National Institute of Economic and Social Research

NIESR Quarterly Term Premium Tracker

Will UK Markets See Turbulence Once the Bank Rate Peaks?

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"UK 10-year gilt yields have fluctuated around 3.6 per cent in the first months of 2023, driven by short-term interest rate expectations. With the exception of a short spell of a rising term premium from 22 December to 10 January, possibly brought on by the statistical release of the November 2022 public sector finances, UK investors seem broadly confident in the path of UK short-term interest rates. That said, the questions of how long the MPC should maintain the Bank Rate at its peak level and the pace at which to loosen remain contested. If the MPC does not provide clear communication surrounding these issues, we wonder if we will see uncertainty return to markets once investors believe the Bank Rate has peaked."

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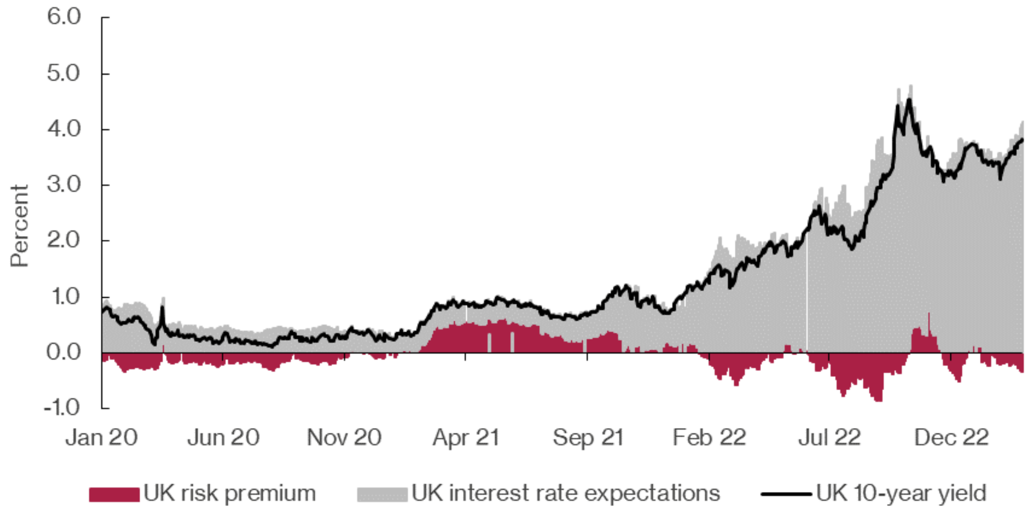
Associate Economist

Figure 1 – UK 10-year government bond yield and decomposition by average current and expected future short-term interest rates and risk premium (per cent)



Source: Authors' calculations based on Bank of England data

Main Points:

- The 10-year UK government bond (gilt) yield was on an upwards trend over the course of 2022 as a result of the Bank of England's aggressive monetary policy tightening cycle. In the first quarter of 2023, the 10-year gilt yield has fluctuated around 3.6 per cent, driven by short-term interest rate expectations.

- Overall, the UK term premium signals that investors are feeling certain about the path of short-term interest rates. In our Winter UK Economic Outlook, we noted that while there is little uncertainty surrounding the current monetary tightening cycle, the questions of how long the MPC should maintain the Bank Rate at its peak level and, once there, the pace at which to loosen remain contested. If the MPC does not provide clear communication surrounding these issues, we may well see uncertainty return to markets once investors believe the Bank Rate has peaked.

- In February, policymakers at the Federal Reserve (Fed) opted for a policy rate hike of 25 basis points, while the MPC and European Central Bank hiked by 50 basis points. All three central banks hinted at further interest rate rises over the coming months given that inflationary pressures remain persistent.

- Despite the ECB broadly tightening monetary policy in concert with the Bank and the Fed, in contrast to those central banks it is facing an increasingly fragmented environment, resulting both from high inflation and term premia dispersion among Euro Area countries. In bond markets, Italy and Greece continue to decouple from trend, with our latest term premia estimates around 1.20 percentage points higher than the Euro Area average. While this pales in comparison to post-Financial Crisis fragmentation, it still presents an important risk to financial stability and the transmission of monetary policy in the Euro Area.

UK Term Premium

Since our last term premium tracker published in December, the 10-year UK government bond yield has fluctuated around 3.6 per cent. In this Tracker, we decompose long-term bond yields into two components: expectations of the future path of short-term interest rates 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.

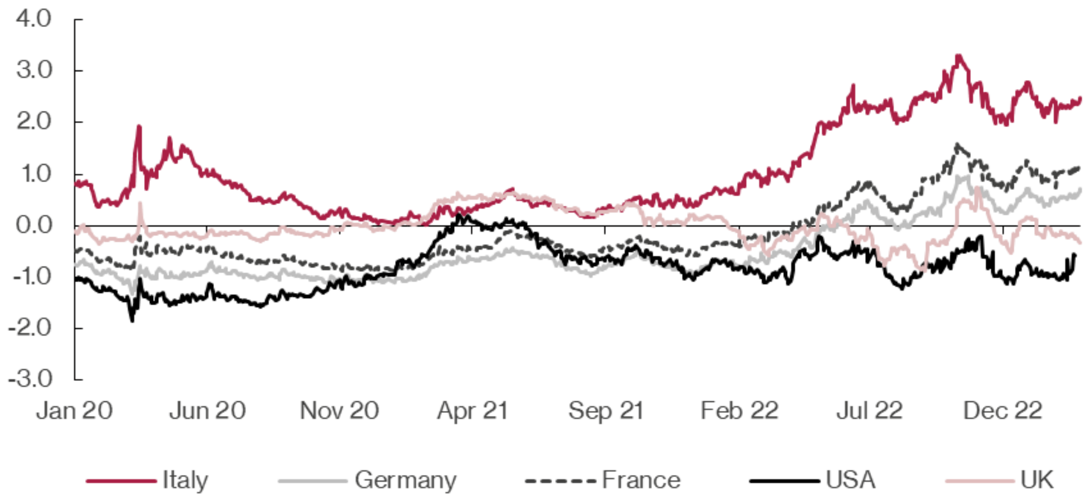
Increasing bond yields in the UK in the past year have been driven by short-term interest rate expectations. The Bank of England's MPC meeting on 2 February acknowledged that though CPI inflation may well have peaked in the UK, domestic inflationary pressures remain elevated. Indeed, our latest inflation tracker highlighted that though headline CPI inflation decreased to 10.1 per cent in January, NIESR's measure of underlying inflation remained at a series high of 9 per cent for a third consecutive month, possibly signalling that we have yet to see a turning point in core inflation. The MPC opted for a 50 basis point hike in the same meeting, bringing the policy rate to 4 per cent. Interestingly, our yield curve decomposition suggests that the MPC meeting did not much alter the path of short-term interest rate expectations; however, these expectations may have been jolted upwards following MPC member Catherine Mann's 23 February speech in which she made a case for further tightening 'sooner rather than later'. Further, the continuation of the Bank's quantitative tightening programme without further market turbulence has likely contributed to consolidating expectations around a general upwards trend in 10-year gilt yields.

At the same time, the corresponding term premium on UK 10-year government bond yields has not moved much in the first quarter of 2023, other than a short spell of increased uncertainty from 21 December-10 January. This period followed the 21 December statistical release of the November 2022 public sector finances, which showed the highest November borrowing since comparable records began and may have been interpreted as a surprise negative development in the public finances. Uncertainty seems to have been curbed following MPC member Huw Pill's 9 January speech on the UK monetary policy outlook, which stressed the MPC's commitment to returning inflation to the 2 per cent target. Overall, the UK term premium signals that investors are feeling confident about the path of short-term interest rates. In our Winter UK Economic Outlook, we noted that while there is little uncertainty surrounding the current monetary tightening cycle, the questions of how long the MPC should maintain the Bank Rate at its peak level and the pace at which to loosen remain contested. If the MPC does not provide clear communication surrounding these issues, we may well see uncertainty return to markets once investors believe the Bank Rate has peaked.

US Term Premium

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-movement between UK and US term premia are particularly suggestive of spillovers (Figure 2).

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



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

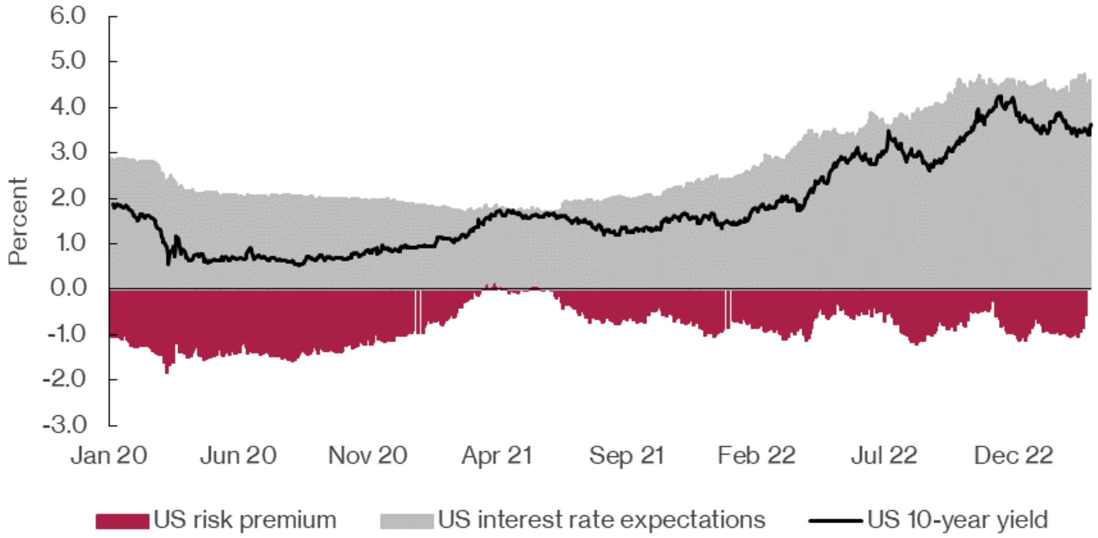
The upwards trend in the 10-year US Treasury yield, which we described in our December tracker as mostly driven by short term interest rate expectations, has now become less pronounced with yields on the decline from early November to January, picking up once more in early February. As discussed in our recent Global Economic Outlook, it is likely that inflation has peaked in the United States. The 12-month US CPI inflation rate has been continuously decreasing since its 9.1 per cent peak in June 2022, the highest rate in 40 years. The rate now stands at 6.4 per cent, slightly down from 6.5 per cent in December. US core inflation, defined as CPI excluding food and energy costs, which tends to follow headline inflation with a lag of a few months, has also been on the decline since its 6.6 per cent peak in September 2022. In January, it stood at 5.6 per cent, which, although less marked, is still above its 20-year average of 2.2 per cent. Meanwhile, the interest rate tightening cycle continues, with the Fed having increased the target range for the fed funds rate by 25 basis points to 4.5-4.75 per cent in its February 2023 meeting. This is the second consecutive hike of only 25 basis points, hinting that the more aggressive hikes we have observed over the past year are likely to be weakened, and perhaps even reversed in 2024.

Euro Area Countries' Term Premia

European countries' 10-year bond yields remain on an upwards trend, driven by interest rate expectations. According to Eurostat estimates, annual CPI inflation in the Euro Area decreased from 9.2 per cent in December to 8.6 per cent in January. The Governing Council's February decision to tighten policy by a further 50 points, as well as their guidance that they intend to raise rates by a further 50 basis points in March has no doubt consolidated the upwards trajectory in short-term interest rate expectations driving this trend in bond yields (Figure 4). As discussed in our recent Global Economic Outlook, the ECB faces a difficult path ahead in pursuing such tightening. In particular, energy prices and the war in Ukraine have dramatically increased the dispersion of inflation rates among Euro Area countries to the highest level on record, at an average inflation dispersion rate of 4.7 percentage points between March and November 2022. As a result, the ECB walks a fine line in tackling heterogenous rates of inflation while not exacerbating heterogeneous exposures to recession.

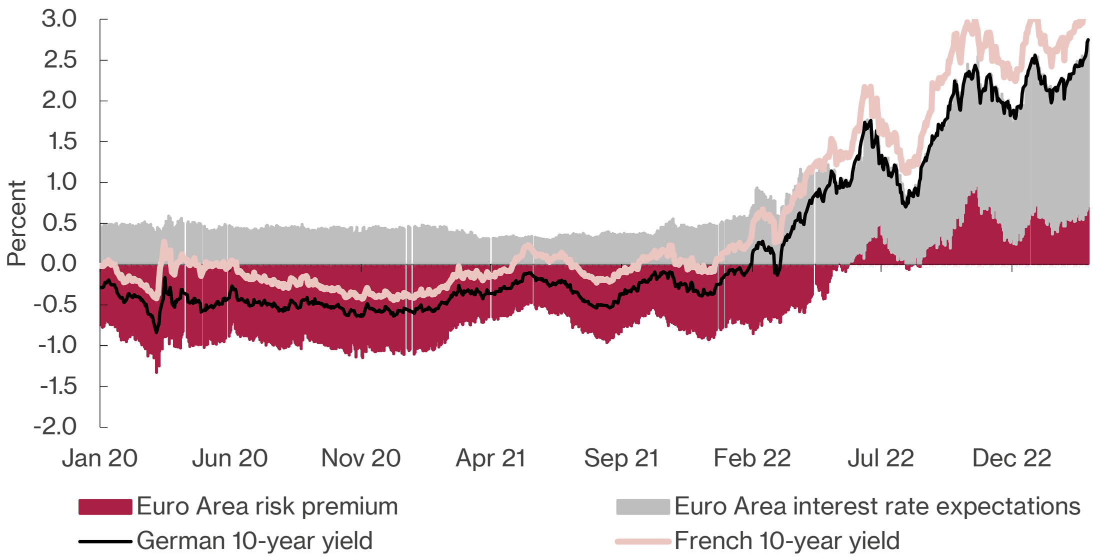
Average term premia in the Euro Area remain elevated in comparison to those in the United Kingdom and United States. Further, bond market fragmentation remains an issue in the Euro Area, with the average bond yield dispersion rate climbing up to 0.9 percentage points between March and November 2022. Our decomposition of Euro Area bond yields suggests that Italy and Greece continue to decouple from trend, with our latest term premia estimates around 1.20 percentage points higher than the Euro Area average for both countries. Interestingly, we have observed a significant fall in the Greek term premium in the first quarter of 2023 from an average of 3.4 percentage points in the fourth quarter of 2022 to 2.7 percentage points. Nevertheless, it remains well above average, which matters because bond market fragmentation presents an important risk to financial stability and the transmission of monetary policy in the Euro Area. Though diverging term premia alone do not necessarily signal the start of a new liquidity crisis, coupled with market fragmentation or possibly speculative dynamics, the threats to financial stability certainly increase. Whether the Transmission Protection Instrument and Next Generation EU package will be effective in maintaining financial stability will become clearer over the medium term.

Figure 3 – US 10-year government bond yield and decomposition by average current and expected future short-term interest rates and risk premium (per cent)



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 yield and decomposition by average current and expected future short-term interest rates and risk premium (per cent)



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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Notes for Editors

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