National Institute of Economic and Social Research

NIESR Quarterly Term Premium Tracker

High Interest Rate Expectations Drove Gilt Trend in Q2

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"Our latest estimates suggest that elevated interest rate expectations continued to drive a stable upwards trend in the 10-year UK government bond (gilt) yield in the second quarter of 2023. These interest rate expectations now exceed 5 per cent, caused by positive surprises in recent CPI data and, in turn, the MPC's continued monetary tightening. At the same time, the corresponding term premium on the gilt yield has not moved much, signalling that investors are feeling confident about the path of short-term interest rates. This is not entirely surprising given that we have yet to see a meaningful turning point in measures of underlying inflation in the UK. However, when markets believe the Bank Rate has peaked, there may be more uncertainty regarding the path of monetary loosening."

Paula Bejarano Carbo
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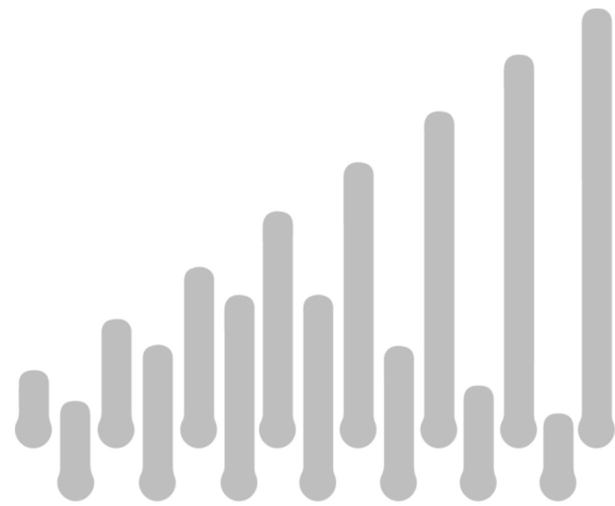
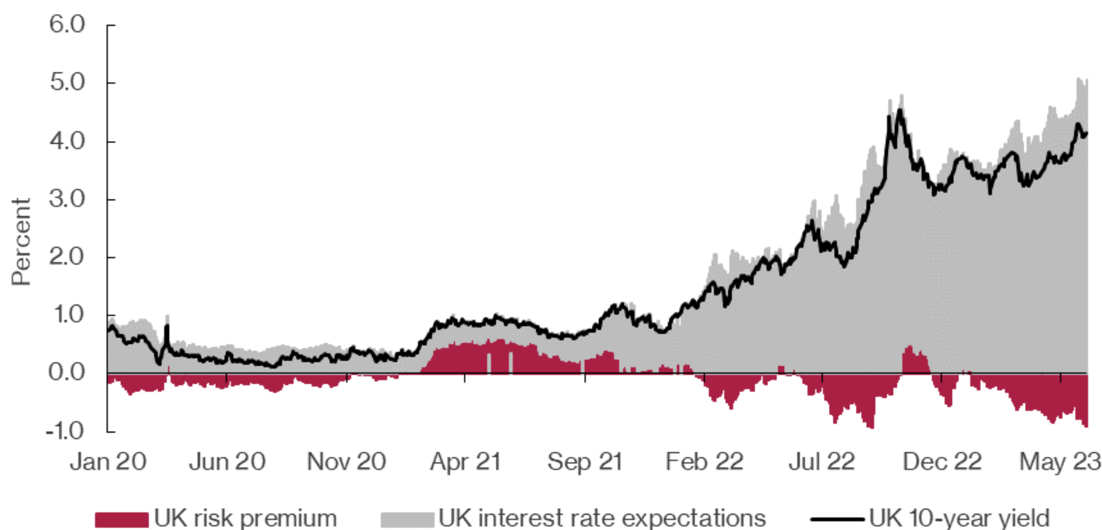


Figure 1 – UK 10-year government bond yield and decomposition by average current and expected future short-term interest rates and risk premium (per cent)



Source: Authors' calculations based on Bank of England data

Main Points:

- The 10-year UK government bond (gilt) yield was on an upwards trend during 2022 as a result of the Bank of England's aggressive monetary tightening cycle. In the first half of 2023, the 10-year gilt yield has fluctuated around 3.5 to 4 per cent, driven by short-term interest rate expectations.

- Overall, the UK term premium signals that investors are feeling confident about the path of short-term interest rates. However, with inflation proving to be even more persistent than previously thought, the questions of where the Bank Rate may peak, 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 in the coming months.

- In June, policymakers at the Federal Reserve (Fed) opted to maintain the target range for the federal funds rate, while the MPC and European Central Bank hiked their policy rates by 50 and 25 basis points, respectively. The latest data indicate that in May, annual CPI inflation rose by 4.0, 6.1 and 8.7 per cent in the United States, Euro Area and United Kingdom, respectively. With the paths of inflation in these economies now de-coupling following months of rising inflation rates, we may well see divergent monetary tightening cycles. As such, we may start to see differences in market dynamics, particularly between the United States and Unites Kingdom, which had previously been fairly similar.

UK Term Premium

Since our last term premium tracker published in March, the 10-year UK government bond yield has not moved much. 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. Our latest estimate of UK interest rate expectations indicate that these have risen past the level observed during the time of the 'mini-budget,' likely caused by positive surprises in recent CPI data and, in turn, the MPC's continued monetary tightening. The Bank of England's MPC meeting on 22 June acknowledged that "second-round effects in domestic price and wage developments generated by external cost shocks are likely to take longer to unwind than they did to emerge," driving persistence in inflationary pressures in the economy. NIESR's latest inflation tracker highlighted that core CPI inflation (CPI excluding energy, food, alcoholic beverages, and tobacco) rose to 7.1 per cent in May, its highest rate since March 1992, from 6.8 per cent in April. At the same time, NIESR's measure of underlying inflation, which excludes 5 per cent of the highest and lowest price changes, fell only slightly to 9.9 per cent in May from 10.2 per cent in April. Trimmed-mean inflation being higher than core inflation indicates that the energy price fall which has driven headline CPI down is a rather volatile price movement. Overall, these figures suggest that we have yet to see a meaningful turning point in underlying inflationary pressure in the United Kingdom, and this is reflected in market expectations of interest rates. 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.

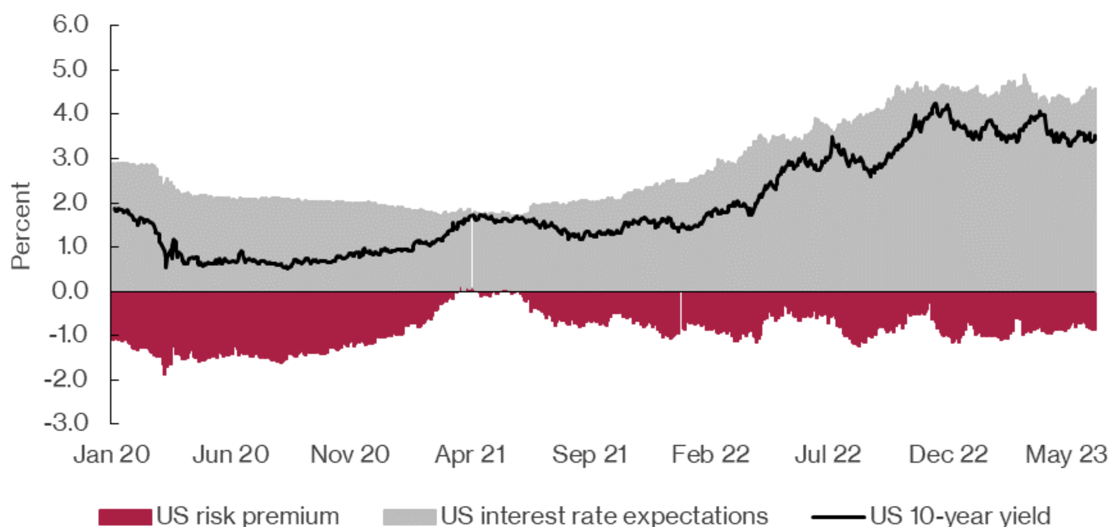
At the same time, the corresponding term premium on UK 10-year government bond yields has not moved much in the second quarter of 2023. Overall, the UK term premium signals that investors are feeling certain about the path of short-term interest rates. However, with inflation proving to be even more persistent than previously thought, the questions of where the Bank Rate may peak, how long the MPC should maintain the Bank Rate at its peak level and, once there, the pace at which to loosen, remain contested. As argued by Jagjit Chadha in this recent article in Central Banking magazine, if the MPC does not provide clear communication surrounding these issues, we may well see uncertainty return to markets in the coming months.

US Term Premium

The 10-year US Treasury yield has fluctuated around 3.5 per cent in the second quarter of 2023, driven by short-term interest rate expectations. That said, with the 12 month US CPI inflation

rate falling from 4.9 per cent in April to 4.0 per cent in May, US interest rate expectations seem to be gradually declining, contrasting noticeably with its UK counterpart.

Figure 2 – 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

The US term premium has moved even less than the United Kingdom's over the course of 2023, indicating that investors in this market are more confident about the path of short-term interest rates. US core inflation (CPI excluding goods and energy costs) fell to 5.3 per cent in May, persistently above its historical average of 2.2 per cent. That it is higher than headline CPI indicates that we have yet to see a full turning point in underlying inflationary pressures in this economy. Still, with the federal funds rate being targeted at 5-5.25 per cent, it is likely that the Fed. has done most, if not all, the 'heavy lifting' needed to return inflation to target.

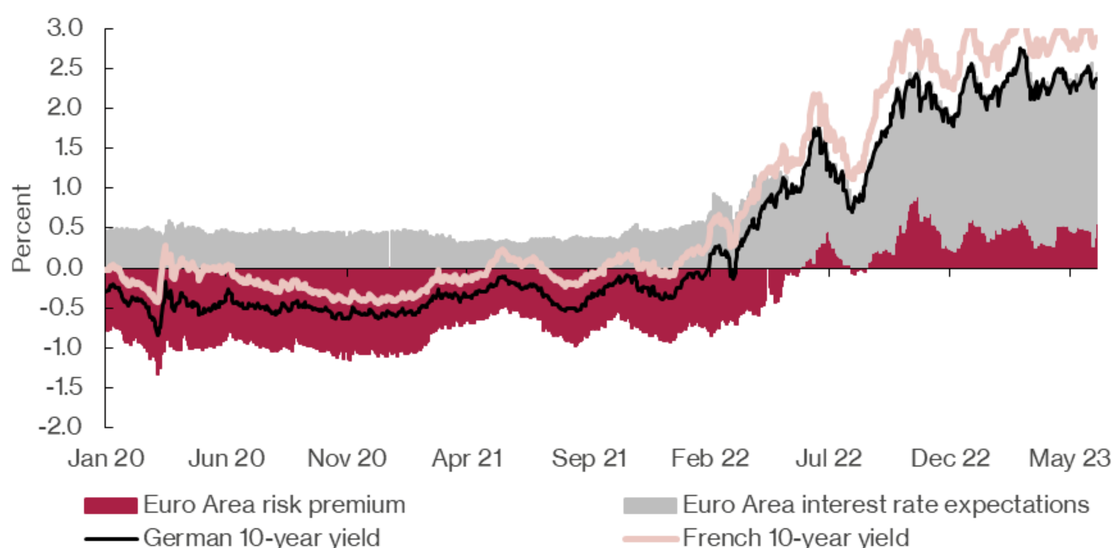
Given the global integration of financial markets, a significant share of the movements observed at the longer end of the yield curve reflect changes in international risk and uncertainty, as well as monetary policy developments abroad. The co-movements in Germany and the United States are particularly suggestive of spillovers (Figure 3).

Euro-Area Countries' Term Premia

European countries' 10-year bond yields remain on an upwards trend, driven by interest rate expectations. Annual CPI inflation in the Euro Area decreased from 7.0 per cent in April to 6.1 per cent in May. The Governing Council's June decision to tighten policy by a further 25 basis points, as well as the fact that core euro-area inflation has fluctuated around 5.5 per cent since January – exhibiting significant persistence – has consolidated this trend in interest rate expectations.

As discussed in our recent Global Economic Outlook, the ECB faces a difficult path ahead in continuing its tightening cycle. In particular, energy prices and the war in Ukraine have dramatically increased the dispersion of inflation rates among euro-area countries to above 5 percentage points, much higher than in the 2007-2012 period of the global financial crisis and sovereign debt crises. As a result, the ECB walks a fine line in tackling heterogenous rates of inflation while not exacerbating heterogeneous exposures to recession.

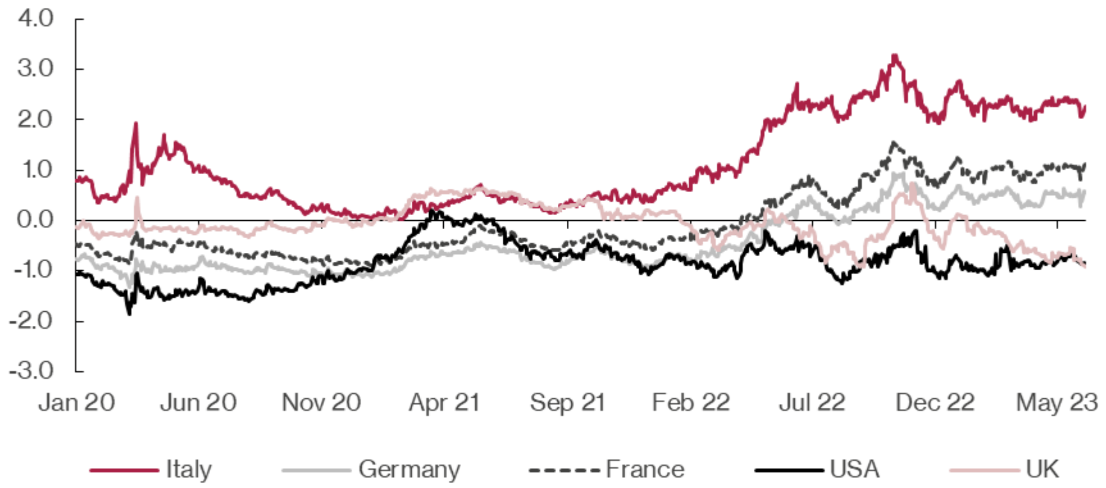
Figure 3 – Euro-area 10-year government bond yield and decomposition by average current and expected future short-term interest rates and risk premium (per cent)



Source: Authors' calculations based on data by Datastream

Average term premia in the Euro Area remain elevated in comparison to the United Kingdom and United States. Further, bond market fragmentation remains an issue in the Euro Area. Our decomposition of euro-area bond yields suggests that Italy and Greece continue to decouple from trend, with our latest term premia estimates more than 1.20 percentage points higher than the euro-area average for both countries. Interestingly, we have observed an increase in the Greek term premium in the second quarter of 2023, rising from an average of 2.7 per cent in the first quarter to an average of 3.2 per cent in the second quarter. 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 4 – 10-year term premium estimates across countries (percentage points)



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

Background

The model we employ enables the decomposition of long-term bond yields into two components: expectations of the future path of short-term 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 yields will not evolve as expected.

The National Institute Term Premium Tracker aims to provide quarterly updates of the bond term premia estimates for the United Kingdom, the United States 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 Adrian et al. (2013 and 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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