

## UK: How much higher can gilt yields rise?

The UK's rapid vaccine rollout combined with the global reflation story have lifted UK 10 year yields by 50bp in the past month, and there's scope for more. If US yields push higher amid the Fed tapering debate, gilts could touch 1%. But a slower UK economic recovery, benign inflation outlook, and Brexit constraints imply the gilt sell-off has its limits



Bank Of England,  
London

Source: Shutterstock

### There are reasons to be cheerful about the UK outlook

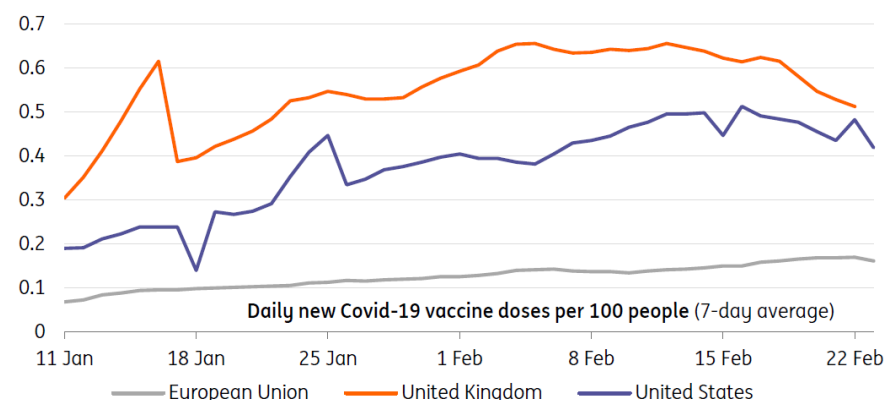
The UK weather has finally turned warmer in recent days, and with it, there's a growing sense that the economy is poised to spring back to life. The vaccine rollout continues to go well, and despite a dip in doses administered over recent days, we see little reason at this stage to doubt the ambition to offer all adults a first vaccine dose by the end of July.

Equally, the plan to reopen the majority of sectors by mid-May looks achievable and should contribute to a 5% bounce in second-quarter GDP - even if, in reality, the plan to end social distancing entirely in June looks somewhat ambitious.

All of this, unsurprisingly, is now firmly embedded in the level of UK yields. So the question now is whether the UK's reopening can translate into a US-style reflation story? There are a handful of

reasons to think it may not.

## The UK's vaccine rollout continues at pace



## The UK is likely to recover more slowly than the US, translating into less 'reflation'

Firstly, while the UK is likely to see a decent consumer rebound, the story probably has its limits. While savings have risen significantly, this has not been the case among lower-income earners, who typically drive the biggest changes in overall consumer spending levels. In the US by contrast, stimulus checks and benefit increases helped lower earners and translated into a huge increase in retail sales shortly after rollout.

### *The feed-through to UK inflation could be more muted*

A more modest consumer rebound potentially suggests the feed-through to UK inflation could be more muted than the States. While there will be some demand/supply imbalances, these are likely to favour services over goods. And [as we wrote a couple of weeks ago](#), UK services inflation a) tends to be more stable over time than goods and b) hasn't actually shown any sign of slowing during the pandemic, once VAT cuts are accounted for.

Remember too that [unemployment is set to rise this year](#), potentially by another 1-1.5 percentage points, and possibly more if wage support is removed relatively abruptly (we should hear [more on this at the budget next week](#)). That will limit wage pressures, and suggests inflation is likely to dip below target after a brief foray to 2% later this year.

### *Unsurprisingly Brexit will also be a long-term drag on UK rates*

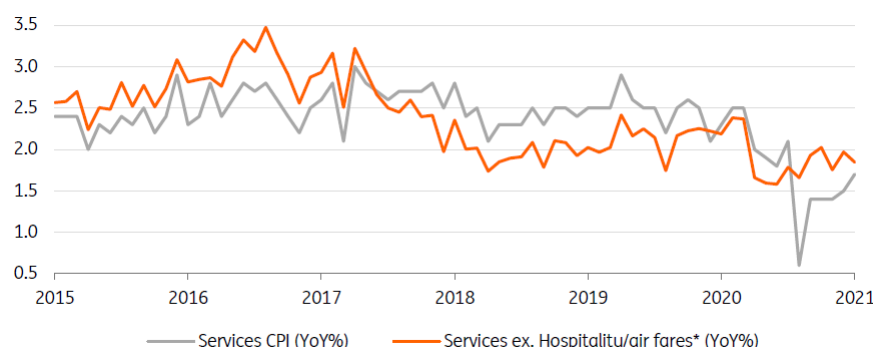
Unsurprisingly Brexit will also be a long-term drag on UK rates. The trade disruption encountered over recent weeks will dissipate, but the root cause of it is largely not teething problems. Customs processes will continue to add costs for businesses and reduce business viability in certain sectors

and the full impact on services is unlikely to show until the pandemic is 'over'.

This implies a slow recovery in investment and hiring over the coming years, suggesting the scope for future rate hikes is - as we saw post-2016 - fairly limited.

[Read: The four challenges UK chancellor Sunak faces at the budget](#)

## UK services inflation is fairly stable over time - including during the pandemic



Source: Macrobond, ING calculations

The hospitality sector received a VAT cut in July 2020, artificially depressing the overall services CPI series. Air fares are disproportionately volatile

## Unlike the Fed, the Bank of England is unlikely to take a hawkish turn

For the Bank of England, a key factor for the short-term direction of rates is whether it could inch towards a more hawkish stance [as we expect from the Federal Reserve](#). Again this seems unlikely. Markets have already priced out negative rates - another driver of the recent rise in yields.

We agree with this view - and continue to doubt that the committee will press ahead sub-zero rates even if the outlook darkens. Instead, while policymakers are divided on the topic, quantitative easing still appears to be the tool of choice for offering further stimulus.

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*Markets have already priced out negative rates, we agree with this view*

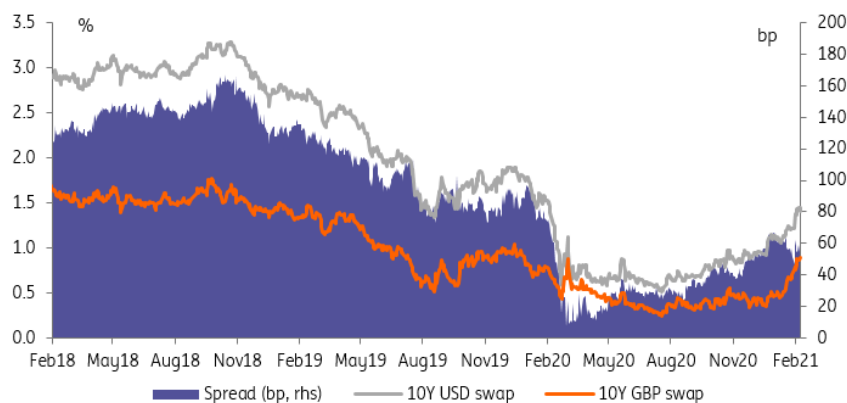
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For now, another QE extension isn't our base case, and we're more likely to see the Bank ease the weekly pace of purchases later in the year and stop expanding the balance sheet at the end of the year.

However, a top-up of around £50bn can't be ruled out, particularly given that bond issuances are likely to remain elevated. Ongoing pandemic-related costs likely mean the 2021/22 budget deficit will remain in the high single digits (circa 9%), albeit down from the 16%+ level likely to be reached for 2020/21.

We also don't expect to see the Bank actively tighten monetary policy until 2023 - although from a rates perspective, it's worth remembering that policymakers appear tempted to reduce the central bank's holdings of gilts in tandem with future rate hikes.

## Rise in GBP rates outpaced that of USD rates this year



Source: Refinitiv, ING

## Gilt's anatomy: What caused the sell off?

Saying that the adjustment higher in GBP rates (gilts and swaps) has been mainly a by-product of the USD reflation trade sounds like an oversimplification.

Yet it is healthy to remember that the UK economy, as we explained above, benefits from neither as aggressive a fiscal easing package nor from as dovish a central bank as the US. We see evidence that the GBP rates sell-off is mostly a 'duration event' and largely disconnected from economic and monetary policy expectations.

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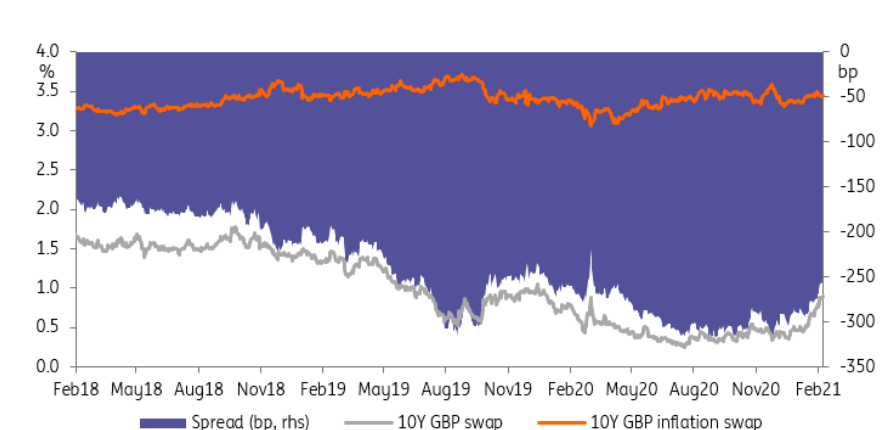
*The GBP rates sell off is largely disconnected from economic and monetary policy expectations.*

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Exhibit one is the lack of pick-up in inflation expectations. Unlike the US, where the nominal rates lift-off was preceded by an increase in inflation expectations in the second half of last year, GBP inflation swaps have remained below their pre-pandemic levels. This suggests a reassessment of gilts riskiness is driving the rise in nominal rates.

One culprit could be the central bank policy.

## Rise in GBP rates was driven by real rates not by inflation expectations



Source: Refinitiv, ING

## Neither reflation, nor policy tightening

A lot has occurred since January.

The February Bank of England meeting not only helped achieve price out negative rates in this cycle but also kicked off a debate on its exit strategy from exceptionally accommodative policy. To be clear, the Bank is not about to tighten, far from it. Still, the rates markets have gone from factoring in policy risks have a net negative (possibility negative rates) to a net positive (tightening within a few years).

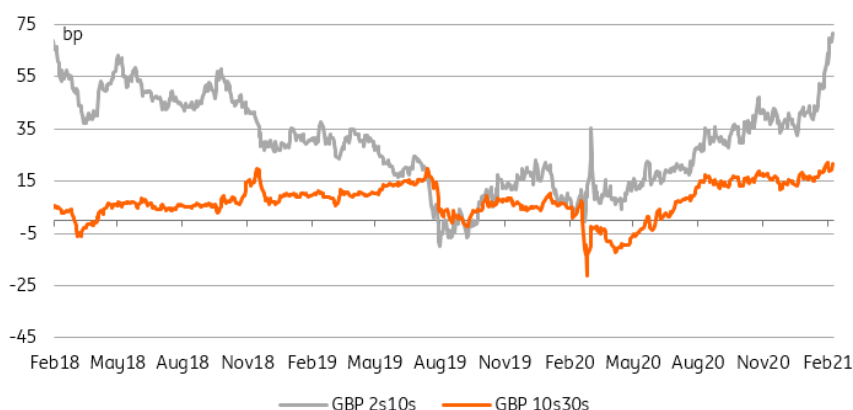
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*This isn't a market concerned with policy tightening*

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At the time of writing, the Sonia swap curve is only pricing one rate hike in 2023 and another one in 2024. Regardless of whether this is justified or not, this isn't a market concerned with policy tightening. Instead, it is the 10-year sector that cheapened the most on the curve. This is visible in the sharp steepening of the 2s10s when the 10s30s has remained stable. Since long-dated rates tend to be more globally correlated, we conclude that curve movements are more consistent with a global reassessment of bond, or duration, risk than with a change in local policy expectations.

## 10-year has borne the brunt of the sell off



Source: Refinitiv, ING

### The global duration event could last longer still

Putting it all together, the increase in GBP rates is neither consistent with a reappraisal of the UK's long-term economic prospect, not with an imminent tightening by the Bank of England. Instead, the sell-off bears the hallmarks of investors reassessing the attractiveness of low yielding products (such as gilts and swaps), a 'duration event' in market parlance.

If we had to guess, we would say the moves in USD rates bear a large part of the responsibility, with a small assist from the Bank ruling out negative rates.

# 1%

## Gilt yields could reach that level in Q2

On a tantrum-style price action in the US

As a risk scenario, in the case of a US tantrum-type of price action, we could see gilt yields temporarily rise to 1%.

Gains above that level would be difficult to justify with fundamentals and to maintain. After all the risk around the Bank's QE program are still skewed towards more purchases in the coming months.

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