National Institute of Economic and Social Research

# NIESR Quarterly Term Premium Tracker

## UK Term Premium Drops to Four Month Low Over Summer

Tracker Number 2

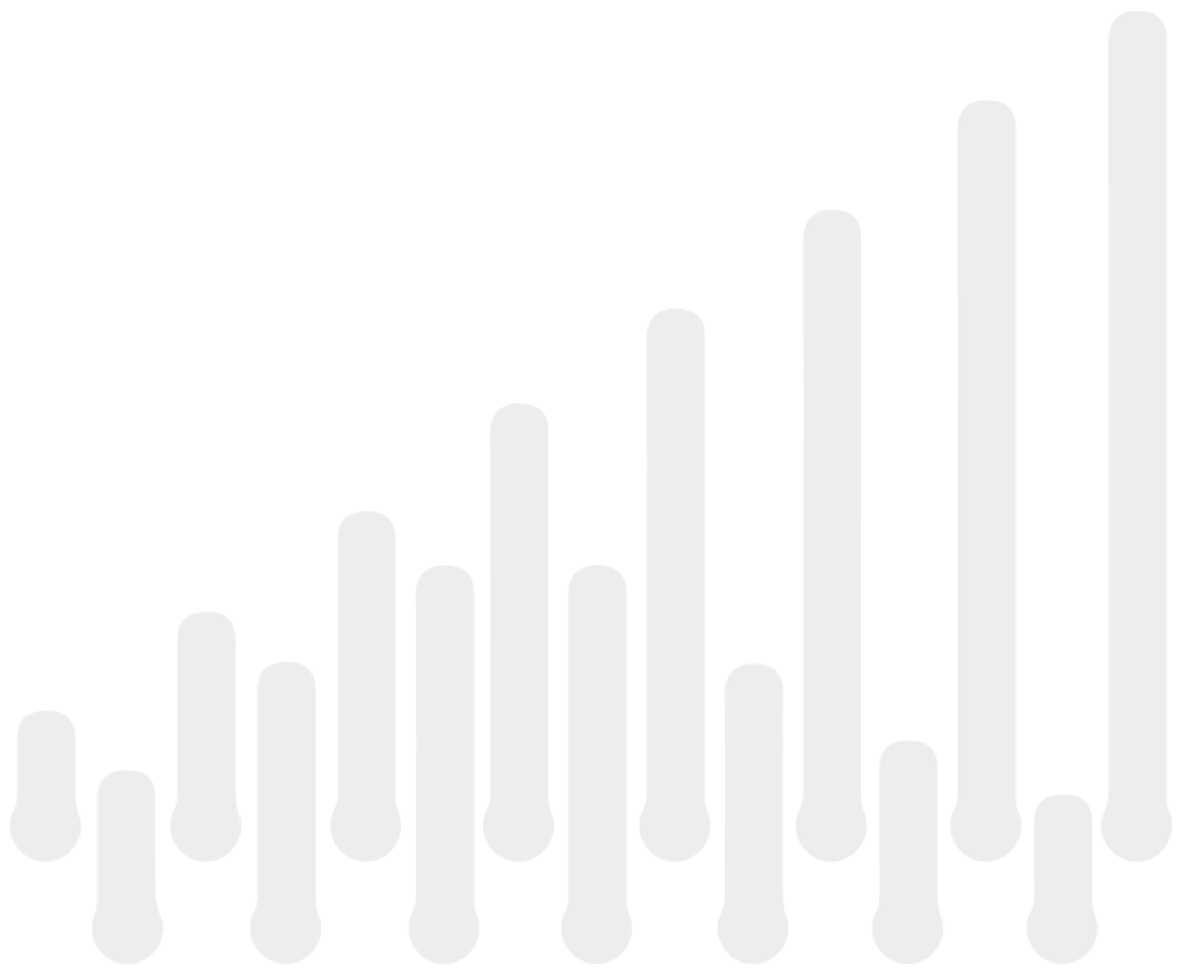
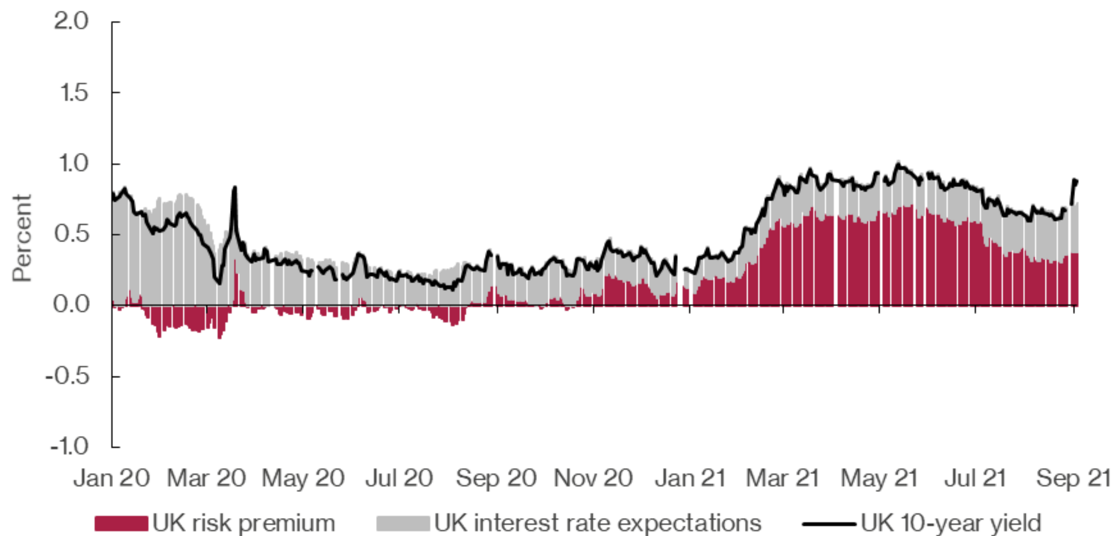


**Figure 1 –** UK 10-year government bond yield and decomposition (percent)




Source: Authors' calculations based on data by Bank of England

## Main Points:

- We decompose long-term treasury yields into two components: expectations of the future path of short-term bond yields and a term premium. The term (or risk) premium is the compensation investors require for bearing the risk that short-term bond yields will not evolve as expected.

- In July 10-year treasury yields fell to 0.7 per cent, the lowest in almost four months and the second largest monthly decline since the start of the pandemic. This has been mainly driven by a drop in the term premium. In contrast, short-term interest rate expectations remained broadly stable, and they have increased in September (figure 1).

- US government bond rates fell by more, driven by the term premium at the 10-year maturity, which now stands at -0.3 per cent, down from 0.3 at the end of May. Interest rate expectations have increased to average 1.6 per cent over the next year and a half. German 10-year Bund yields dropped to -0.3 percent from over 0 percent in May, with euro are interest rate expectations and term premia remaining largely negative.

- The Federal Reserve's tone during its latest meeting on 25 July and in its minutes showed the FOMC is moving towards tapering. In his speech to the 'Jackson Hole Economic Policy Symposium' at the end of last month, Fed's Chair Powell downplayed the possibility of additional sustained inflation, focusing instead on the need for job creation to hit the Fed's target of "maximum employment". He said tapering the Fed's bond purchases would likely begin in 2021.

- According to the most recent US payroll data, job growth slowed significantly in August as the Delta variant curbed services demand and labour supply. In the light of this, market expectations have increased that during its upcoming meeting, on 22

September, the Fed could delay starting to taper by a few months. The Bank of England is likely to follow this lead, as the ONS confirmed in July that the UK labour market remains about 200.000 jobs below pre-pandemic levels.

- For the moment, the central banks significant presence in the bond market is likely to keep yields subdued.
- The adjustment in the UK risk premium is consistent with our latest GDP growth forecast of 4.8 per cent q/q in the second quarter of 2021. The risk premium decreased from 0.6 per cent at the end of May to 0.37 per cent in September. Interest rate expectations, capturing markets expectations of rates over the longer horizon, remained broadly stable at 0.35 per cent.
- While consumer confidence is not expected to plummet, UK households continued to build up savings during the summer, implying that the spike in Covid-19 cases because of the Delta variant hurt private spending.
- The consumer price index will be released by mid-September. If data continues to be strong, treasury rates may rise again possibly driven by movements in the risk premium.

*"Extreme yield movements are likely to be limited for now. The idea that a robust economic recovery, underpinned by monetary easing, would boost inflation – and inevitably force a tightening – remains a possibility, particularly as inflation is projected to overshoot the BoE inflation target earlier than expected. Nevertheless, the central bank is now rather engaged in a balancing act with softer-than-expected labour market data and worries about Covid-19 variants representing downsize risks."*

**Dr Corrado Macchiarelli**
**Research Manager for Global Macroeconomics**

In July, rates on 10-year UK gilts fell to their lowest levels since the peak in May, while yields on US Treasuries fell to their lowest levels since February. This is in sharp contrast to the large increase witnessed during the first quarter of this year, when inflation fears were the main drivers of a fixed-income sell-off.

According to data from the Bank of England, inflation risk premia have been one of the main drivers of the term premium in the UK. Since the successful vaccine rollout at the start of the year, the economic outlook has improved; inflationary pressures have since moderated particularly in July 2021. The inflation environment is consistent with the observed risk premium in the UK. Headline consumer inflation decreased by a large margin, to 2 per cent in July from 2.5 per cent in June 2021. Base effects had a significant negative effect in July and will continue to add volatility to the headline inflation number in the near future.

Based on NIESR calculations, inflation is nevertheless expected to rise in the second half of the year due to transitory factors, such as shortages in intermediate inputs and ongoing disruption in supply chains. Labour shortages and the associated increase in wages could also feed through headline inflation figures. Furthermore, the planned increase in the OFGEM home energy price-cap in November 2021, along with the reversal of the 2020 VAT reduction in October 2021 and April 2022, are expected to further boost consumer prices. The Bank of England expects inflation at year-end to be 4% y/y. Nevertheless, NIESR sees a great deal of this pick up to be temporary and expects headline CPI inflation to be back down to 2.4 per cent in the year to July 2022, slightly exceeding the Bank of England's 2 per cent target. If not fully anticipated by markets, these developments might increase the scope for a rise UK risk premium, pushing up nominal yields.

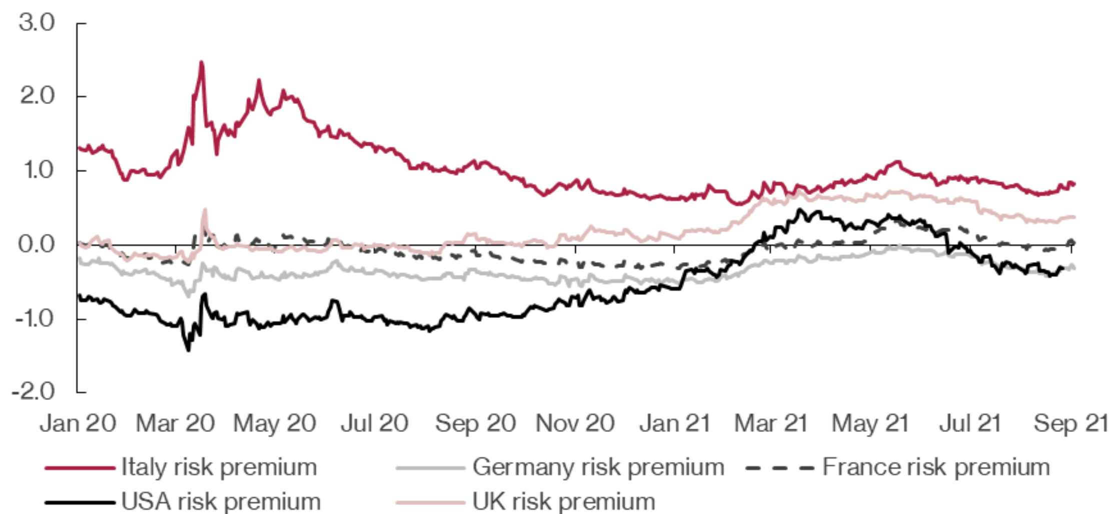
For now, reflation trade, on the one hand, and softer than expected ONS economic data on labour market activity, on the other, suggest that the inflation outlook remains uncertain, and the Bank of England's somewhat divided Monetary Policy Committee is waiting for more evidence before deciding on its next move. Fears of inflation have not completely warned UK investors off this year; yet those who had "short" gilt holdings have been compelled to liquidate their positions, sending yields down further over the second half of the summer.

Given the global integration of financial markets, a significant share of the movements observed at the longer end of the yield curve reflect changes in international risk and uncertainty, as well as monetary policy developments abroad. The co-movements in the UK and the US are particularly suggestive of spill-overs from the US (figure 2).

Prices on U.S. 10-year Treasuries have shot up, pushing yields just below 1.3%. Until May 2021, the observed increase in risk premia was due to both growth concerns related to the Covid-19 Delta variant as well the possibility of an early Fed tapering due to an unexpected surge in inflation. Later in the summer, the market rebounded as the Delta variant slowed the economy and, more crucially, inflation fears calmed, and the Fed detailed a taper plan that was seen as

more dovish. Federal Reserve Chairman Powell hinted at a possible reduction of the Fed's monthly asset purchases this year but stressed it wouldn't be a prelude to a rate hike. He also emphasised the Fed's openness to allowing inflation to overshoot 2% for a while. The 10-year inflation break-even rate has been relatively stable in recent months at 2.35 percent, which, allowing for the gap between the CPI (to which Treasuries are linked) and the deflator of consumers' expenditure, is consistent with Fed targets. Short term interest rate expectations rose at the end of June and remained broadly steady since (figure 3).

**Figure 2 –** 10-year term premium estimates across countries (percentage points)

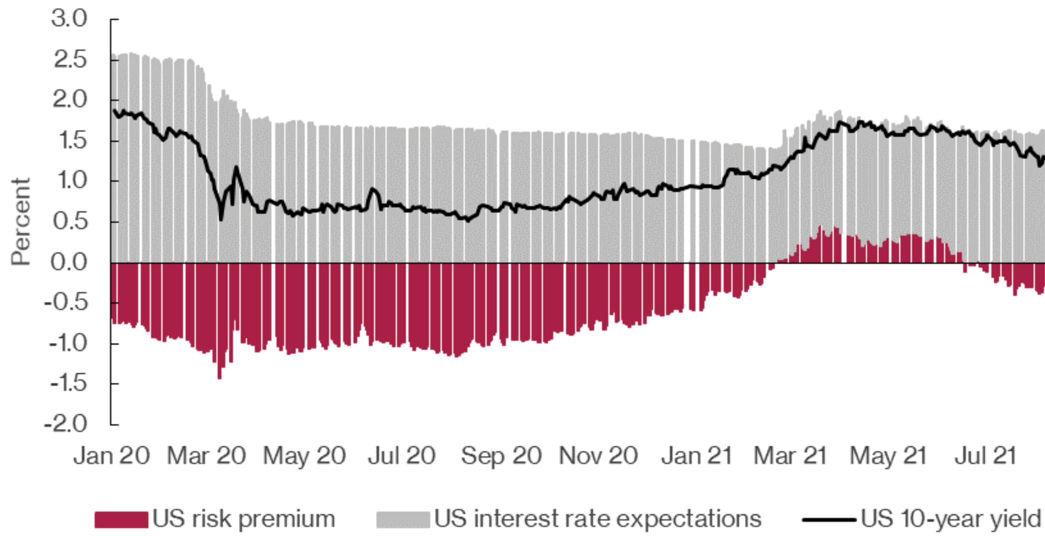



Source: Authors' calculations based on data by Bank of England

Looking at international movements in risk premia for countries such as Germany, Italy and France, suggests that risk premia have receded in European countries as well, but not quite as much as in the UK or the US. This is possibly due by a surprise inflation surge to 3% in August 2021, a 10-year-high for the euro area, up from 2.2% in July. Due to an increase in vaccinations across Europe, the latest wave of the Covid-19 Delta variant was not as bad for the region as it could have been. This summer's economic recovery has continued, and profit reports have been generally positive, countering fears of a new wave of infections and uncertainties about the region's future trajectory. However, vaccination rates remain highly heterogeneous across the euro area. The monetary policy stance remains generally more accommodative than in the US, even though pressure is mounting for the ECB to slow its asset purchase programme. For the Euro area, the average bond interest rate remains negative, with several euro area bonds (Austria, Germany, Ireland, and to a lesser extent, France, Finland and Belgium) trading with mostly negative yields up until recently.

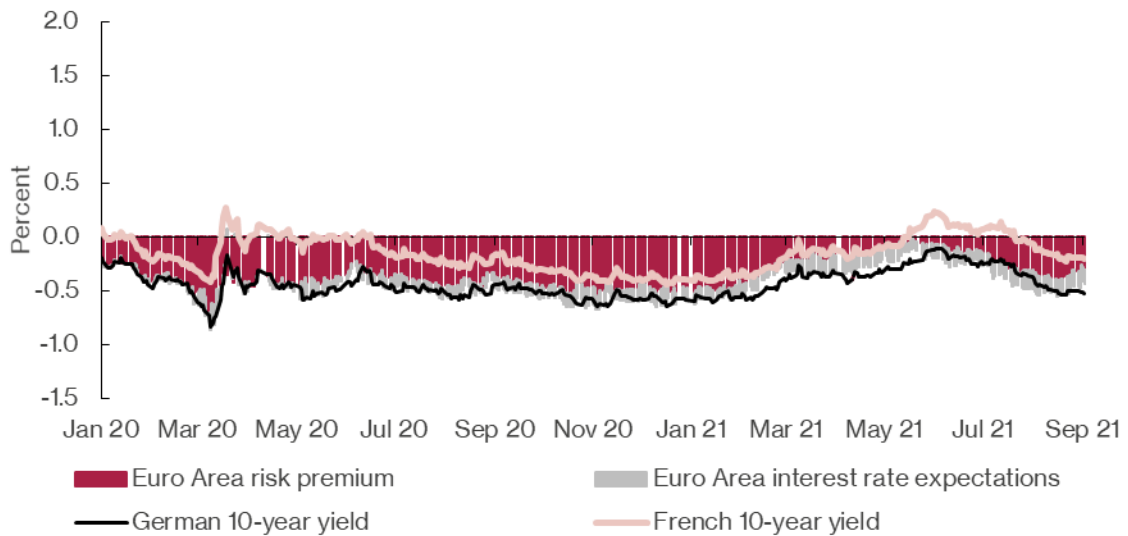
Long-run expectations of euro area interest rate remain negative as well (figure 4) owing to both the negative ECB policy rate since 2014 and the model employed for generating future expected short-term rates based on average short-rate predictions. Our approach makes no assumptions on the structural macro-financial relations in the economy, thus not imposing any long-run equilibrium conditions for either employment or inflation. Some structural long-term drivers of the "lower for longer" interest rate scenario still apply (see also Macchiarelli, 2020; 2021).

**Figure 3 –** US 10-year government bond and decomposition (percent)




Source: Authors' calculations based on data by FRED database at the Federal Reserve Bank of St. Louis

**Figure 4 –** Euro Area 10-year government bond and decomposition (percent)




Source: Authors' calculations based on data by Datastream

## Background

The model we employ enables the decomposition of long-term treasury yields into two components: expectations of the future path of short-term treasury yields, and a term premium. These are, respectively, the average current and expected future short-term interest rates, and the compensation investors require for bearing the risk that short-term Treasury yields will not evolve as expected.

National Institute Term Premium Tracker aims to provide quarterly updates of the bond term premia estimates for the UK, the US and some selected European countries based on current daily zero-coupon bond yields data. The bond term premia estimates at the 10-year maturity and the expected average short-term rates for the same maturity are based on daily data from 1961 to Sept 3rd, 2021. The analysis is based on a five-factor, no-arbitrage term structure model, described in detail in the references below (see Adrian et al., 2013; 2014). The estimates we obtain for the US are consistent with those produced by the Federal Reserve Bank of New York.

## Data

Daily nominal bond yields for the UK are obtained from the Bank of England https://www.bankofengland.co.uk/statistics/yield-curves

Benchmark bond redemption yields for European countries and the US are obtained from Datastream. Nominal bond yields for the US are obtained from FRED-Federal Reserve Bank of St. Louis Database https://fred.stlouisfed.org/series/DGS10

## References

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Adrian Tobias, Richard K. Crump, and Emanuel Moench (2013), Pricing the Term Structure with Linear Regressions, *Journal of Financial Economics* 110, no. 1 October: 110-38

### Notes for Editors

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