Liquid Insight

Room for improvement. BoE active QT might be going okay but could be better

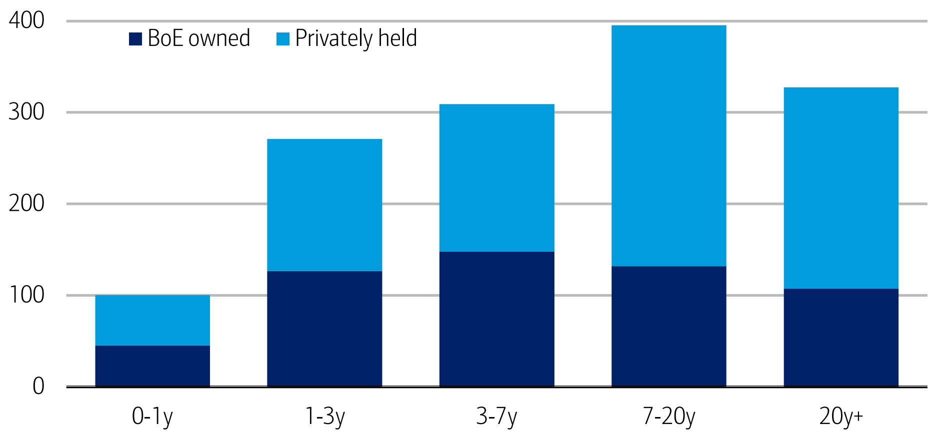
06 December 2023
Rates and Currencies Research
Global

Key takeaways

- Our hopes for a shorter tilt to BoE Gilt sales seem to have been dashed by a Bank expressing contentment with progress.
- We discuss moving away from a case centred on market functioning and aligning sales with portfolio structure.
- There are bigger macro arguments. We use the 80s experience with an earlier incarnation of QT to explain.

By Mark Capleton and Agne Stengeryte

Chart of the day: Remarkably, BoE now owns more 1-3y Gilts than 20y+Gilts by value, £bn
Letting 1-3y Gilts go would not interfere with passive run-off, and would encourage bank buying.



Source: BofA Global Research, Bank of England, DMO, Bloomberg

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Okay isn't necessarily optimal

We've long argued that the BoE should alter the maturity buckets used for its Gilt sales, saying that with the passage of time and the market sell-off having collapsed the WAM of the QE portfolio, it would be appropriate for the Bank to tilt its sales shorter. Despite the enticing addition of line in a Market Notice that hinted at change, subsequent comments from the Deputy Governor suggest that nothing is likely to be imminent.

So we need to broaden out the debate. We think Ramsden is right to say that P&L considerations shouldn't affect Bank decisions, up to a point, but if there is a large term premium that can be saved by selling fewer longs and more shorts, then perhaps that could be considered? More importantly, there are broader macro benefits from such a change, concerning money supply, the adjustment away from superabundant liquidity and the portfolio effect. We use the experience of "overfunding" in the 80s to illustrate this.

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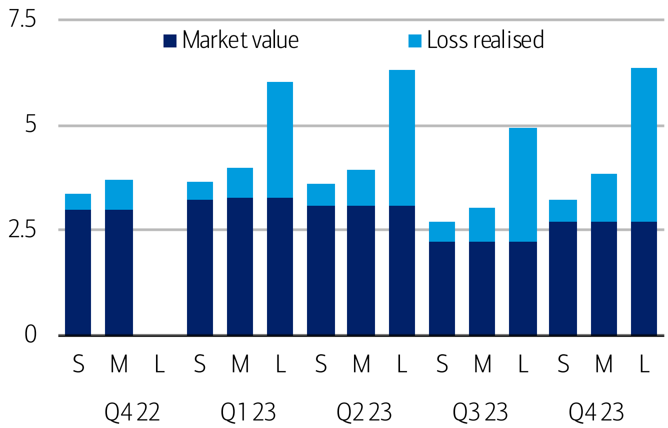
Size can deceive

On Monday, the Bank of England conducted its usual Quantitative Tightening (QT) active sales operation, for the usual £670m size - an amount designed to be modest enough to operate "in the background", as the Bank likes to say.

But it packed a punch. The amount of QT actually achieved, as the BoE measures it, was a less inconspicuous £1,833bn. This is because QT is calibrated in terms of the original purchase cost of the bonds that the Bank sells, and the bonds sold on Monday happened to be issues standing on very large discounts to their purchase prices (primarily because the accepted bids were largely for the longest of the Bank's holdings, UKT1.625 2071).

The QT amount done was the largest of any operation to date, and by selling long-dated Gilts at little more than a third of their cost, the Bank crystallised a loss of £1,163bn (also a record for a single operation).

Exhibit 1: Active Gilt sales by BoE, quarterly totals by bucket, £bn
Dark bar = value of operations; total bar = QT achieved by them, with the difference representing losses crystallised. Losses concentrated at long end.



Source: BofA Global Research, Bank of England

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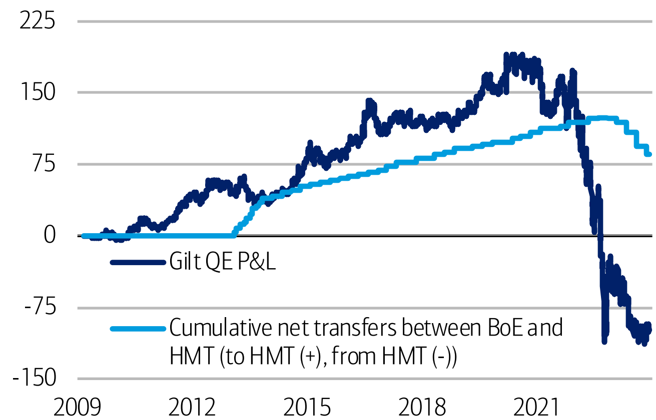
Exhibit 2: The £184bn hole in the Asset Purchase Facility
Comprising a cumulative P&L loss of £98bn to date, plus a net £86bn that has been paid away to the Treasury.



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QE losses. Not a consideration, but should they be?

Exhibit 1 shows the full history of the Banks' active sales by quarter, breaking down the QT achieved into the market value of Gilts sold in the operations and the losses crystallised in the process. Assuming the final operation of the current quarter (for the medium 7-20y "bucket" next Monday) has an outturn in line with the average of the past three, then over five quarters of active Gilt sales to date, the Bank will have achieved £58.7bn QT selling Gilts with a value of £39.7bn, to realise a loss of £19.0bn.

As is probably intuitively obvious but as the chart makes clear, losses are heavily skewed to the long end. Over the full five quarters, £12.4bn of the £19.0bn loss was recorded in long bucket (20y+) operations.

Now as the Bank has made clear, these losses do not influence its decisions. That is as it should be, insofar as we would not want a reluctance to accept losses to interfere with either the goal of achieving the inflation target or the programme to reduce its balance sheet size. And, unlike other central banks, the BoE is in the fortunate position of enjoying an explicit indemnity against losses, with the Treasury taking the hit.

However, if, in the distant future, the Bank is thinking about deploying quantitative easing again, the P&L of its experience this time around will surely be a consideration in any cost/benefit analysis, both for it and for a government that might be asked to provide another indemnity.

We do think there are strong reasons for adjusting the buckets, selling fewer long Gilts and introducing sales of 1-3y Gilts. Our case up until now has been largely about Gilt market functioning, not the prospective P&L, although we will explain below why we think it should be a consideration. But more than those things, we see bigger picture macro benefits, which we will go on to discuss later.

The rise in term premia – a reason to adjust the distribution of Gilt sales?

We have argued for some time that we felt that the Bank should tilt its sales shorter for a number of reasons, and we had been expecting this change to be announced on 15 December after the completion of the current sales programme schedule and in advance of the new schedule beginning in January.

In a 20 September note, '[BoE preview: one more hike and done'](), we summarized our case as follows:

- The Bank has been selling Gilts with equal amounts in the same 3-7y, 7-20y and 20y+ buckets that it used to buy them. However, the passage of time and the Gilt market sell-off means that the weighted average maturity (WAM) of the Quantitative Easing (QE) portfolio has collapsed. It would therefore seem appropriate to scale sales in the different buckets accordingly.

- Although the Bank measures changes to the stock of QE in original purchase cost terms, sales are conducted in equal market value amounts in each bucket. The Bank is therefore doing far more QT at the long end, because it is selling those Gilts at less than half their cost.

- This means that the Bank is selling a disproportionately large share of longs. In particular, the market value of 1-3y APF Gilts, now exceeds the total value of 20y+ APF Gilts by a considerable amount.

We added in a 27 October BoE preview that the sell-off in Gilts made it harder for the Bank to argue that it was operating in the background. We were even hoping that the November Monetary Report would flag the case for such a change, in one of those nice box features the Bank does, after a subtle additional line was added to the Gilt market notice announcing the current quarter's Gilt sales calendar:

> *"The Bank will continue to monitor the impact of its gilt sales programme on market conditions, and reserves the right to amend its schedule, including the gilts to be sold and the size of its auctions, or any other aspect of its approach at its sole discretion.* ***As part of that, the Bank will continue to monitor whether the current approach of selling gilts evenly across short, medium and long maturity sectors in sales proceeds terms remains appropriate****."*

Market Notice, 21 September (addition bolded by us)

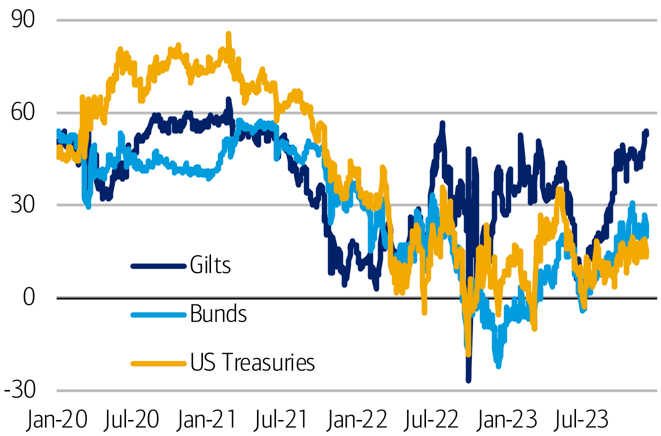
Not only did the November Report fail to hint at a future bucket change, but comments at the end of the BoE Monetary Report press conference (and subsequently) from Deputy Governor Dave Ramsden appeared to manage down expectations of change.

Although Ramsden's commitment to operational predictability and to completing the current schedule (ending next week) certainly didn't preclude the possibility that future schedules might be tweaked, especially in light of the addition to the Market Notice, the overarching message seemed to be that the sales programme was going well in its current form, and this was understandably taken by many as a steer that no changes were likely for the foreseeable future.

However, Ramsden did say that some of the rise in Gilt yields reflected a rise in term premia (although he didn't believe that the Bank's activities made a significant contribution to that rise). We would argue that whatever the cause of the rise in term premia, and a net issuance of Gilts from the DMO and Bank combined equivalent to 8%/GDP this year is surely a contributor, to the extent that Gilt yields now exceed "fair" rate expectations by a large term premia at the long end, that is money that can be saved by the Bank if it holds them to maturity (if those expectations are realized). The cause of the term premia doesn't matter; it's still a reason for the Bank to consider tilting its Gilt sales shorter.

Exhibit 3: 10s30s Gilts as steep now as in 2020, unlike others, bp

Other curves have flattened as bonds sold off. So did Gilts, but not for long.



Source: Bloomberg

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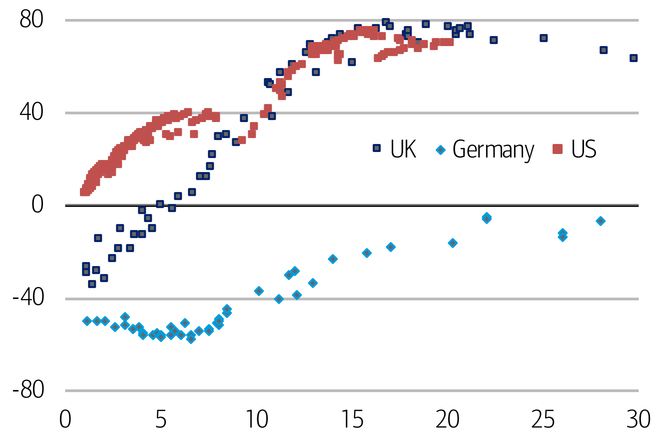
Exhibit 4: Z-spreads across the curve, bp

Gilts as cheap as Treasuries at the long end; more like Bunds at the front.



Source: Bloomberg

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The fact that the long end of the Gilt market is struggling is plain to see. The current 30y spread to Germany has only been exceeded in recent times during the LDI crisis (which prompted the BoE to *buy* Gilts). And the usual pattern in such a profound sell-off, whereby 10s30s ultimately flattens as yields approach perceived neutral, is a feature of other markets but can no longer be said of Gilts. And although short-dated Gilts have cheapened materially versus Sonia, Exhibit 4 still shows a picture of long Gilts trading like Treasuries versus the risk-free rate, while short-dated Gilts trade more like Bunds. Yes, official involvement in the repo market is normalizing, but normalizing isn't yet normal. There shouldn't need to be continuous daily lending of official Gilt holdings. The message seems clear – combined supply from the DMO and boE is skewed too long on the curve given the sheer scale of issuance and diminished appetite from the historically important life and pensions sector.

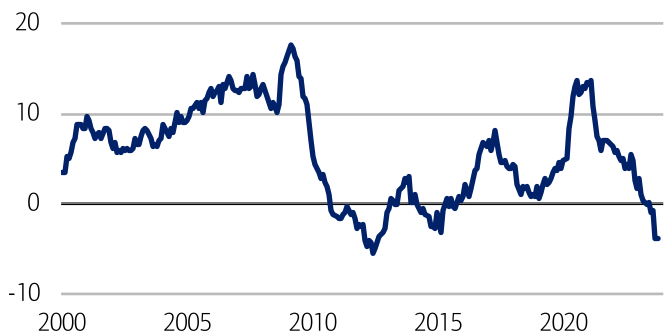
The liquidity path, money supply, credit growth – a lesson from the 80s

The money supply seems to attract less interest these days. When M4 growth fell into negative territory in August, old-school 80s monetarists saw this as a harbinger of recession, and as Exhibit 5 shows, it has fallen further since, to -3.8% yoy in October. To a large extent, this is a mechanical response to quantitative tightening, but this doesn't necessarily make it any less alarming to those who care about such things.

More concerning to us is the trend weakness in bank lending to companies (Exhibit 6). Disintermediation may be a factor in the decline in the real volume of lending to large companies but is unlikely to be an influence for SMEs. And this is not just about whether quantitative tightening might aggravate the issue, we must contemplate how the system will cope with the run-off of the Term Funding Scheme for Small and Medium Sized Enterprises (TFSME), probably in conjunction with continuing APF shrinkage.

This recalls an earlier incarnation of quantitative tightening, although we called it "overfunding" then. At the end of the 70s and into the 80s, the UK was in thrall to monetarism. And the UK's particular flavour of monetarism involved attempting to rein in excess broad money growth by selling large amounts of Gilts over and above what was necessary to finance redemptions and the budget deficit. There was an extra complication that is salient now – these extra Gilts had to be bought by the non-bank private sector; any sold to the banking sector did not help restrain money growth.

Exhibit 5: M4 growth plunges into negative territory, %yoy
A mechanical function of QT or something more worrying?



Source: Bloomberg

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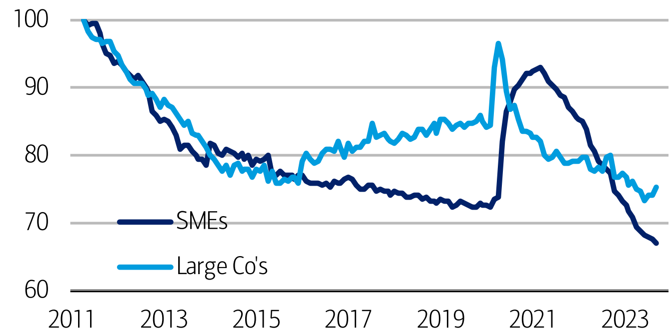
Exhibit 6: Bank lending to SMEs and large co's, deflated by CPI, rebased
Is this supply- or demand driven? Either way, it's disturbing.



Source: Bank of England, Refinitiv

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Why is that relevant now?

If a non-bank investor buys Gilts, it draws down a deposit with a bank and the bank draws down central bank reserves. Both sides of the banking sector balance sheet shrink, and broad money shrinks because the non-bank sector has shed deposits in exchange for Gilts. If, on the other hand, a bank buys the Gilts, the bank's balance sheet does not shrink – it loses one high quality liquid asset (reserves) and acquires another (Gilts) – and the money supply (the deposits of the non-bank sector) is unaffected.

We would say now that in order to both underpin the money supply and facilitate a smoother managing down of the BoE balance sheet, it would be greatly preferable if the latter path was taken, with much more of Gilts sold (by both the Bank and the DMO) being bought by the banking system.

Banks obviously prefer short-dated Gilts, and in an ideal world these short-dated Gilts would need to be cheap enough for Banks to consider replacing the so-called "structural hedges" (currently executed in Sonia term rates) with Gilts.

The Bank currently owns 0-3y Gilts with a market value of £172bn. It probably shouldn't sell sub-1y issues because it sets its QT programme for a year and that would complicate understanding of what is destined for passive and active QT over the period. However, its 1-3y holdings, at £127bn more or less match its 7-20y holdings (£132bn) and comfortably exceed its entire holdings beyond 20-years (£107bn). We strongly suggest that the Bank split its active sales programme four ways, adding a 1-3y bucket to its schedule, reducing the amounts sold in the existing buckets.

Finally, we should discuss the "portfolio effect". This was an often-mentioned benefit of QE, whereby (non-bank) selling of long Gilts to the Bank would encourage them to move out along the risk frontier into credit and other risk assets. However, we don't hear a lot about the threat of a negative portfolio effect. Heavier duration delivery by both the Bank and DMO combined risks the reverse – a crowding out of risk appetite. We think it is in the mutual interest of both (from a prospective loss and cost effectiveness viewpoint, respectively) and the private sector (supporting risk appetite) if Gilt supply is tilted shorter.

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