp rally in USTs over that time frame. The move lower in yields has been further aided by the dovish tilt from the BoE at the May meeting, as well as some moderation in the May FOMC minutes. With European politics again taking a step back, we reassess the current valuations for the Gilt curve.

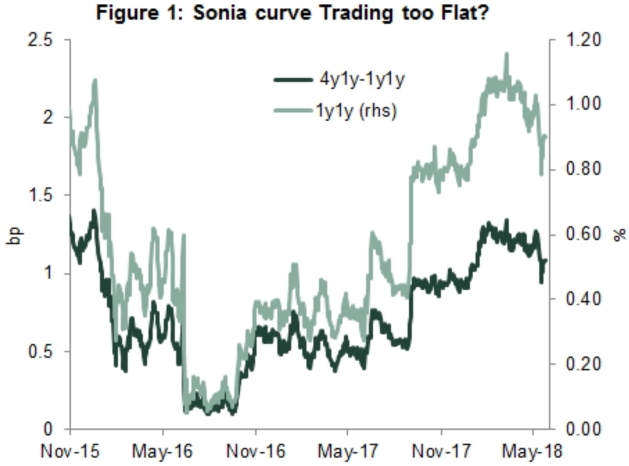
Short-end: Positioning for a near-term hike

The dovish hold from the BoE at the May MPC meeting has pushed market expectations for the next full 25bp rate hike to early 2019. However, signals from the BoE clearly suggest that the timing of rate hikes will be opportunistic and data dependent. The stage for a tentative hiking cycle still remains the base case for the BoE, with the forecast for inflation conditioned on three hikes over a period of three years. The recent uptick in UK's macro data (PMIs, retail sales) continues to support our base case for the BoE hiking rates at the August 2018 meeting.

The front end is currently pricing in only 45% odds of a hike in August and around 85% chance by the end of 2018. Thus we hold a bearish view for the Aug-18/ Sep-18 MPC dated contracts. However, rather than outright paying Aug 2018, we continue to prefer to pay Aug 18 vs. receive Nov 18 BoE MPC dated contracts. This micro curve trade should work if the BoE maintains its dovish rhetoric as well as if the BOE signals a hike in August since we don't expect more than one hike between August and November.

Looking further out the curve, we continue to hold our 4y1y-1y1y Sonia Steepeners (Figure 1). With the BoE maintaining its stance of a "gradual and limited" pace of rate hikes, we think that the 1-4y OIS curve should steepen as the market is likely to push back the rate hike trajectory by the BoE. With the Brexit deal still being a slow burner in the background, the front-end curve should continue to follow a steepening path as markets push back the neutral rate pricing for the BoE.

Figure 1: Sonia curve Trading too Flat?



Source: Bloomberg, TD Securities

Figure 2: Capturing Moves Since End-April

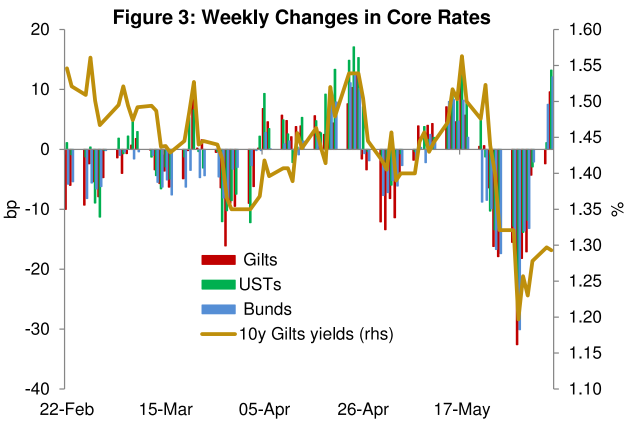
	2y	5y	10y	30y
Gilt yields	-14.00	-12.20	-16.20	-11.50
Sonia - cash	5.70	5.60	10.08	7.25
Swap spreads	4.70	3.36	9.59	10.09
ASW	-4.04	-4.36	-10.41	-9.65
Libor-OIS	-3.95	-1.58	1.05	2.55
3s6s basis	0.35	0.95	0.55	-0.25
XCCY basis	4.75	3.36	9.59	10.09

Source: Bloomberg, TD Securities

Outright: 10y Gilts have outperformed global rates, but risks are binary

With 10y Gilt yields hovering around the 1.30% mark, we are currently trading close to the lows seen since the beginning of the year. In Figure 3, we look at the weekly changes in core rates vs. the evolution of 10y Gilt yields. Interestingly, Gilts seem to have outperformed both USTs and Bunds in rallies over the last couple of months. Even during the sell-off phases, Gilts have seen better support than USTs. Clearly, Gilts can be considered as a good "hedge" for risk-on/risk-off phases. Figure 4, highlights the ongoing richening of 10y Gilts when compared to an equally weighted Bund and UST fly. However, with 10y Gilts still being driven by market expectations of BoE rate hikes and overall risk sentiment, we think selling them outright can be relatively risky. **Thus, we prefer curve/ spread trades, which can work better given different BoE scenarios.**

Given the recent moves in Treasuries, we still prefer positioning in Gilts vs Bunds/OATs than vs Treasuries. We continue still favor our short 5y5y GBP vs 5y5y EUR swap trade. We think that the risk term premium in Gilts is likely to increase as focus turns to the BoE rate hike cycle and its forward rate guidance on reinvestments.



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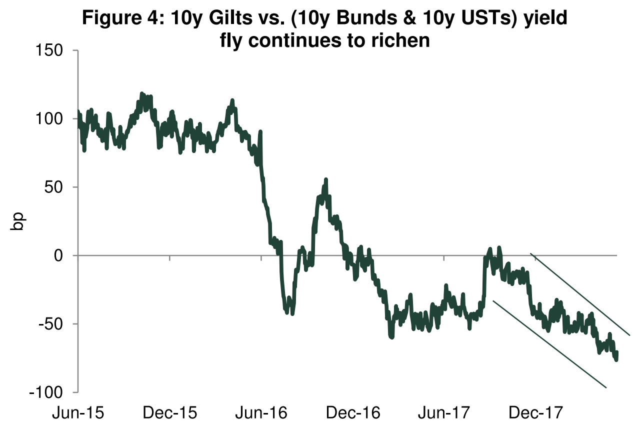


Source: Bloomberg, TD Securities

Curve: Sell the belly of 5s10s30s Gilts yield fly

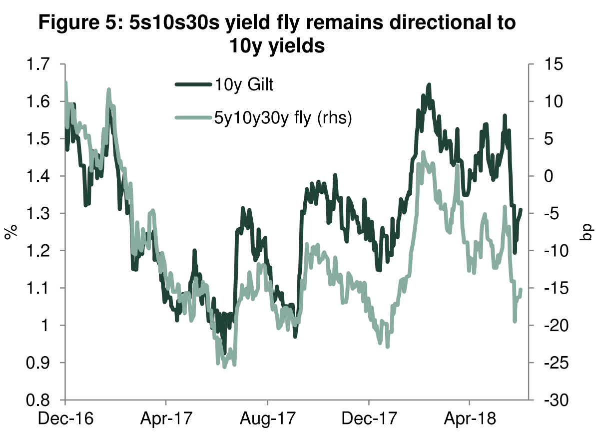
Since the end of April, the 5s30s Gilt curve has been relatively rangebound. But the 5s10s30s fly has continued to richen, following its directionality to 10y outright rates (Figure 5). As highlighted below, net supply dynamics remain fairly supportive in June/ July to trigger any duration driven sell-off. We think a safer way to play an outright short in 10y Gilts would be selling the belly of 5s10s30s fly. We think it is likely to perform in both the scenarios below:

- **Hawkish BoE:** We think that rate hike expectations should impact the belly of the curve, while the ultra long curve should enjoy the support of LDI/PF demand. Thus 10s30s should flatten more than the 5s10s segment of the curve.

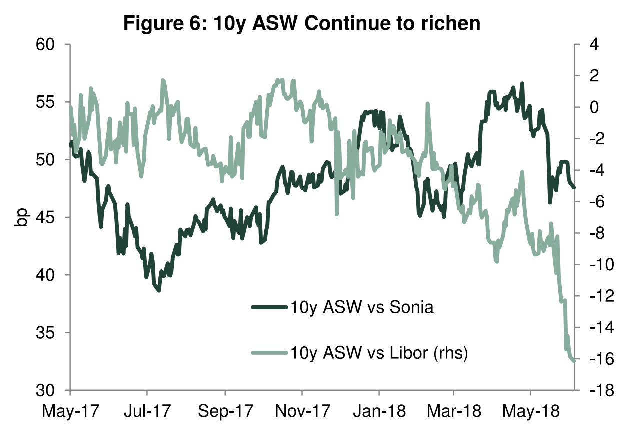
- **Dovish BoE:** 5s10s should steepen more than the 10s30s segment of the curve as the BoE should anchor the short-end.

Thus, we could expect the fly to cheapen in both the cases in near term. Furthermore, low net ultra long issuance over the next few months should continue to create a flattening bias for the 10s30s curve.

Thus **sell £25k DV01 of the 5s10s30s fly at -18bp, targeting 10bp with a stop of -25bp.**



Source: Bloomberg, TD Securities



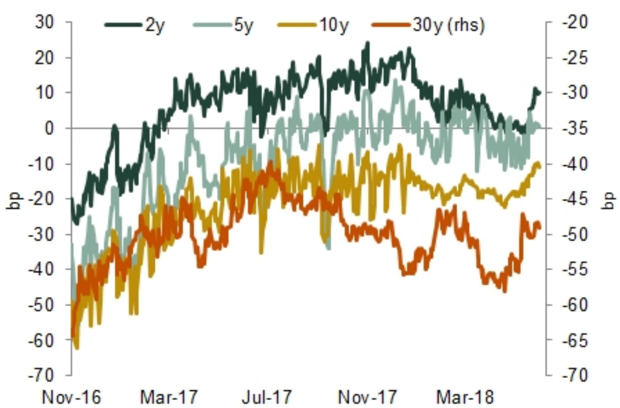
Source: Bloomberg, TD Securities

Swap spreads: Less flight to quality and corporate issuance to tighten swap spreads

The recent risk-off episode has supported wider swap spreads across the curve, with the widening move most prominent in the 10y+ sector (Figure 2). 10y Gilts ASW vs Libor have richened nearly 15bp since beginning February. To some extent, we could justify the move with some receiving fixed positions shifting away from Libor to Sonia due to ongoing uncertainties around Libor reform (Figure 6). However, in the recent move in Gilts, the ASW richening also stands out vs Sonia (Figure 6 and 7). With risk-on momentum again starting to pick up, we would expect some of the flight to quality premium embedded in Gilts to decline. Thus, we could see investors reevaluating the spreads between cash and swap curve.

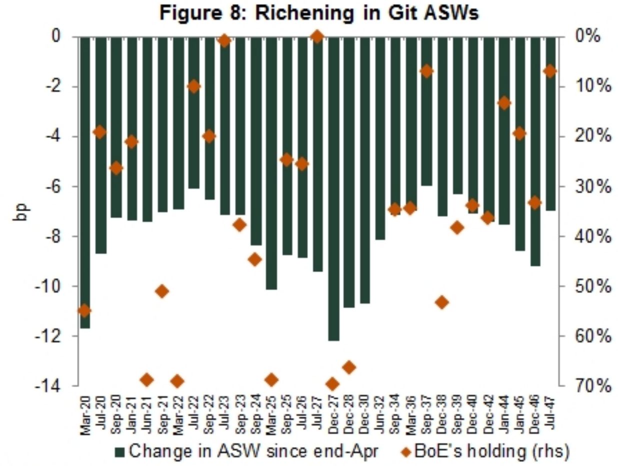
The favorable risk environment should further encourage corporates/SSA issuers to be active in the primary markets. This is particularly true as seasonals suggest issuance activity generally starts slowing down around mid-July/August. Increase in corporate issuance should support tighter swap spreads, in our view. As mentioned above, even from a hedging perspective, the recent widening of 10y Sonia vs cash spreads should support receiving activity in swaps/OIS. This should further add to the tightening move in swap spreads. Thus from a tactical perspective, **we continue to favour receiving 10y swap rates against Gilts in the near term.**

Figure 7: Sonia cheapens vs. Gilts



Source: Bloomberg, TD Securities

Figure 8: Richening in Git ASWs



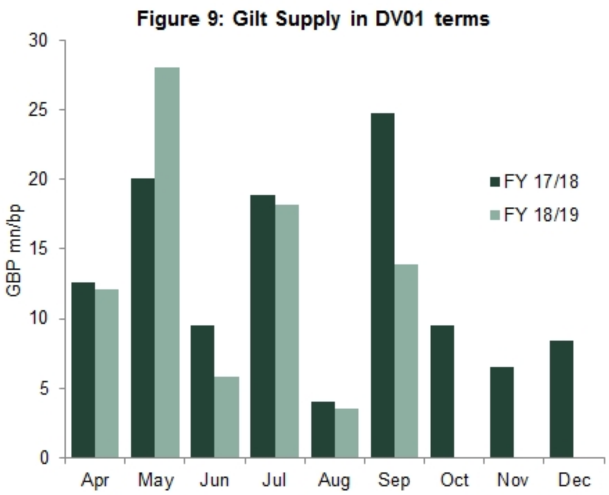
Source: Bloomberg, TD Securities

Quarterly Gilt Supply Update

We expect to see around £25bn in gross Gilt nominal and linker issuance in the coming quarter (July-Sep), which is marginally below the £28bn expected in this quarter. In DV01 terms this equates to around £35mn/bp in supply as compared to the bumper £48mn/bp seen in April to June.

In terms of syndications, we expect to see **a new ultra-long linker syndication** (20-25y maturity) in early July. In addition, we also see the DMO issuing a **new 5y benchmark (July 24) and 30y Benchmark (Sep 11)** in the coming quarter.

Net Nominal supply to remain low: Gilt supply will see support from a £34.8bn redemption of UKT 1.25% Jul 18s on July 22 (of which the BoE holds only £2.9bn). Support from coupon flows will be relatively light, with only £3.52bn being redeemed on July 22. However, we note that nearly 60% of coupons belong to the 20y+ sector of the curve. In terms of index impact, the FTSE all stock index could see around +0.28yr extension in its daily rebalancing.



Source: UK DMO TD Securities

Figure 10: Issuance Calendar for Jul-Sep18

Date	Bond	Amount (£bn)**	Sector
03-Jul-18	1 5/8% UKT 2028	2.5	Medium
10-Jul-18	Linker Syn 20-25y area*	3	IL
19-Jul-18	1¾% UKT 2057	2.5	Long
24-Jul-18	New UKT April 2024	3	Short
08-Aug-18	1 5/8% UKT 2028	2.25	Medium
21-Aug-18	UKTI 2028	1.75	IL
06-Sep-18	UKT April 2024	2.75	Short
11-Sep-18	New UKT January 2049	3	Long
20-Sep-18	1 5/8% UKT 2028	2.5	Medium
25-Sep-18	0 1/8% UKTI 2048	1.25	IL

* Tentative, **Expected amounts, Source: DMO, TD Securities

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