

Rates: Three reasons 10Y gilt yields should revert below USTs, eventually

The 10Y gilt yield seems too high and should revert to around 4% by mid-2025, below our UST target of 5%. Markets seem to have overreacted to the recent UK budget announcement. Having said that, due to a lack of near-term catalysts, a recalibration lower may take until early 2025



Rates markets may have overreacted to the recent UK budget by Chancellor Rachel Reeves

Gilt yields have jumped further since the budget announcement

The 10Y gilt yield has peaked since the UK government's budget announcement on 30 October, and with a yield of 4.5%, it now trades above the 10Y US Treasury bond at 4.4%. We analyse three drivers of the higher 10Y gilt yields and why, overall, we think the next direction will be for lower yields, especially relative to USTs. Having said that, the recalibration may take time to gain traction due to a lack of clear catalysts and thus, for the next few months, gilt yields could remain relatively elevated.

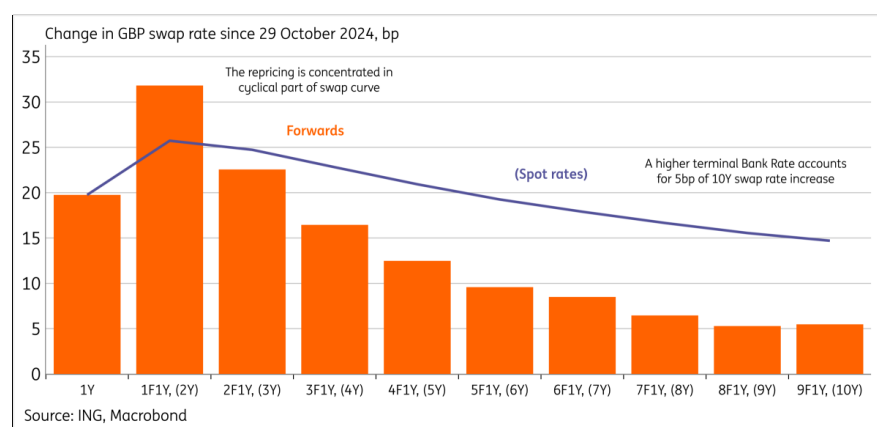
Markets overestimate the near-term impact of the budget announcement

The recent increase in 10Y GBP rates can mostly be explained by a repricing of the front end of the curve. A decomposition into forward rates shows that the 1-year rate one year forward (1F1Y) moved up the most since the budget announcement. Beyond five years, the increases in forward rates were less than 10bp, much less than the rise in spot rates.

The 30bp increase in the 1F1Y rate is more than a full Bank of England rate cut being priced out. That seems like an overreaction, particularly when considering there are now fewer than three rate cuts priced across the next two years.

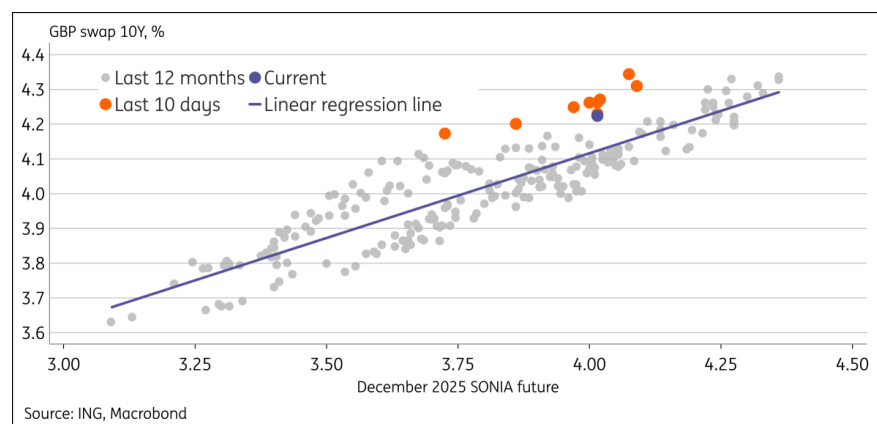
While the UK's budget will inevitably lead to higher growth next year, we're sceptical that the government will manage to increase investment spending as quickly as planned. And in the Bank's own words, the budget is just one of a number of things affecting the inflation outlook right now. Our read of November's policy meeting was that the Bank doesn't think it will materially change the direction for policy. Though not our base case in the very near term, if services inflation once again undershoots the Bank's forecasts, that would dwarf any latent concerns about the budget's impact on policy decisions.

Repricing of the GBP curve can mostly be explained by the front end



Bank of England rate-cutting expectations have been a dominant driver of 10Y GBP rates over the past year. When we take the September 2025 SONIA future as a proxy for the amount of future BoE easing that's priced, the correlation is very tight. Since the budget, 10Y swap rates have been trading roughly 10bp higher than we'd expect, based on its historical relationship with the amount of BoE easing priced in. This can be partly explained by expectations of a higher terminal rate (around 5bp), but the rest can be interpreted as an added-term risk premium.

The 10Y swap rate has closely followed BoE cutting expectations the past year

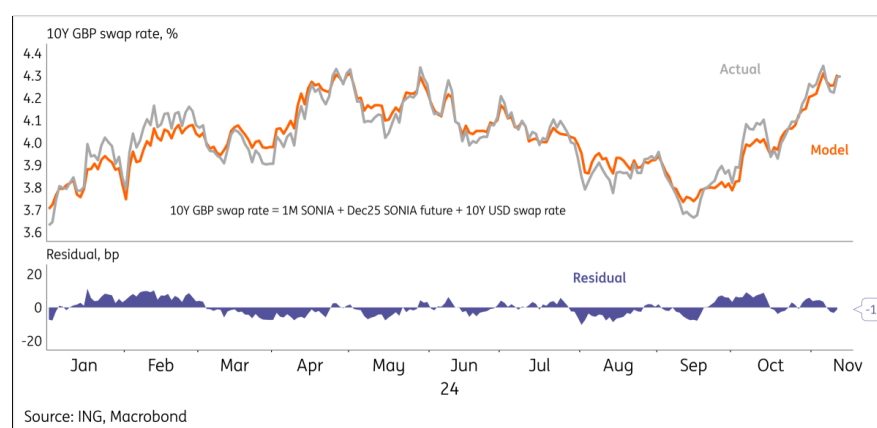


2 The term premium in GBP rates can largely be explained by US rates

This term premium in the GBP curve can at least partly be attributed to a global term premium, which is predominantly driven by US rates. A simple model with just information from the front end of the curve already captures 80% of the variation. When we extend a 10Y GBP swap model with the 10Y USD swap rate, as seen in the figure below, the variance explained by the model (R²) rises to 90%. The residual also falls to practically zero, suggesting 10Y GBP rates are fairly priced in relation to the front-end and US rates.

The coefficient on the 10Y USD rate is 0.38, lower than 1.0, suggesting that an upward move in the USD rate would intuitively widen the USD-GBP spread. In the near term, US rates take a more wait-and-see approach to Trump's presidency, which limits the upside potential. Going into 2025, however, we maintain a bearish bias for US rates as Trump's inflationary policies start materialising. As such, the full impact on the gilt-UST spread due to higher US rates may have to wait until a few months into Trump's presidency.

The current 10Y GBP swap rate is justified based on the front end and US rates

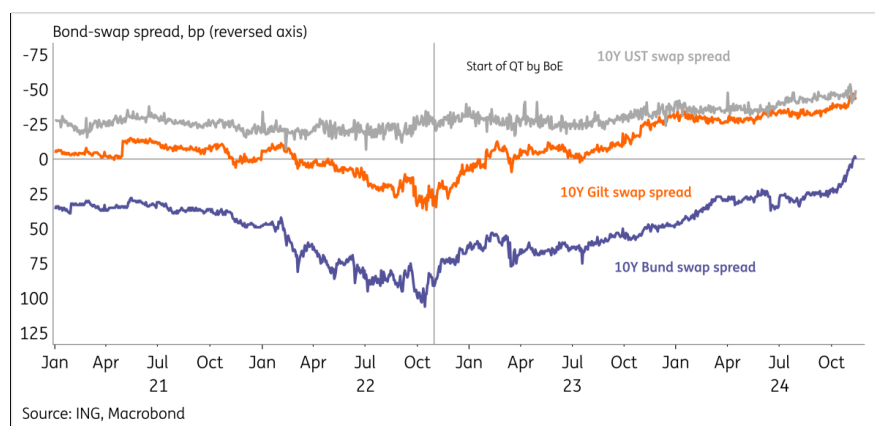


The 10Y gilt swap spread already prices in higher issuance

A last important driver of the higher gilt yields has been the swap spread, and with the recent spike, the pressure should lessen going forward. The swap spread measures the difference between the swap rate and the equivalent gilt yield, whereby a negative number indicates that those yields trade above swaps (note the reversed axis of the chart). Since QT, swap spreads have already turned significantly more negative on the back of increased gilt supply in the market.

The budget announcement accelerated the upward trend and accounts for about 5bp of the move in 10Y gilt yields. Compared to Bund and UST markets, the gilt swap spreads are already more stretched, which should limit the risks of a sudden further widening. Although we do not recommend pushing against the trend, we don't expect the coming months to see a repeat of the post-budget acceleration. In contrast, tax cuts from Trump's administration could pressure 10Y swap spreads further as issuance expectations are adjusted upwards.

Gilt swap spread jumped up in response to budget announcement



A move lower of gilt yields may take a couple of months to materialise

The bottom line is that gilt yields should recalibrate to lower levels, to around 4% by mid-2025 in our view, and the spread between UK and US yields should then gradually widen. But the impetus to get there has to come from Trump's presidency, UK data or guidance from the Bank of England, and we think it might not be until the new year before we begin to see such catalysts.

In terms of UK data, take services inflation. That undershot the Bank's August forecasts by more than half a percentage point. But this looks less likely to happen over the next three months. Bank of England forecasts have services inflation bouncing around its current 4.9% level for the next six months, something we don't really disagree with. The caveat is that we expect much of this stickiness to be driven by categories the Bank has explicitly told us it is paying less attention to. So-called "core services" inflation, which the BoE likes to focus on and excludes volatile/irrelevant items, is likely to continue trending lower.

But barring any downside surprises, that fairly nuanced story is unlikely to be enough to catalyse an independent, downward move in gilt yields. Wage growth is likely to be similarly sticky for the

rest of this year while jobs market data continues to prove unreliable.

All of that means the Bank's pre-Christmas meeting may prove to be something of a non-event. At this stage, we expect officials to keep rates on hold and simply reiterate that further easing will be gradual.

Come February, however, we think the Bank will have more confidence that the inflation story is improving, particularly if core services inflation does come lower as we describe. This could be the point where we see a more noticeable dovish shift in the Bank's communications, opening the door to back-to-back cuts thereafter.

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