Macro Keys
Lowering our 10y Gilt yield forecasts

Global Macro Strategy

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10y Gilt yield now seen at 1.10% end 2017, 1.35% end 2018
Since late January 2017, 10y Gilt yields have fallen by over 40bp. In the process, they have outperformed equivalent maturity US Treasuries by around 15bp, and German Bunds by 30bp. When we last published yield forecasts in November 2016, we deliberately set them below forwards, as our expectations for the UK economy were more pessimistic than the consensus, meaning we perceived a higher likelihood of additional QE over the course of our forecast horizon to the end of 2018.

The rally has taken both current and forward yields below our previous targets
In our November 2016 forecasts, we predicted that 10y Gilt yields would fall from 1.40% to 1.20% by the end of Q1 2017, before slowly climbing to end 2017 back at 1.40%, and 2018 at 1.65%. At the time, forward yields for the end of this year and next were at 1.54% and 1.70% respectively. They are currently at 1.20% and 1.44%, meaning that without any material alleviation of our concerns for the UK economic outlook, our forecasts have swung from being bullish relative to forwards to being bearish. This does not fit with our underlying narrative, and has precipitated this forecast revision.

Targets for cross market outperformance have been reached, or exceeded
Our concerns for the UK economic outlook were both absolute and relative compared to other major economies, and our 10y forecasts captured this by anticipating cross market outperformance. We expected the spread against 10y Treasuries to widen from -84bp to -100bp by the end of 2017, and against 10y Bunds to narrow from +110bp to +70bp. The first of these targets has already been exceeded, with 10y Gilts currently -116bp v Treasuries, and the second has been reached.

Onset of the real earnings squeeze, and path to EU exit, reinforce UK concerns
We identified two key factors as the expected catalysts of a worsening UK economic performance. The first was intensifying pressure on the consumer generated by a combination of accelerating inflation and anaemic wages, and since we published our previous forecasts the former (CPI y/y) has accelerated from +0.9% to +2.7% while the latter (whole economy average earnings 3m / y/y) is unchanged at +2.4%. The second was gradual but persistent cooling of investment activity as companies became increasingly focused on the date of the EU exit, which will remain a time of intense uncertainty until, and unless, a comprehensive transitional deal is struck between the UK and the EU.

There are signs in recent data that these headwinds are starting to blow
While both the squeeze on real earnings and the EU exit process are in their early stages, several indicators increasingly suggest a modest slowdown in some areas of domestic demand is underway, and may intensify. Even after a better April, retail sales growth is clearly slowing, consumer confidence is softening (especially in forward looking sub-indices), the housing market is losing momentum, and longer term investment plans are cooling, presumably due to the very elevated uncertainty about the environment beyond March 2019. If these signs proliferate and intensify as we expect they will, the market will gradually price in a strengthening possibility of monetary easing and QE. That would cause front end yields to decline, and conventional Gilts to outperform further against linkers, on asset swap, and cross market.

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Lowering our 10y Gilt yield forecasts

Since late January, 10y Gilt yields have fallen by over 40bp. In the process, they have outperformed equivalent maturity US Treasuries by 15bp, and German Bunds by 30bp (Figure 1). When we last published yield forecasts in November 2016, we deliberately set them below forwards, as our expectations for the UK economy, were more pessimistic than the consensus, meaning we perceived a higher likelihood of additional QE over our forecast horizon to the end of 2018. We continue to expect downside risks to crystallise over the coming quarters, and our UK GDP forecasts of 1.4% for 2017 and 0.7% are well below consensus expectations.

10y Gilt yields, have fallen 40bp since late January, outperforming Treasuries and Bunds in the process

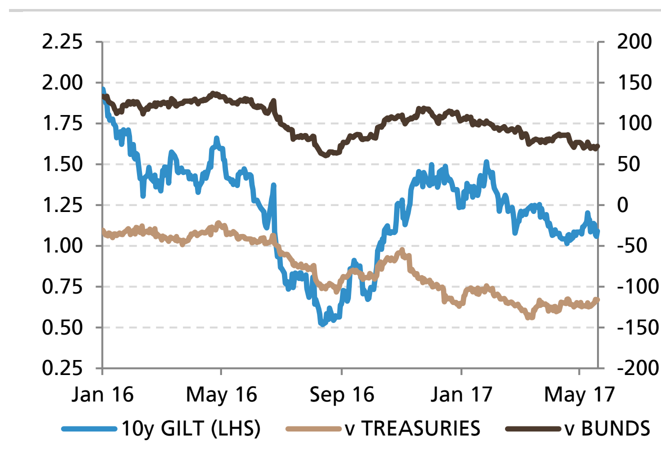
We therefore still expect the implied probability of additional monetary easing and a resumption of QE through Gilt purchases to increase as the data deteriorates. This in turn has led us to **lower our 10y Gilt yield forecasts, to 1.10% for the end of 2017 and 1.35% for the end of 2018**. This re-establishes our bullish stance relative to forwards (Figure 2), and on cross market valuations.

We forecast 10y Gilt yields at 1.10% at the end of 2017, 1.35% at the end of 2018

The rally has taken yields below our previous targets

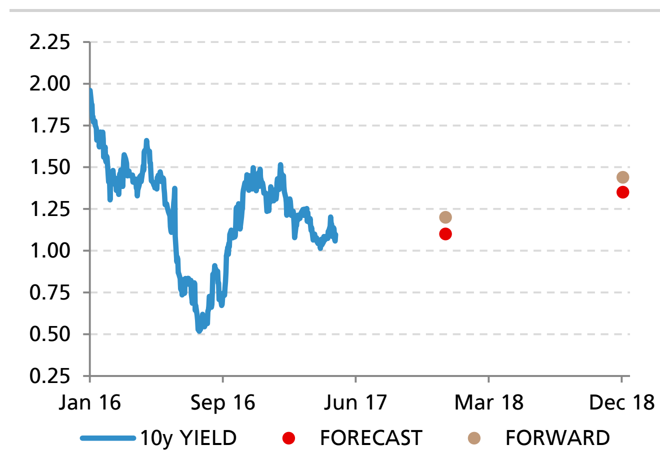
In our November 2016 forecasts, we predicted that 10y Gilt yields would fall from 1.40% to 1.20% by the end of Q1 2017, before slowly climbing to end 2017 back at 1.40%, and 2018 at 1.65%. At the time, forward yields for the end of this year and next were at 1.54% and 1.70% respectively. They are currently at 1.20% and 1.44%, meaning that without any material alleviation of our concerns for the UK economic outlook, our forecasts have swung from being bullish relative to forwards to being bearish. This does not fit with our underlying narrative, and has precipitated this forecast revision.

Figure 1: 10y Gilt yield (%), and cross market spread history (bp), Jan 2016-May 2017



Source: Bloomberg, UBS Global Research

Figure 2: 10y Gilt yield (%), Jan 2016-May 2017, with new UBS forecasts and current forwards at end 2017 and 2018



Source: Bloomberg, UBS Global Research

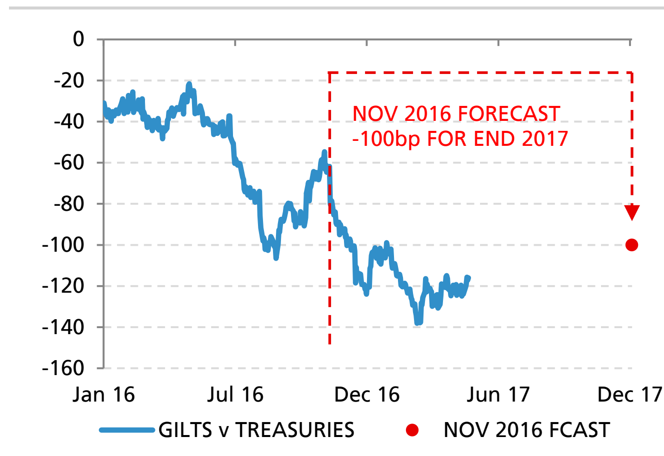
Targets for cross market outperformance reached, or exceeded

Our concerns for the UK economic outlook were both absolute and relative compared to other major economies, and our 10y forecasts captured this by forecasting cross market outperformance. We expected the spread against 10y Treasuries to widen from -84bp to -100bp by the end of 2017 (Figure 3), and against 10y Bunds to narrow from +110bp to +70bp (Figure 4). The first of these

We have reached our year end 2017 target against Bunds, and exceeded it against Treasuries

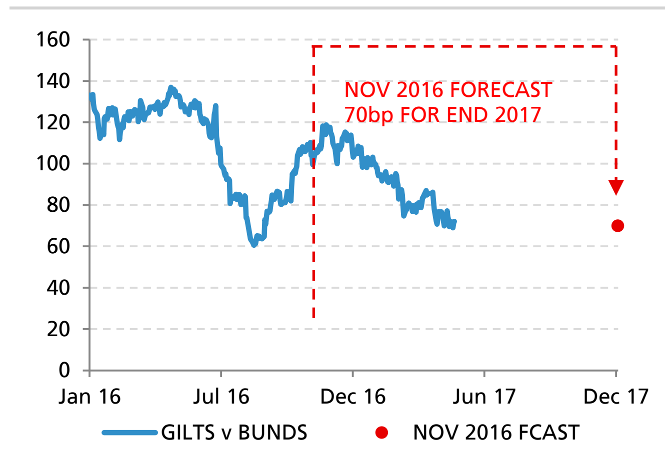
targets has already been exceeded, with 10y Gilts currently -116bp v Treasuries, and the second has been reached.

Figure 3: 10y yield spread between Gilts and Treasuries (bp), Jan 2016-May 2017, with UBS Nov 2016 forecast



Source: Bloomberg, UBS Global Research

Figure 4: 10y yield spread between Gilts and Bunds (bp), Jan 2016-May 2017, with UBS Nov 2016 forecast



Source: Bloomberg, UBS Global Research

Real earnings squeeze, and path to EU exit, reinforce UK concerns

Real earnings squeeze and cooling investment activity as EU exit process unfolds the expected catalysts of a persistent UK economic slowdown

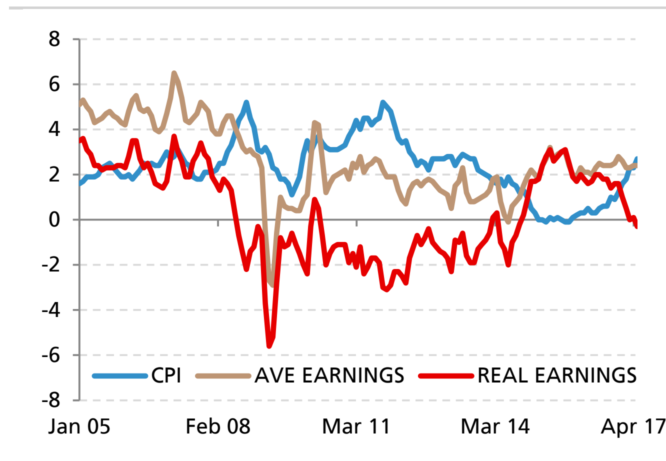
We identified two key factors as the expected catalysts of a worsening UK economic performance. The first was intensifying pressure on the consumer generated by a combination of accelerating inflation and anaemic wages, and since we published our previous forecasts the former (CPI y/y) has accelerated from +0.9% to +2.7% while the latter (whole economy average earnings 3m / y/y) is unchanged at +2.4% (Figure 5). The second was a gradual but persistent softening of investment intentions and activity in the domestic private sector as uncertainty surrounding the UK's exit from the EU, and the potentially radical changes to terms of trade and other economic dynamics such as freedom of movement may – or may not – change after the now-fixed exit date of 29th March 2019.

As the triggering of Article 50 of the Lisbon Treaty, which set in motion a two year period for negotiation of exit terms before that exit occurs, did not happen until more than nine months after the EU referendum, there was a significant delay between the referendum itself and the actual departure of the UK from the EU with its possible associated material changes to trading arrangements. Trade weighted sterling, meanwhile, lost as much as 21% of its value between November 2015 and October 2016 in the run-up to and initial aftermath of the referendum, and the discrepancy in timing between the eventual date of exit from the EU, and the sharp fall in sterling that reflected concerns about how this exit would play out, gave companies a powerful tailwind to take advantage of.

Companies with long order books are less confident, as their investment plans straddle the date of the UK's exit from the EU

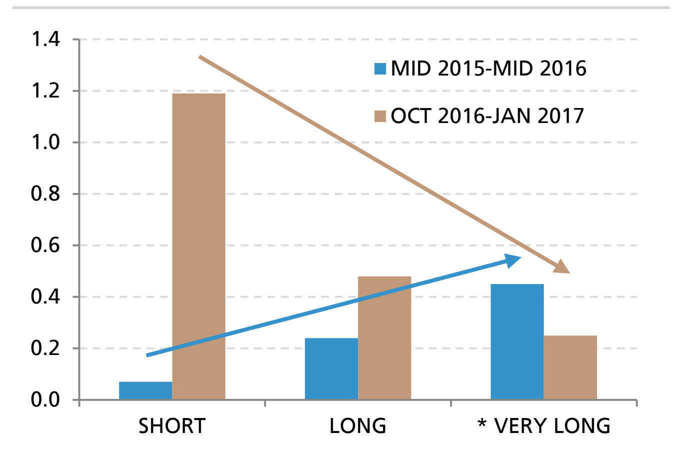
However, as Figure 6 clearly shows, the impact this had on export optimism differed dramatically between sectors with short order books, and those with long order books. We believe the latter are far less optimistic about the outlook because their investment plans straddle the end of the 2y exit process, and until there is a clear transitional deal in place – something we expect to occur only very late in the 2y process, if indeed a deal is possible at all – we expect ever more investment projects to be delayed, postponed, scaled back or cancelled.

Figure 5: UK CPI (% y/y), whole economy average earnings (% 3m / y/y), and real earnings (average earnings less CPI % y/y), Jan 2005-Apr 2017



Source: Bloomberg, UBS Global Research

Figure 6: Sectoral UK industrial export optimism (standard deviations from 20y average), split by normal length of order books



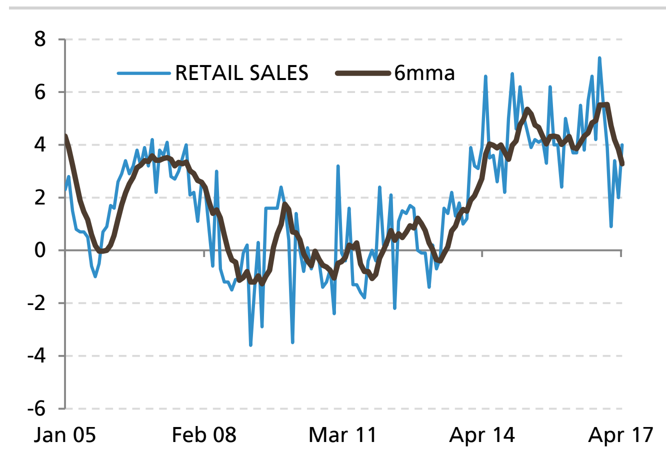
Source: CBI, Bank of England, UBS Global Research
*VERY LONG – those sectors where at least 15% of firms on average have an order book equal to over 12m of production

Signs in recent data that these headwinds are starting to blow

We see signs of softening retail sales, a weaker housing market, and waning consumer confidence

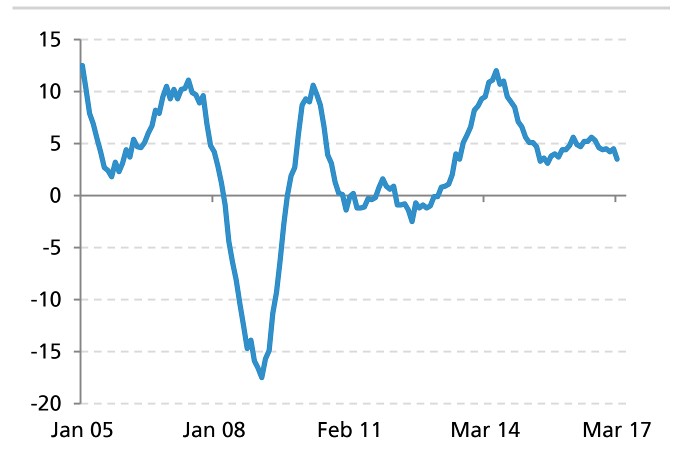
While both the squeeze on real earnings and the EU exit process are in their early stages, several indicators increasingly suggest a modest slowdown in some areas of domestic demand is underway, and may intensify. Even after a better April, retail sales growth is clearly slowing (Figure 7), the housing market is losing momentum (Figure 8), consumer confidence is softening (especially in forward looking sub-indices (Figure 9, Figure 10)), and longer term investment plans are cooling (as shown in Figure 6), presumably due to the very elevated uncertainty about the environment beyond March 2019. If these signs proliferate and intensify as we expect they will, the market will gradually price in a strengthening possibility of monetary easing and QE. That would cause front end yields to decline, and conventional Gilts to outperform against linkers, on asset swap, and cross market.

Figure 7: UK headline retail sales (% y/y) and 6m moving average, Jan 2005-Apr 2017



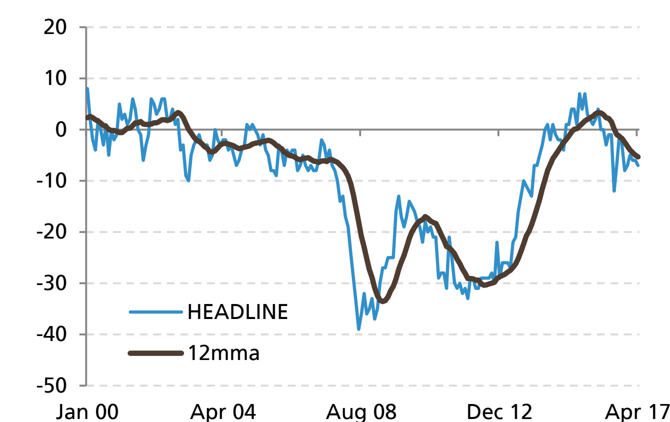
Source: ONS, UBS Global Research

Figure 8: Change in house prices (% y/y), Jan 2005-Apr 2017



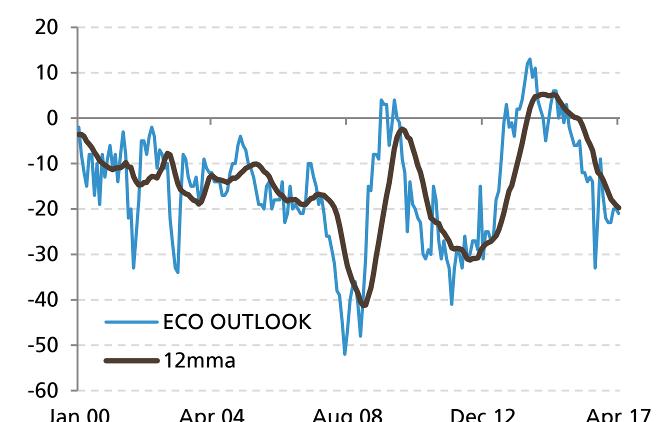
Source: Nationwide, UBS Global Research

Figure 9: Consumer confidence – headline index (and 12m moving average), Jan 2000-Apr 2017



Source: GfK, Bloomberg, UBS Global Research

Figure 10: Consumer confidence – economic outlook next 12m (and 12m moving average), Jan 2000-Apr 2017



Source: GfK, Bloomberg, UBS Global Research

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