GBP rates: A slow return to normality

2023 will be the year the UK yield curve re-steepens. Bank of England hike expectations are still too high and recession fears will bite. Long-dated gilts will continue to trade with a political risk premium but the 10yr will converge to 3% by the end of the year

2022 was a bruising year for gilts and GBP rates

Source: Shutterstock

The long and arduous road to regaining credibility

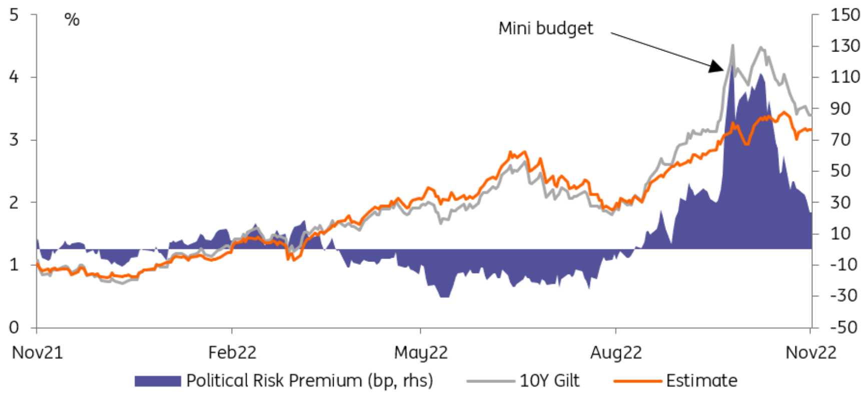
2022 was a bruising year for gilts and GBP rates in general. The bar for a more stable 2023 is not a very high one to clear. Yet, it will take a long time to restore market confidence. UK markets had to deal with a uniquely adverse interplay between fiscal and monetary policy, effectively undoing each other's work. We would love to say that this is a thing of the past and that the two main institutions in charge of the UK's economy, the Treasury and the BoE, are now coordinating better. Sadly, this is far from certain.

Sterling-denominated assets are justified to trade with a greater risk premium

In letting the Treasury feel the force of market pressure, the BoE may have won a battle but left the persistent impression that it will only step back into the bond market when it absolutely has to, as it did in September 2022. Barring a more severe crisis of this sort, sterling-denominated assets are justified to trade with a greater risk premium than previously.

Our base case is for the fiscal tightening promised by the incoming government to be delivered at least in part. This, in turn, will ultimately close the gap between hawkish market expectations for monetary policy, in part justified by hopes of intervention to defend the currency, and ours. Markets have challenged the BoE's stance ever since the start of this tightening cycle. Tighter fiscal policy is a potential catalyst for this to happen although we're not holding our breath here. A severe recession could also go some way to convincing market participants that rates aren't heading as high as current pricing suggests.

Gilt yields should decline to 3% in 2023, but will continue to trade with a political risk premium



Source: Refinitiv, ING

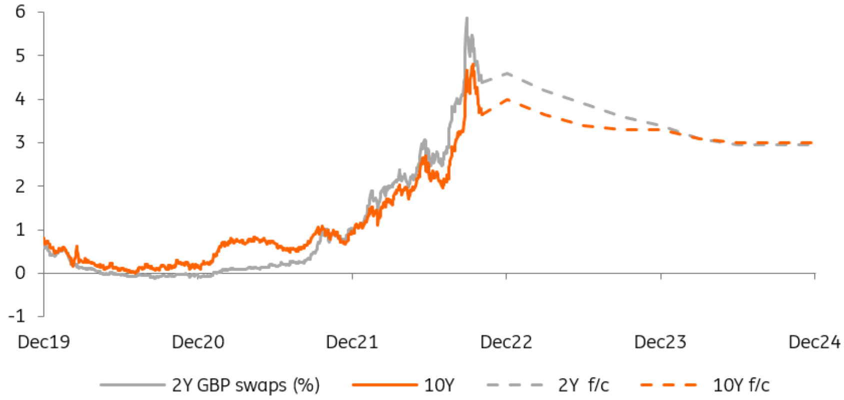
Re-steepening in the cards

Our working assumption for 2023 is that we've seen the peak in market interest rate hike expectations. Markets routinely priced a terminal rate above 5% in late 2022 but we think a more realistic figure is between 3.5%-4%. Even in the case of persistent inflation, this leaves some margin for front-end rate rates to fall further, especially since the end of the BoE's hiking cycle will likely bring expectations of rate cuts, with Bank Rate ending this cycle above what most would describe as the neutral level.

> *We expect 2Y Sonia swaps to fall below 4% by mid-2023*

We expect 2Y Sonia swaps to fall below 4% by mid-2023 as cuts come into view but we think longer-dated rates will retain a significant risk premium. This implies that 10Y swap rates will struggle to fall as fast as their shorter equivalent even in the event of a more dovish BoE. Firstly, this is because the Sonia swap curve is already dramatically inverted, and so a re-pricing at the front end would likely re-steepen the curve. Secondly, because the scars of the long-end market meltdown in September/October will take time to heal and we think duration/term premium is here to stay. All this is to say we expect a comparatively smaller drop in 10Y swap rates over the course of 2023. Translating this to 10Y gilt yields, we think 3% is an achievable target by year-end.

2023 will see the GBP swap curve gradually dis-invert



Source: Refinitiv, ING

Market liquidity remains a challenge

Market functioning will remain an issue for sterling-denominated markets for some time. Liquidity indicators in the gilt and swaption markets certainly point to decreased risk-taking ability on the part of participants, also pointing to greater transaction costs. Policy choices may have exacerbated market functioning issues in 2022 but the underlying cause, macroeconomic uncertainty, could persist for a quarter or two in 2023, provided our forecast for a gradual decrease in inflation proves correct.

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