National Institute of Economic and Social Research

NIESR Quarterly Term Premium Tracker

UK Gilt Yields One Year on from the Mini-Budget

Paula Bejarano Carbo

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"While the 10-year UK government bond (gilt) yield is now at a similar rate as that observed a year ago following the aftermath of the 'mini-budget', our latest estimates suggest that elevated interest rate expectations generated a stable upwards trend in the gilt yield in the third quarter of 2023, in line with the MPC's monetary tightening cycle. Overall, the UK term premium signals that investors are feeling certain about the path of short-term interest rates, though this certainty has decreased somewhat in recent weeks. This contrasts significantly to last September's gilt market dynamics, which were driven by volatile, but temporary, increases in short-term interest rate expectations and the term premium."

Paula Bejarano Carbo
Associate Economist, NIESR

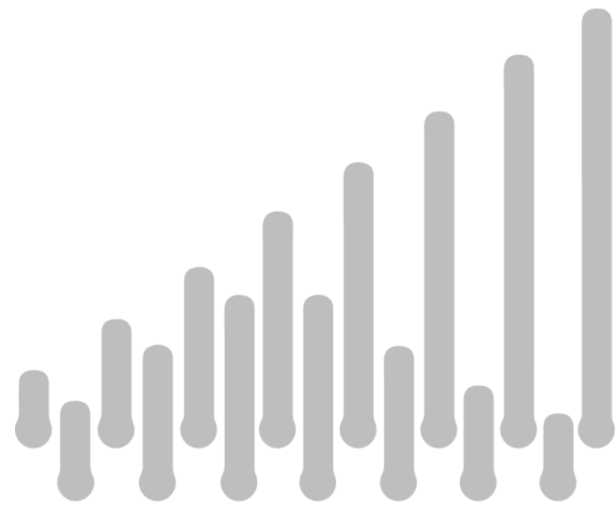
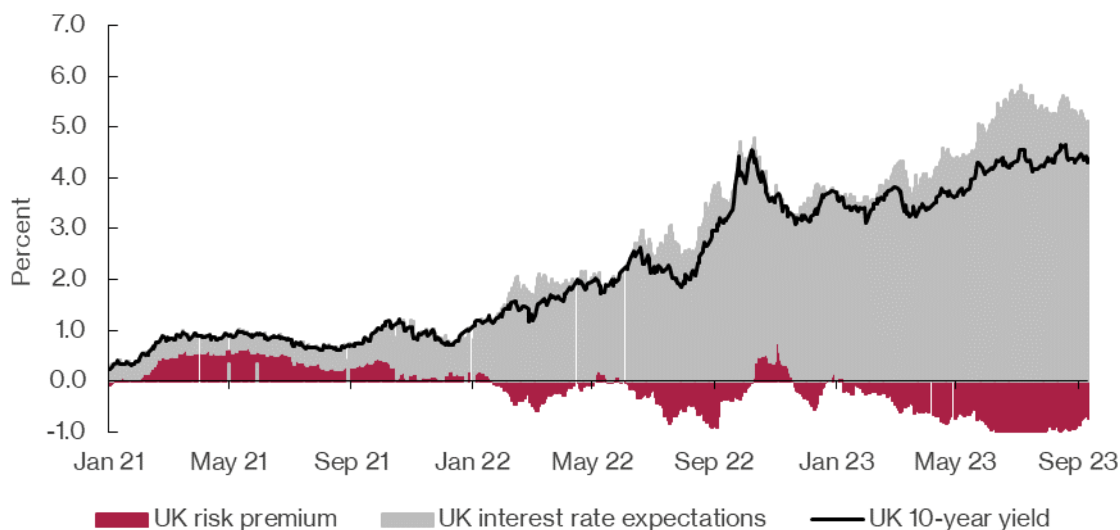


Figure 1 – UK 10-year government bond yield and decomposition by average current and expected future short-term interest rates and risk premium (per cent)



Source: Authors' calculations based on Bank of England data

Main Points:

- The 10-year UK government bond (gilt) yield has been on an upwards trend since 2022 as a result of the Bank of England's aggressive monetary tightening cycle. In the third quarter of 2023, the 10-year gilt yield has fluctuated around 4.4 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.

- One year on from the 'mini-budget', our latest estimates indicate that while gilt dynamics were largely driven by short-term interest rate expectations during the weeks before and following the mini-budget, the UK term premium did rise in this time and contributed to raising the gilt yield further. It is also important to note that our estimates suggest that this rise in interest rate expectations and the term premium was a 'blip' that corrected rather quickly. Thus, though the gilt yield is now at a similar level as a year ago, bond market dynamics have changed significantly, one year on.

- In September, the Federal Open Market Committee (FOMC) in the United States and the Monetary Policy Committee (MPC) in the United Kingdom opted to maintain their policy rates, while the European Central Bank hiked interest rates by 25 basis points. With all three central banks' policy rates potentially at, or close to, their peak level in this global monetary tightening cycle, uncertainty has begun to rise in markets. This is not entirely surprising, given that the questions of whether policy rates have peaked and, once there, how long policy rates should be maintained at peak and the pace at which to loosen, remain contested. Improved communication around these issues may help to prevent further uncertainty seeping into term premia.

UK Term Premium

Since our last term premium tracker published in June, the 10-year UK government bond yield has risen gradually. 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. This tracker is based on daily estimates up until 13 September.

Increasing bond yields in the UK in the past year have been driven by short-term interest rate expectations, which have fluctuated around 5.5 per cent in the third quarter of 2023. Short-term interest rate expectations peaked in the third quarter of 2023 at 5.82 per cent in July, the highest level since the second quarter of 2000. That said, these expectations have been steadily decreasing since the last week of August, possibly influenced by the downwards surprise to July's CPI data, the release of weak Purchasing Managers Index data for August and lower-than expected public sector net borrowing data for July. With the August CPI data indicating that we have finally reached a turning point in underlying inflationary pressure in the United Kingdom, it is likely that this trend has continued. Indeed, the Bank of England's MPC meeting on 21 September, at which the Bank Rate was maintained at 5.25 per cent, noted that there had been a reduction in market expectations for the Bank Rate path, now averaging just under 5 per cent over the next three years.

At the same time, the corresponding term premium on UK 10-year government bond yields has risen during the course of the third quarter of 2023. Overall, the UK term premium signals that investors are feeling confident about the path of short-term interest rates. However, with the Bank Rate potentially at, or very close to, peak, 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, may be dampening certainty in markets. NIESR have been arguing for some time now that the MPC ought to improve its communication; in particular, it is essential that it lets markets as well as the public know when it thinks that it's done enough to bring inflation back to target. As noted in this NIESR discussion paper, the MPC could consider publishing a forecast for the path of interest rates in its Reports, as is done in other central banks, such as the Norges Bank and the Sveriges Riksbank. This would help adjust markets', and the wider public's expectations, to a particular, but not definite, trajectory.

The 'Mini-Budget': One Year On

On 23 September 2022, then-Chancellor Kwasi Kwarteng delivered the 'mini-budget,' an inflationary fiscal package comprising mostly of unfunded tax cuts and a large energy support package, in the context of soaring inflation and low growth. This fiscal event followed on from months of rhetoric and actions challenging the institutional independence of HM Treasury, the OBR and the Bank of England.

Following this fiscal event, there was significant disarray in financial markets that ultimately resulted in the Bank of England intervening via a 'special operation' to prevent a crisis for

pension funds. We turn to examining what happened to the 10-year gilt yield in this time based on our decomposition.

As shown in figure 1, short-term interest rate expectations had been gradually rising over the first half of 2022 in line with the MPC's monetary tightening cycle. A first break in the gradual rise in short-term interest rate expectations followed after the 17 August ONS data release, in which CPI inflation was estimated to have risen to 10.1 per cent; interest rate expectations rose on impact by 30 basis points, reaching 3 per cent by 18 August. Our first data point following 23 September indicates that expectations jumped by 40 basis points immediately following the mini-budget, reaching 4.5 per cent on 26 September and peaking at 4.7 per cent on 27 September.

At the same time, the term premium on UK 10-year government bond yields had been rising since the first day following the announcement of Liz Truss's premiership; on 6 September, we estimate that the UK term premium rose by 23 basis points. We estimate that this rise continued steadily throughout the Truss days, though there was a further 30 basis point rise between 11 and 12 October, in which the prime minister announced she would not fund tax cuts. Our estimates suggest that the UK term premium continued rising until early November, weeks after Truss resigned, but stabilised by December.

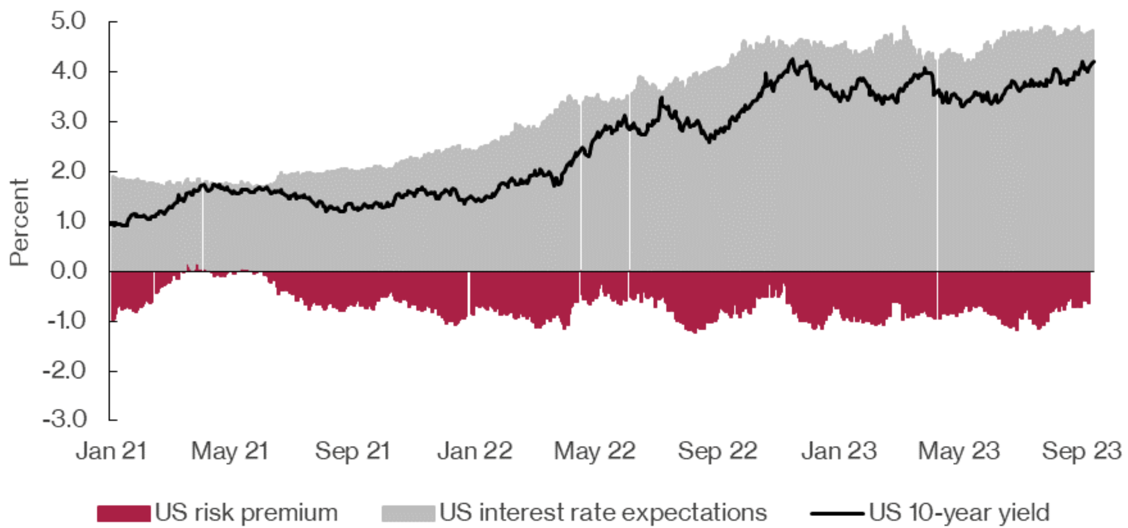
Altogether, our estimates indicate that, while gilt dynamics were largely driven by short-term interest rate expectations during the weeks before and following the mini-budget, the UK term premium rose in this time and contributed to raising the gilt yield further. It is also important to note that our estimates suggest that this rise in interest rate expectations and the term premium was a 'blip' that corrected rather quickly. Thus, though the gilt yield is now at a similar level as a year ago, figure 1 illustrates how distinct the bond market dynamics are, one year on.

US Term Premium

The 10-year US Treasury yield has fluctuated around 4.1 per cent in the third quarter of 2023, driven by short-term interest rate expectations. Interestingly, the US term premium has also been rising since August, indicating that investors in this market are also feeling less confident about the path of short-term interest rates (Figure 2). With the federal funds rate at, or very close to, peak, it is not entirely surprising that certainty has also decreased in this market as the questions of how long the Fed should maintain the target range at its peak level and, once there, the pace at which to loosen, remain contested.

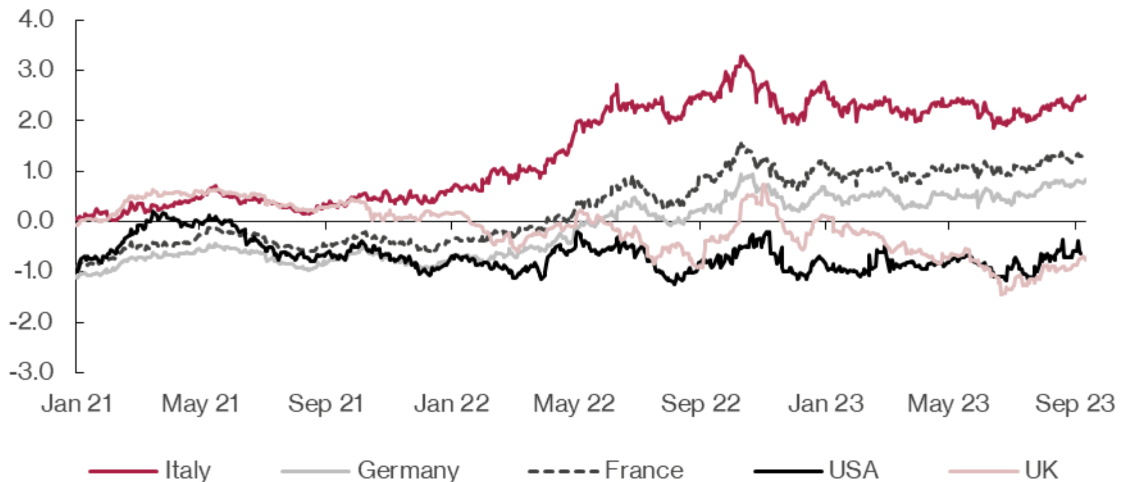
Given the global integration of financial markets, a significant share of the movements observed at the longer end of the yield curve reflect changes in international risk and uncertainty, as well as monetary policy developments abroad. The co-movements in the United Kingdom and the United States are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

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

Figure 3 – 10-year term premium estimates across countries (percentage points)



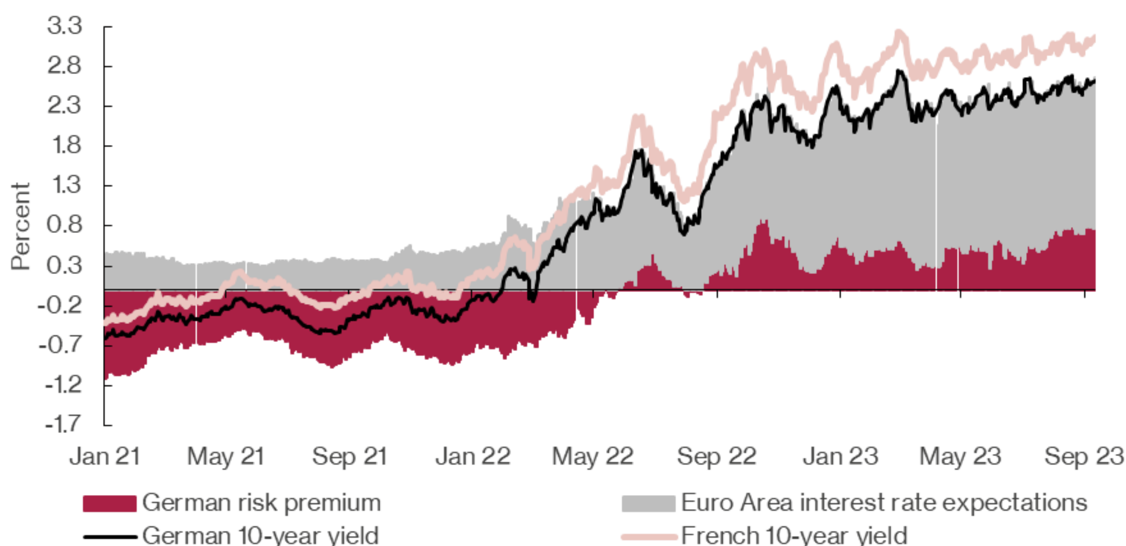
Source: Authors' calculations based on data by Bank of England

Euro-Area Countries' Term Premia

European countries' 10-year bond yields remain on an upwards trend, driven by interest rate expectations, likely consolidated by the Governing Council's September decision to tighten policy by a further 25 basis points.

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 a much higher level 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 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

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 remain decoupled from trend, with our latest term premia estimates between 1-2 percentage points higher than the euro-area average for both countries. 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.

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's 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 yield data. The estimates of bond term premia at the 10-year maturity and the expected average short-term rates for the same maturity are based on daily data from 1961 to 3 September 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 United States are consistent with those produced by the Federal Reserve Bank of New York.

Data

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

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

References

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Adrian, T, Crump, R K and Moench, E (2013), 'Pricing the term structure with linear regressions', *Journal of Financial Economics*, Vol. 110, pages 110-38.

Notes for Editors

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