NIESR
Quarterly Term Premium Tracker

Bond Markets React to Summer Elections

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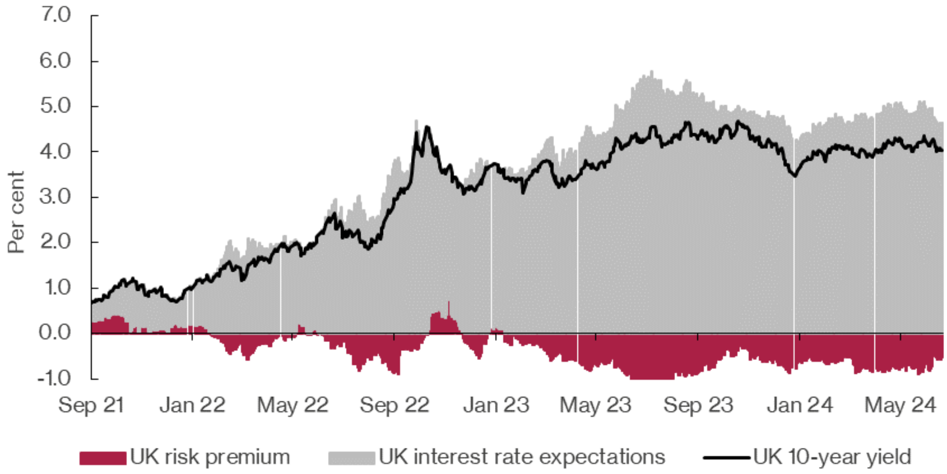
"In the second quarter of 2024, the 10-year UK government bond (gilt) yield has fluctuated around 4.2 per cent, rising from 4.0 per cent in the first quarter of the year, driven by slightly rising but volatile short-term interest rate expectations and more recently, a rising term premium. Both developments may reflect increased uncertainty in markets following the announcement of the UK general election. Further, upwards-trending co-movements in term premia estimates in both British and European economies following the European Parliament elections are suggestive of spillovers of international risk and uncertainty."

Paula Bejarano Carbo
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 was rising from early 2022 to mid-2023 due to the Bank of England's monetary tightening cycle, but has since been relatively stable. In the second quarter of 2024, the 10-year gilt yield has averaged 4.2 per cent, rising from 4.0 per cent in the first quarter of the year, driven by volatile short-term interest rate expectations and more recently, a rising term premium. Both developments may reflect increased uncertainty in markets following recent political events.

- With inflation falling to 2 per cent in May, we believe that, conditional on inflationary developments, the MPC may begin its monetary loosening cycle in August. 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. This would help adjust markets', and the wider public's expectations, to a particular, but not definite, trajectory of monetary loosening – potentially preventing future volatility in the gilt market.

- Most European countries, except for Germany, saw a slight uptick in term premia in June. This may be a consequence of the European Parliamentary elections, and the decision to call an election in France, given significant movements in our estimates of risk premia on impact following these events. Notably, the gap between France and Germany's 10-year bond yields is back to levels last seen during the 2017 French Presidential Election. Uncertainty over which parties will gain control in France adds to geopolitical risk that will affect the euro area more widely.

- The Federal Reserve remains cautious against an early interest rate cut given a stickier than expected inflation rate and a continuing strong labour market performance. Therefore, despite gradually falling, US treasury yields remain high due to elevated interest rate expectations and upwards-trending risk premia.

UK Term Premium

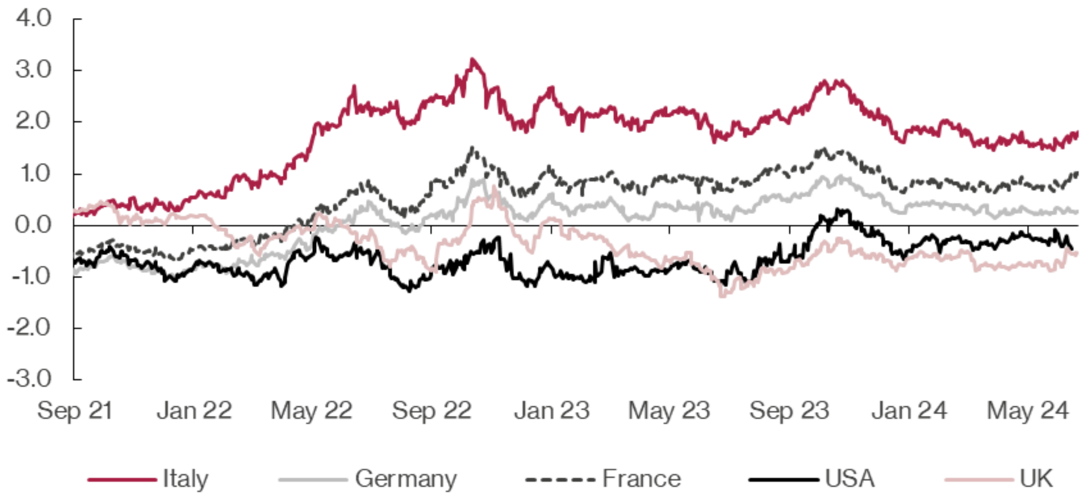
Since our last term premium tracker published in the first quarter of 2024, the 10-year UK government bond yield has averaged 4.2 per cent, rising from 4.0 per cent in the first quarter of the year. In this Tracker, we decompose long-term bond yields into two components: expectations of the future path 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 20 June.

Rising UK bond yields in the past two years have been driven by elevated short-term interest rate expectations in response to the MPC's aggressive monetary policy tightening cycle. That said, interest rate expectations have been on a decreasing trend since mid-2023, after peaking at 5.78 per cent in July 2023, the highest level since the second quarter of 2000. This overall moderation in interest rate expectations relative to last summer likely reflects significant falls in the CPI inflation rate. With CPI inflation falling to the Bank of England's 2.0 per cent target in May, monetary loosening is on the horizon. Broadly, this nearly year-long softening of interest rate expectations can be interpreted as a sign that markets also believe that the Bank's policy rate has peaked, and rate cuts can be expected in the coming months. That said, figure 1 above indicates that interest rate expectations have yet to fall below their December 2023 peak, when markets around the world became optimistic about the prospect of rate cuts in early 2024. Since last quarter, interest rate expectations have exhibited some volatility, possibly in relation to the announcement of the general election. In particular, interest rate expectations jumped 15 basis points on impact following the announcement of the general election on 22 May but have been steadily decreasing in June.

Overall, the corresponding term premium on UK 10-year government bond yields signals that investors are feeling confident about the path of short-term interest rates. However, the term premium has risen sharply since early June, rising 26 basis points between 7 and 10 June, the weekend in which the European Parliament elections were held. 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 term premia estimates among British and European economies illustrated in figure 2 are particularly suggestive of spillovers following these elections.

With inflation falling to 2 per cent in May, we believe that, conditional on price and wage inflation developments, the MPC may be able to begin its monetary loosening cycle in August. However, inflation is set to rebound somewhat in the second half of 2024 due to base effects and still-high core and wage inflation. As a result, this expected August rate cut may only be a small signal, and the MPC may proceed with caution throughout the rest of its tightening cycle. Whether this creates uncertainty for investors will become clearer in the coming months. NIESR have been arguing for some time now that the MPC ought to improve its communication; in particular, it may want to generate greater certainty around the expected pace of monetary loosening. 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.

Figure 2 – 10-year term premium estimates across countries (percentage points)



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

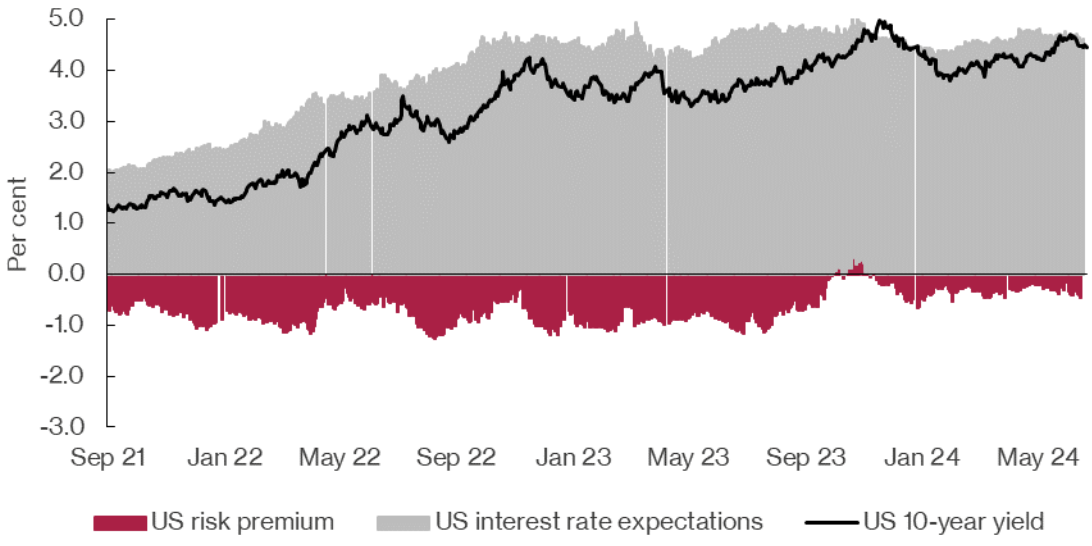
US Term Premium

After reaching a high of 4.8 per cent in October 2023, the 10-year US Treasury yield had gradually fallen to 4.2 per cent in the first quarter of 2024, driven by decreasing short-term interest rate expectations. Since then, yields rose in April and May, averaging 4.5 per cent, before returning to an average of 4.3 per cent in June.

Despite gradually falling, treasury yields remain high amidst elevated interest rate expectations and upwards-trending risk premia. This comes amidst sticky inflation rates, which have fluctuated around 3 per cent the past year, despite tight monetary policy. In addition, the labour market has recorded a stronger than expected performance, as indicated by the June 7th data release - coinciding with a jump from 4.28 to 4.43 per cent in yields in a single day. As a result of elevated underlying inflationary pressures, the Fed remains cautious against an early rate cut, as indicated by the decision to keep interest rates unchanged during the June 11-12 Federal Open Markets Committee (FOMC) meeting.

Uncertainty around the upcoming US elections is likely one of the main drivers of term premia. Additionally, given that interest rate cuts are taking longer to materialize than expected, there is a need for the FOMC to improve communication and let markets and the public know how it plans to conduct monetary loosening to minimize volatility and upward risks to the term premium.

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



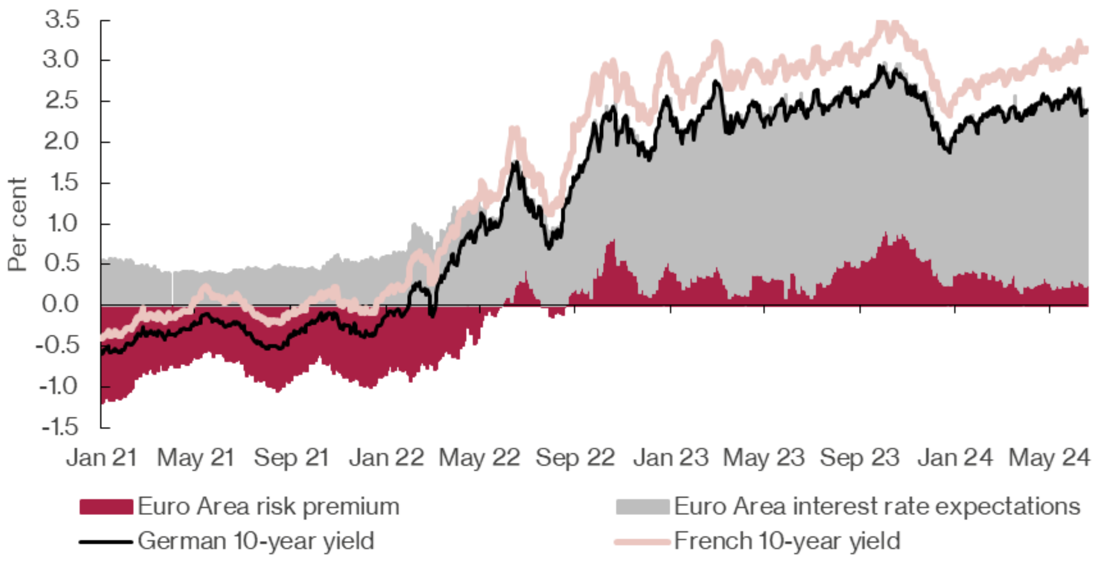
Source: Authors' calculations based on data by FRED database at the Federal Reserve Bank of St. Louis

Euro Area Countries' Term Premia

Since our 2024 Q1 tracker, European 10-year bond yields have remained largely stable, though rising somewhat. Term premia remained stable in euro-area countries during the majority of the second quarter of 2024, though all countries apart from Germany saw a slight uptick in June, particularly in the aftermath of the European Parliament elections. Thus, this recent rise in term premia might signal rising political uncertainty being priced into yields, especially in France, where term premia jumped by 10 basis points between the 7th and 10th of June, relative to a euro-area average rise of 7 basis points, and a 4 basis points rise in Germany. Notably, the bond yield spread between France and Germany remains close to its 7-year high (Figure 2).

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, especially the widening of risk premia spreads between major countries. Our decomposition of euro-area bond yields suggests that Italy and Greece remain decoupled from trend, with our latest term premia estimates for both countries between 0.5-1 percentage points higher than the euro area average. However, it is encouraging that this fragmentation has decreased in the second half of 2024, particularly for Greece – which previously had a term premium over 2 percentage points above the euro area average. Still, 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, when coupled with market fragmentation or possibly speculative dynamics the threats to financial stability certainly increase.

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

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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Notes for Editors

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