

Investment roadmap

DECEMBER 2024

AT A GLANCE

- The main article examines whether **UK retail investors may be distorting the gilt market**. Gilts are not subject to capital gains tax for individual investors. After the financial crisis, coupons on new gilt issues were very low, in line with market yields at the time. As market yields rose, making fixed income a more investible asset class, the tax advantages for higher rate UK taxpayers of investing in low coupon gilts became more apparent. Low coupon gilts deliver more of their return through (untaxed) capital appreciation. There appears to have been significant retail inflows into these low coupon issues – might these flows depress yields enough to start eroding the tax advantages? We note that retail investors still appear to account for only a small proportion of a very large market. Moreover, the more attractive these low-coupon issues are for retail investors, the less attractive they may be for investors in different tax regimes. ‘Fungible’ allocations across the gilt market allows different groups of investors to concentrate exposures in different parts of the market. Saranac’s more formal analysis suggests that the yield on low coupon gilts may be ~15% less than ‘fair value’, but this is still not sufficient to offset the tax advantages.
- **Global equity market** multiples have risen further on the broad market rally, and are elevated by historic standards: the MSCI world index has a PE of over 21x, compared with the longer-run average around 18x. Much of this valuation stretch is attributable to the US market. Markets outside the US tend to be on ratings in line with or even below historic norms. These lower ratings appear to reflect warranted differences in corporate earnings prospects rather than a clear misvaluation signal.
- A **significant divergence in economic growth has emerged between the US and Europe** in particular (but also Japan and China). US growth is holding up, and the ‘recession scare’ of a few weeks back in retrospect looks odd. This cyclical divergence is one factor which has driven the dollar higher, and lead to further US equity outperformance. Both these trends have, however, become strongly consensual. We are sceptical that Europe faces a fiscally related financial crisis, despite evident economic and political tensions.
- There is also a strong consensus that **the Fed has embarked on a sustained phase of monetary easing**, reflecting perceptions that US monetary policy is too tight. Whether significant rate cuts are delivered is, however, highly dependent on the direction of US policy next year. Inflation risks associated with employee repatriations, tariffs, expansionary fiscal policy and perhaps a more politically constrained Fed suggest the consensus may be too optimistic. The path to lower rates in Europe seems clearer.

- In commodity markets, **precious metals have corrected** following their material strength earlier in the year, as the US delivered an uncontentious election result. Other commodity prices have recently delivered flatter trends. We continue to view gold as an effective way of hedging global political risk, which remains extended.
- An important theme underlying Saranac multi-asset positioning has been the relatively low expected returns, by historic standards, of equities over fixed income. However, while **risk premia** remain low (in credit as well as equity markets) we do not regard the structure of market pricing as speculative.

Box 1: Returns from UK gilts

	Tax rate 45% Yield 4%		
	Gilt A	Gilt B	Gilt C
Coupon	4	0.125	1
Maturity	100	100	100
Issue price	100.0	96.3	97.1
Pre-tax expected return	4.0%	4.0%	4.0%
o/w income	4.0%	0.1%	1.0%
Capital gain on maturity	0.0%	3.9%	3.0%
Tax paid	1.8	0.06	0.45
Post-tax return	2.2%	3.9%	3.5%
Grossed-up yield	4.0%	7.2%	6.4%

UK gilts owned by retail investors have not been subject to capital gains tax (CGT) since the introduction of CGT in 1965.

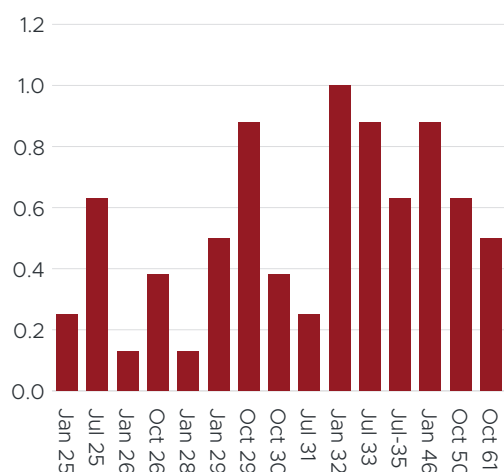
Are UK retail investors distorting the gilt market?

1. Low coupon gilts – background

UK gilts owned by retail investors have not been subject to capital gains tax (CGT) since the introduction of CGT in 1965. The original rationale, to support the broader gilt market, has remained intact. Even during the more intense scrutinisation of the CGT regime, and indeed of the UK tax system more generally in recent months, there has been no intimation that this exemption was likely to be lifted. Of course, this does not mean that change cannot come into play at some stage, but its status appears secure for now.

The value of this tax exemption has been enhanced in recent years, as an accidental by-product of the extended period of low interest rates after the global financial crisis of 2008, and the rebound in gilt yields in the past couple of years. The broad strategy of the UK’s debt management office over time has been to issue new gilts with coupons (the ‘fixed’ element in a gilt return) broadly in line with the prevailing market yield. As gilt yields fell close to zero, so did the coupons on newly issued debt. As the rise in gilt yields has made the asset class more investible for many investors, the CGT exemption has become more valuable – particularly to higher-rate taxpayers, but also to individuals in all tax-paying bands.

Consider the first simple example (gilt A) in box 1, in which a gilt with a one-year maturity is issued with a coupon of 4, and at an initial price of 100, delivering a pre-tax yield of 4%. Since the gilt will be redeemed at 100, there is no scope for a capital gain on issue, so the CGT exemption adds no value at this stage. Assuming that the gilt was bought on issue, the high tax-rate purchaser would pay income tax on the coupon, reducing the return from a gross 4% to a net 2.2%. Of course, the gilt price may fall during the year if market interest rates increase. A rise to 5% immediately on issue would lead to a price decline to 99, so an investor purchasing the gilt at that stage would capture a small capital gain. However, the total return of the gilt would still be dominated by the taxable coupon, even if the CGT exemption in this example has some value.

Chart 1: Low coupon gilts by maturity (%)

Source: Saranac, Bloomberg.

A benign legacy from the financial crisis was that a greater volume of low-coupon gilts was issued in its aftermath, facilitating the tax-efficient opportunity.

Compare this with gilt B, issued when interest rates were lower, has one year left to its maturity and which has a 0.125% coupon. The initial yield must be 4%, but in light of the low 0.125% coupon, most of its expected return must come as a capital gain. For a gilt maturing in a year at a price of 100 plus the 0.125% coupon, the issue price must be 96.3 ($100.125/96.3 = 4\%$ yield). When the gilt matures, there is no CGT to pay on the ~3.9% capital gain, and income tax only on the small 0.125% coupon. Hence, the post-tax return to the top-rate taxpayer is still close to 4%, almost double the after-tax return of the higher coupon-paying gilt. If other investments of the top-rate taxpayer do incur income tax, they would have to deliver a return in excess of 7.2% (gross of the 45% tax rate) before the return on the gilt began to be exceeded. The tax advantage diminishes the higher the coupon, but as gilt C in box 1 shows, even with a coupon of 1% the yield advantage is significant.¹

As noted above, there was scope for the preferential CGT treatment on gilts to be supportive for high-taxpaying investors even when initial coupons on gilts were systematically higher, particularly in periods of rising market rates. However, there was less scope for gilt prices to drop a long way below the ultimate redemption price, because a significant element of the total return was still coming from the coupons – particularly those issued in periods of higher market rates and coupons.

A benign legacy from the financial crisis was that a greater volume of low-coupon gilts was issued in its aftermath, facilitating the tax-efficient opportunity outlined above. As shown in chart 1, there are eleven gilt issues with coupons of 1% or less up to around the ten-year maturity, and four with longer, or much longer maturities, allowing investors flexibility in terms of implementing tax-advantageous investment strategies.

¹ Note that this is true for UK gilts, which have non-zero coupons, but not for zero-coupon UK Treasury Bills. For tax purposes, UK T-Bills are considered “deeply discounted securities” and therefore have different tax rules to UK gilts. This means that any gains from UK Treasury Bills are taxed as income, rather than capital gains. This differs to gilts, where capital gains are tax-free but coupons are taxed as income. Hence, the sweet spot lies in UK gilts, which have the lowest coupons possible, often between 0.125% and 0.5%.

Box 2: Comparing gilt duration

	Gilt A	Gilt B	Gilt C	Gilt D
Maturity	10 years	5 years	10 years	5 years
Coupon	4%	0.125%	0.125%	4%
Price change on 1% rise in yields	-8.1%	-5.0%	-9.9%	-4.4%

There are two broad rationales for taxpayers investing in low coupon gilts. The first is as a way to enhance cash returns or to support low-risk investment strategies. However, this approach is most suited only to relatively short-maturity gilts. As the duration of a gilt increases so does the price sensitivity to interest-rate changes: when interest rates change by a given amount, the price change is more significant for longer duration issues, as shown in box 2. In addition, the lower the coupon associated with the gilt, the higher the price change for a given maturity when interest rates do change. It may be that even for some tax-paying investors, gilts paying higher coupons, which are taxable but also limit price volatility and the scope for capital losses for the same maturity, may be more appropriate. More generally, for those not in a position to tolerate significant capital losses on the journey to maturity, even if full recovery will occur on the gilt’s eventual redemption, the strategy may be limited to shorter-maturity low coupon issues. Such an approach could also involve including some higher-coupon gilts in the portfolio, to provide income and to dampen the scope for capital losses.

The second rationale for buying low-coupon gilts is for those investors wishing to implement a directional view on the gilts market. If there is a high-level conviction that a significant rise in gilt prices is coming, the largest tax-efficient ‘bang for the buck’ may come in the very long-maturity low-coupon issues.

2. Is this tax exemption distorting the gilt market?

This may seem too good to be true. The potential gains for taxpayers who purchase low-coupon gilts can be significant, with only a limited but transparent increase in risk. Is this really a ‘free lunch’, or can a closer examination of the issue identify costs which dilute – or at worst eliminate – the potential benefits?

One issue is possible scarcity value. Unless gilt yields collapse back to their low levels of a few years ago, or the debt management office issues gilts with coupons significantly lower than market yields (both unlikely), the tax-efficient low-coupon gilts will disappear over time. Indeed, four will go

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over the next couple of years, even if the remainder have much longer maturities. At the same time, it has become easier for retail investors to access individual gilts directly through the large retail platforms, whose capabilities have recently been expanded to include individual participation in new debt auctions. There are no transparent data on these flows in aggregate, or which gilts retail investors are buying, but some firms have reported a 2-3x increase in the volume of retail activity in gilts compared with a couple of years ago.

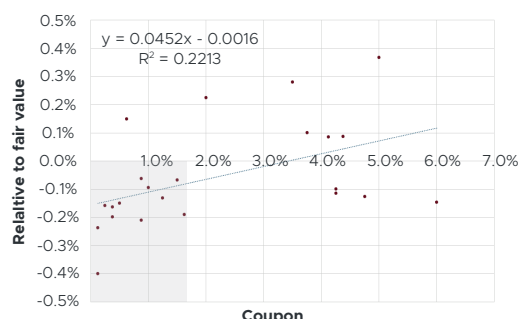
However, it is important to bear in mind how negligible direct retail participation in the gilts market was to begin with – and it appears still to be very small, even if it has increased recently. The gilts market is dominated by overseas investors, financial institutions and pension funds, all of them facing different tax regimes. Moreover, the gilts market is very large. Gilts up to 10 years to maturity with coupons of less than 1% have a market value of some £330bn, and so can absorb what in comparison seems to be only a modest step-up in retail interest.

In addition, the very diversity of tax regimes among investors in the gilt market limits the scope for substantial market movements. For example, if in the unlikely event of very material retail inflows into a particular tax-attractive gilt issue did depress the yield, other investors from different regimes would be likely to sell that issue and reinvest in nearby issues with similar investment characteristics, but with higher coupons. This would limit the scope for yield divergence. More generally, if high-rate UK taxpayers do avoid certain issues because of their high coupons, this potentially makes these issues more attractive for investors facing different tax structures.

Finally, the focus on gilts alone understates the tax-efficient UK bonds available to higher tax-paying investors. Some corporate bonds (QCBs) are not liable to capital gains tax either, and while this market is smaller and less liquid than the gilt markets, and also requires corporate credit risk to be managed, it nevertheless represents a further potential investment for higher-rate taxpayers.

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Chart 2: Yield relative to fair value and coupon level



Source: Bloomberg, Saranac.

These are all good principled reasons to believe that there is still considerable scope for the UK gilt market to absorb even a significant increase in tax-efficient gilt investing. The empirical evidence also bears this out. Even just a simple ‘eyeballing’ of the data suggests that the yields on high and low coupon gilts do not diverge by nearly enough to eliminate the potential tax advantage, although close examination of the relative attraction of different issues is required to maximise a tax-efficient strategy.

However, we thought it worth exploring the data somewhat more robustly, to identify whether the free lunch was absolutely free. To do this, we first estimated the yield curve for conventional gilts out to ten years as a measure of ‘fair value’, and calculated the difference between the annualised yield on each gilt and its yield on the estimated curve.

Interestingly, these deviations do seem to be related to different coupon levels. A disproportionate number of the gilts which trade below ‘fair value’ have low coupons, with higher coupon gilts more likely to have higher yields, although the relationship is not perfect. This would be consistent with some tax-driven effect on yields. However, the impact is small – low coupon gilts are estimated to trade on a yield discount on average of about 0.15% compared with the estimate of fair value (chart 2). If this is to some extent tax-driven, it would suggest that there may be some yield cost to investing in low-coupon gilts – the lunch is perhaps not quite free. However, this is very small in a broader context, and not nearly enough to eliminate the much more significant tax advantage. Importantly, Saranac has the models in place to detect if a more significant market impact were to emerge over time.

Public markets

EQUITIES



Public markets

GOVERNMENT BONDS



- Asset class outlook +

Short maturity



Long maturity



Positive

US 5Y TIPS, US Agency MBS, Australian Sovereign and Agency bonds across tenors

Negative

>5 year European sovereign bonds, Japanese government bonds

Market background

In November, the German Bund market outperformed, as deteriorating Eurozone macro data and France's budget issues led to a flight-to-quality. The UK Gilt market experienced a relief rally after sharply selling-off at the back-end of October, following the 1st Labour budget. The Australian sovereign curve bull flattened, benefiting our AUD duration positioning. Finally, US Treasuries lagged amidst the Trump win and resilient US economic data. That said, US Treasuries retraced earlier losses as the appointment of Scott Bessent as Treasury Secretary was saluted by the market.

Targeted exposure

We think some of the Trump policies create upside inflation risk. Hence, following a pull-back in inflation break-evens, we added to the TIPS allocation. We maintain significant exposures to MBS, as we believe the asset class will be supported by (i) its stable convexity profile (ii) the phasing-out of the Federal Reserve Quantitative Tightening program in 1H25 and (iii) increased US bank demand, as the regulation designed to increase bank capital requirements gets shelved by the Trump administration. Finally, at a time where fiscal angst is on the rise in the US, the UK and continental Europe (France), we believe the Australian SSA market offers attractive return prospects, with elevated yields, a slowing economy and a healthy fiscal position (limited public deficit, debt to GDP <40%). Conversely, we believe last month's UK budget increases fiscal risks in the UK and will slow down the pace of BoE rate cuts. As such, we favour a short-to-intermediate GBP duration stance.

Public markets

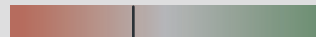
CORPORATE AND EMERGING MARKET DEBT



Investment grade credit



High yield



SUB



EM debt



Positive

AAA/A securitisation

Negative

Long-dated US High Yield, Emerging High Yield Sovereign

Market background

November was characterised by (i) resilience across IG markets (ii) a material outperformance of US vs European HY and (iii) the underperformance of European AT1s, with (ii) and (iii) fuelled by rising nervousness regarding the French political situation and the prospects of US tariffs. \$IG spreads tightened by 4bp down to 74bp, at levels unseen since 2005. \$HY spreads tightened by 13bp to end at 299bp, making a new post-GFC record low. IG yields declined across the board as lower sovereign yields compounded with tighter IG spreads, fuelling positive returns across IG credit markets. £IG (+1.75%) and €IG (+1.64%) outperformed \$IG (+1.18%). This relative performance was mainly driven by duration dynamics in the respective sovereign bond markets. In HY markets, there was a notable outperformance of \$HY spreads (-13bp) compared with European HY, with €HY (+24bp) and £HY (+22bp) both widening. The 3 markets delivered positive returns as the European HY spread widening was offset by sovereign yield declines and the carry.

Targeted exposure

We now think credit spreads offer little room for further spread compression, in particular in USD markets. Still, we expect demand for credit to remain extremely robust in 20225, supported by attractive corporate yields, wide open primary markets enabling refinancing operations and low credit defaults. Geographically, Europe continues to offer attractive relative value compared with \$ credit, but we note some weakness over the past month in the French banking sector. Overall, we think rates risk is now better priced than credit risk and we have therefore been switching some investment grade corporate positions to duration positions such as US Agency MBS. In High Yield, we prefer to harvest elevated yields at the front-end of the curve (1-3Y) in order to limit sensitivity to a potential widening in credit spreads. Combining floating coupons and attractive spreads, we think securitised credit offers an attractive relative value proposition compared with traditional credit.

Public markets

HEDGE FUNDS



Global Equity Fundamental long/short Funds had a strong November driven primarily by beta gains as US stocks rallied post elections. Those managers with a sector focus towards the technology arena finished up over 600bps in the month recording their best monthly performance since May 2023 (source: Goldman Sachs Prime Services). Gross trading activity saw the largest notional increase since September 2022, led by single stocks as long buying and short selling flows were both elevated. Overall, the reported book gross leverage (GS Prime) ticked up as net leverage saw relatively modest changes. US L/S gross leverage rose sharply in November, whilst Europe and Asia L/S gross leverage ratios both saw a continuation of declines.

Regional positioning-wise, managers bought the dip in European stocks and sharply unwound risk in Chinese equities post US elections. Chinese equities saw the largest de-grossing activity on record (as per Goldman Sachs Prime, since 2016), driven by short covers and to a lesser extent long sales. In the US, managers have broadly rotated into Consumer Discretionary, and net sold both TMT and Defensives at the fastest pace in four months. Financials saw the largest increase in gross trading flow as managers net bought the sector in the first half of November.

Public markets

CURRENCIES

Dollar

Euro

Sterling

Yen

Market background

The broad dollar index built on its October momentum last month and rallied to 2-year highs following the US election. Trump’s convincing win has been interpreted as dollar-bullish, principally due to his pro-growth and likely inflationary agenda, while the threat of tariffs is also seen to present USD upside risks. The bounce in the dollar has coincided with not just the election result but a meaningful divergence in global macroeconomic data: the US has generally remained robust, at a time when Europe, the UK and Japan have all delivered weaker macro prints. This economic outperformance of the US versus peers has reinforced the narrative of US exceptionalism that has been fueling the ~6% USD rally over the last two months.

Targeted exposure

Recent FX positioning data reflects the generally consensus view that the dollar offers more upside from current levels, with aggregate FX options positioning showing the market long the USD but short the EUR, GBP and BRL in particular. European political risk has dented EUR sentiment further and for clients looking to accumulate euros, elevated FX volatility presents opportunities to position to be buyers on any further weakness while picking up attractive yields.

COMMODITIES

Gold

Industrial metals

Energy

Softs

Market background

The dominance of gold and silver as sources of return in the commodities universe has unwound in recent weeks. We attribute this to profit-taking after the US election result, and possibly to allocations to bitcoin. In aggregate, industrial metals prices have remained within their ranges of the past few months, and agricultural prices have been trendless. The oil price has stabilised following its weakness over the summer months.

Targeted exposure

Support for the gold price is likely to be sustained, given high global political tensions and the potential for additional central bank purchases. Industrial metals prices require a stronger phase for the global economy to make significant progress, and such strength is not at present visible. Energy prices may remain weak while the potential for a large increase in supply after the US election remains significant.

Private markets

Global distressed credit update

As we head towards year-end, we use the final publication of the year to reflect on a theme we had written about at the start of the year – distressed exchanges.

Over the past year, we have seen an increase in the number of liability management exercises taking place across the market, as higher rates and political and economic uncertainty has adversely affected the viability of many privately held companies.

Using Pitchbook's Dual-track US loan default rate, which accounts for traditional defaults and distressed exchange transactions, the rate has increased to 4.4% in October, up from 3.8% that in December 2023. This increase has occurred while the default tracker that excludes distressed exchange transactions has fallen to 1.3% from 2% during the same period, highlighting how the increased use of liability management exercises has masked the traditional default rate picture for investors.

What is still more concerning about this increase of distressed exchange transactions is that when we review the historical data, we see that a significant share of companies has returned with a full-blown payment or bankruptcy default within three-years, highlighting that these restructurings, while they work for a significant portion, do not solve the issues for all companies.

This becomes even more concerning when we combine this statistic with the increased use of PIK (payment-in-kind) restructurings that we have seen take place this year. The dynamics we have seen unfold this year would suggest to us that a significant portion of private credit and private equity participants has chosen to defer portfolio issues rather recognise potential losses now.

Therefore, we continue to remain cautious of traditional, sponsor-led private credit opportunities, and instead tilt towards distressed/opportunistic credit.

Private markets

ALTERNATIVE SOURCES OF RETURN

Secondaries



Undercapitalisation of the secondary market has created a structural imbalance between supply and demand, creating an attractive environment for long-term allocation to secondaries

Special situations



Favourable market environment given the likely stress corporates will face in a higher rate environment

Venture capital



Early-stage venture has benefited from the correction in late-stage valuations, providing an opportune time to invest in long-term productivity gains, labour replacement and other venture investment qualities

Infrastructure



Attractive, long-term asset class given supply chain issues, regulatory initiatives and geopolitical uncertainty are driving demand for new / the development of infrastructure higher

Real estate



As cap rates have expanded and lending has tightened, we see opportunities to acquire high-quality assets at attractive entry prices

GP stakes and financing



Opportunity for higher yield and greater structural protection as a result of limited GP liquidity

Real assets



At risk from weak growth environment

Private debt



A negative economic outlook with the potential for above-trend default rates and extension risk make private direct lending unattractive on a risk-adjusted basis

Leveraged buyouts



Softened valuations, reduced debt levels, and increasing focus on corporate carve-out opportunities has created a window for investors to deploy into operationally focused private equity strategies

Mid-market growth



A prolonged period of weak/negative earnings growth as a result of a weak economic environment and increased cost of capital will see valuations struggle in the short term

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Strategy. Planning, governance and oversight



Financing. Access to diverse sources of capital



Investments. Allocation and deployment of capital



Corporate advisory. Supporting corporates and business owners

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