UK Macro and Financials

Government rather than consumer stress, although maybe consumer stress too

Industry Overview

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A different mix of stress to the last few times

UK rates and yields are not especially high in a historical (Exhibit 4) context, but the pace of increase has been rapid. We discuss in this report that while the mix of risks is unusual, historical UK fragilities are again on show. The consumer is surprisingly resilient, and as detailed in the BofA Global Research Equity report, UK Banks: Rapidly rising savings rates, mid-teens returns 04 July 2023, the banks are robust. Indeed, bank earnings are positively geared to higher yields. But this time, it is government finances at risk: we see a cumulative £200bn more interest (per BofA Global Research Economics; Exhibit 6) and £200bn of Bank of England losses.

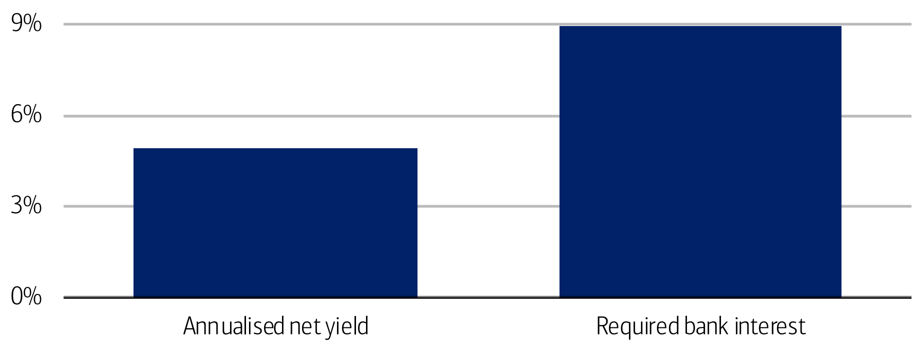
Consumer cashflows and behaviours may diverge

Because less than a third of households have a mortgage, consumer cashflows are potentially as impacted near term by higher interest on savings as higher mortgage rates (Exhibit 8). This is not the same as no stress: households with high savings may have a low propensity to consume, and households with mortgages may change spending in advance of mortgage repricing. But it dilutes monetary policy transmission (Exhibit 9).

Deposit movement to accelerate

Tax-free capital gains on Gilts with coupons as low as 1/8% mean that 2.5-year tax-equivalent yields are >8.5% for individuals (Exhibit 13). Retail ownership of Gilts is very low. However, the yield pickup for 45% tax rate payers is greater than for 50 years (Exhibit 1). We have not seen a 'tipping point' in consumer behaviours out of bank deposits into Gilts. However, the financial incentive is now material. Such moves would lead to banks reducing their hedges, which could exacerbate the move in swap rates.

Exhibit 1: Tax exemption for individuals and low-coupon Gilts make tax-equivalent yields high
Illustration of tax-equivalent yield on January 2026 1/8% Gilt



Source: BofA Global Research, Bloomberg

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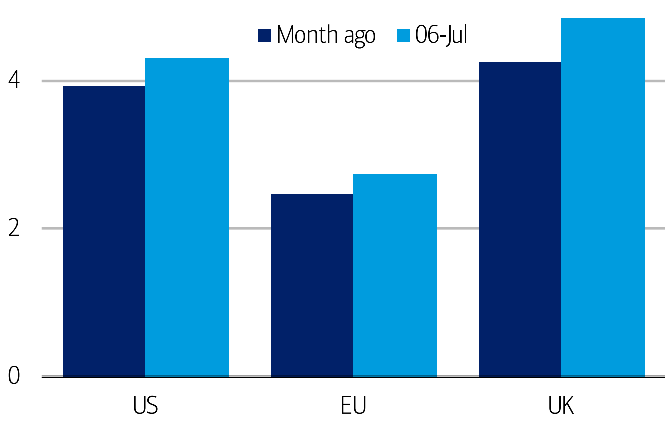
Same challenges in a different order

In the short time since we wrote UK Macro and Financials: Risk premium re-establishing as carelessness comes home (see our 28 June 2023 report), global yields have moved higher (Exhibit 2), and the risk premium of the UK has spiked to closer to historical averages (Exhibit 3).

Exhibit 2: German yields up 26bp, US up 37bp, UK up 59bpp
5-year bond yields (%), latest and one month ago



Source: Bloomberg

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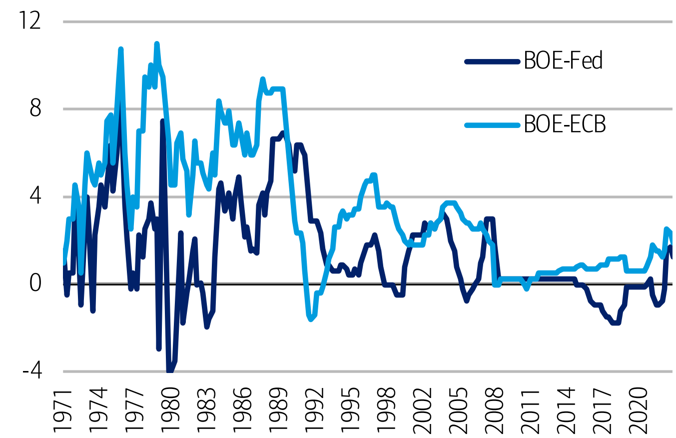
Exhibit 3: UK rates priced to be higher than US and EU from 2024
UK, US and German policy rate, 1971-2025



Source: Central Banks, Bloomberg

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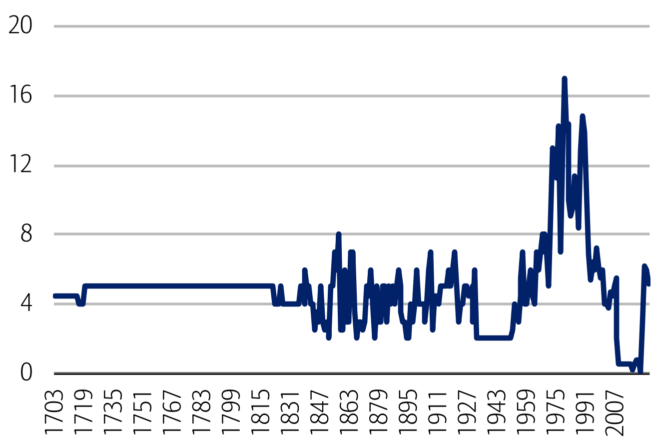
UK rates and yields are not especially high in an historical (Exhibit 4) and peer context, but the pace of increase has been unusually rapid. We discuss in this report that while the mix of risks is unusual, historical fragilities are again on show. The UK consumer is surprisingly resilient, and as detailed in UK Banks: Rapidly rising savings rates, mid-teens returns (see the 4 July 2023 Equity Research report), the banks are robust. Indeed, bank earnings are positively geared to higher yields. But this time, it is government finances at risk, and we see the rate of change in yields and rate forwards as potentially a challenge to UK markets.

Exhibit 4: Market pricing for Bank Rate to hit 6.5%, a relatively typical level historically
Bank of England Bank Rate 1701-2025



Source: Bank of England, Bloomberg

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Exhibit 5: Up six percentage points in two years
UK two year swap rate (%) 2021-23

Source: Bloomberg

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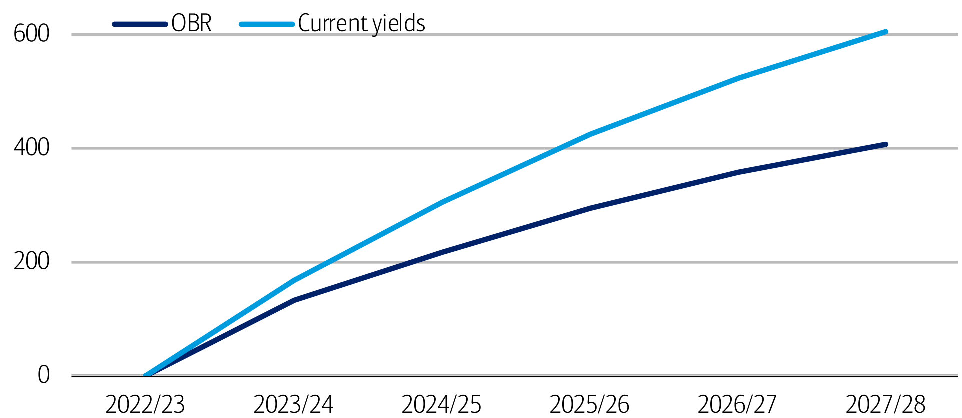
As discussed in UK Macro and Financials: Risk premium re-establishing as carelessness comes home (see our 28 June 2023 report), the £800 billion quantitative easing portfolio at the Bank of England and the £600 billion inflation-linked debt means that the UK faces the fiscal costs relatively rapidly. Exhibit 6 details the pass-through of £200bn in additional debt costs to the UK budget over five years should current yields prevail.

Exhibit 6: An additional £200bn in interest cost
UK government deficit, as expected by Office for Budget Responsibility and given current debt yields (£ bn) 2023-28



Source: BofA Global Research Economics estimates, OBR

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The precise path of borrowing will depend on whether the government can restrict government spending in nominal terms while allowing higher inflation than expected to boost tax revenues, as more taxpayers are dragged into higher tax bands. But adjusting government forecasts just for the likely change in debt interest costs (and another freeze in fuel duty), the UK could see a budget deficit of more than 5% heading into the election year of fiscal 24/25. Government debt to GDP would likely be on a rising trajectory.

Another £219bn on the debt from quantitative easing

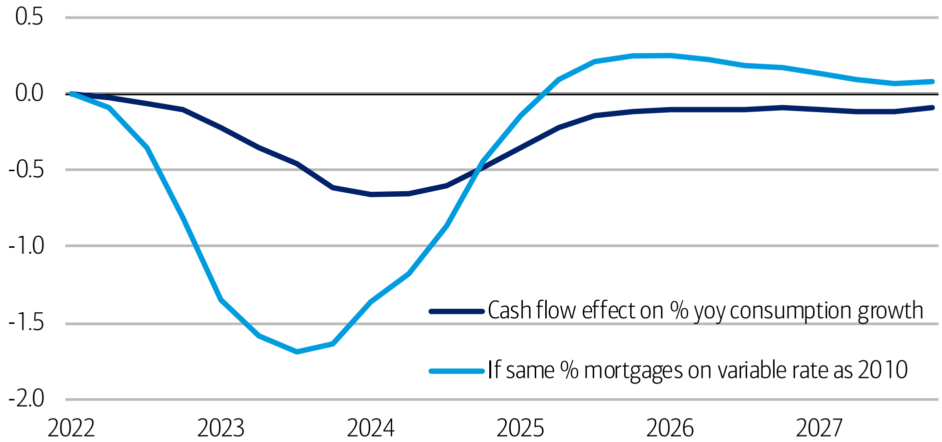
These deficit figures are not impacted by losses that the Bank of England has incurred on its £800bn quantitative easing portfolio. However, as the losses are realised, they will add to the government debt. BofA Global Research's rates strategists estimate that if yields remain at their current level, QE losses would total £219bn, close to 10% of GDP.

Consumer strain complex

It has been hard to avoid UK media coverage of the impact of higher yields on mortgage rates, and these are indeed striking. We discuss them in UK Viewpoint: Strong housing credit quality vs entrenched inflation = higher for longer (see our 9 June 2023 report). However, because so few mortgages reprice each year, the impact is heavily delayed.

We show in Exhibit 7 (BofA Global Research Economics) that with current yields, we estimate that the cash flow effect – which is just one channel through which rate hikes affect the economy – would cut y/y consumer spending growth a peak of 0.7ppt in early 2024. Had the same proportion of mortgages as in 2010 been variable rate, this cash flow effect would be 2.5 times larger and mean that the economy would almost certainly be in a material recession currently.

Exhibit 7: Fixed-rate mortgages mean that consumer cashflow impact slows; the Bank of England, we assume, realised this
Percentage-point impact on consumer spending of higher rates via mortgages (%), 2022-27E



Source: BofA Global Research Economics estimates

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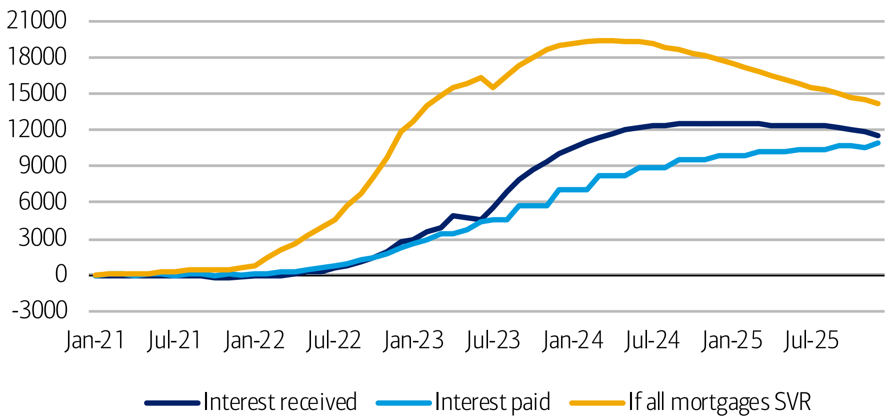
Compounding this, because less than a third of households have a mortgage, consumer cashflows are potentially as impacted in the near term by higher interest on savings as higher rates paid on mortgages (BofA Global Research Economics; Exhibit 8).

Exhibit 8: Interest received on deposits set to outpace mortgage payments near term
Household cashflow from higher rate (£ mn), 2021-25E



Source: BofA Global Research Economics estimates

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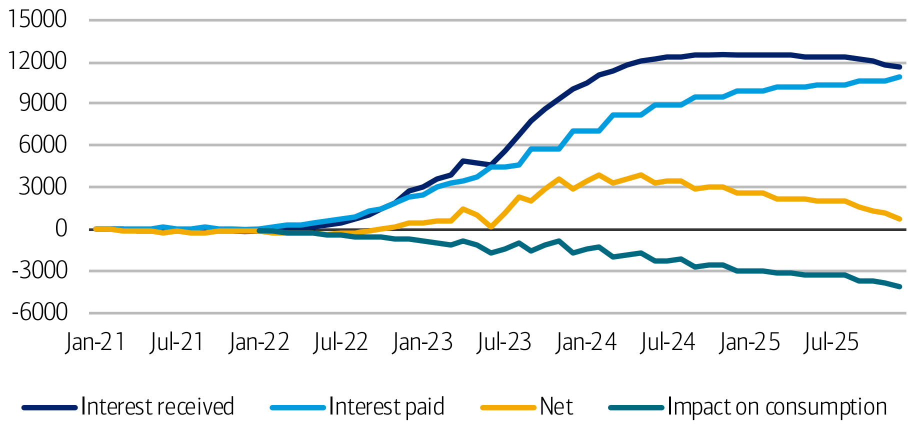
Different households; behaviours may change

This is not the same as there being no stress: cash flow effects of monetary policy work by shifting income away from households with a higher propensity to consume (debtors) to those more liable to save (savers). But it does complicate the picture and dilute the transmission of monetary policy to the consumer. We illustrate in Exhibit 9 (BofA Global Research Economics).

Exhibit 9: Consumer spending may decline even as consumer cashflow rises
Household cashflow from higher rate (£ mn) and changes to consumption, 2021-25



Source: BofA Global Research Economics estimates

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The rise in debt interest costs may eventually mean that households begin to see or expect higher taxes down the road. For instance, the government's freeze of tax thresholds is raising considerably more revenue than expected, due to higher inflation, which partially covers increasing interest costs. Such precautionary behaviour would likely be negative for GDP.

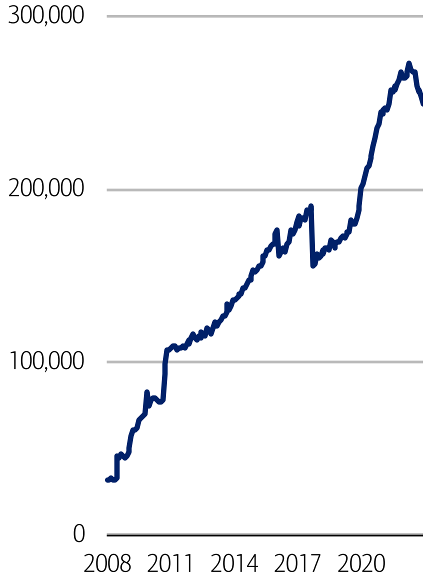
In short, the consumer's behaviour is likely to be complex and the government to struggle to meet its fiscal goals. What of the third leg in the system, the banks?

Banks – deposit outflows to accelerate

In contrast with 2008, the banking system is robust to this rate and yield shock. Indeed, higher yields are particularly valuable to the banks given the size of their deposit portfolio hedges. Nevertheless, it is relevant at times like this to consider convexities. Bank deposits have been very sticky and surprisingly price insensitive so far in this hiking cycle. We show in Exhibit 10 to Exhibit 12 that non-interest bearing current accounts have only declined a little following their eight-fold rise post the financial crisis and that total deposits remain very close to their peak on an improved mix.

Exhibit 10: Non-interest bearing current account balances reduced slightly after rising eight-fold

UK non-interest bearing deposits £mn, 2008-23



Source: BofA Global Research estimates, Bank of England

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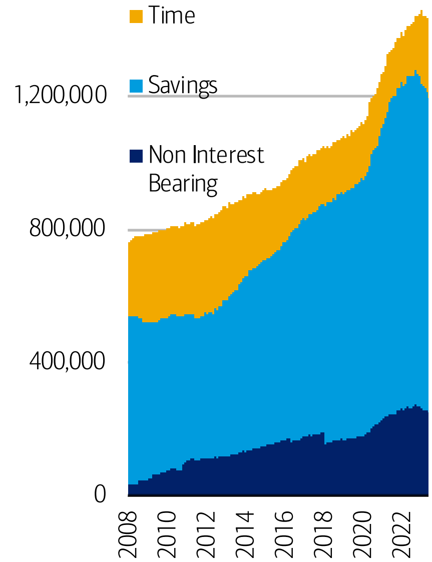
Exhibit 11: Total deposits have grown strongly, mix improved

UK household deposits by nature, 2008-23 £ mn



Source: BofA Global Research estimates, Bank of England

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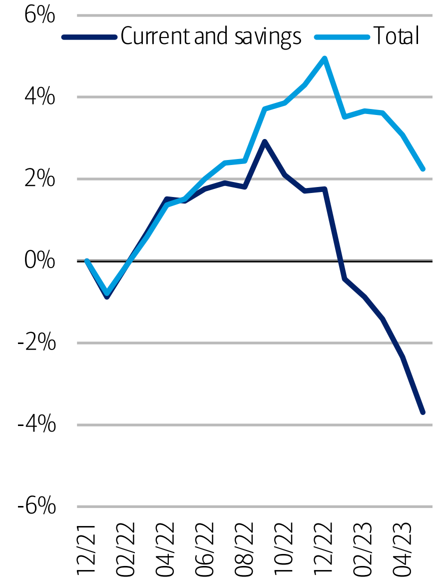
Exhibit 12: Deposits have declined only slightly since the start of the rate hike cycle

Cumulative change in household deposits since December 2021 (£ mn)



Source: Global Research estimates, Bank of England

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However, very significant yield rises would mean that banks need to anticipate a material acceleration in the move of their overnight deposits into term – or, as is beginning to emerge as a discussion in the media, to move out of deposits into Gilts.

Tax-equivalent yields 8.5%+ on 2.5-year Gilts

The tax-free nature of capital gains on Gilts and the significant number of very low-coupon Gilts outstanding means that for those willing to lock up cash for 2-5 years, the sort of duration time deposits often aim at, tax-equivalent yields of over 8.5% are achievable for individuals. We illustrate this in Exhibit 13 for a January 2026 bond with a particularly low 0.125% coupon.

Exhibit 13: Illustrative example of tax impact of capital gains exemption (%)

Low-price Gilts have significant effective yield pickup to bank deposits: recent pricing (£)

	Yield	Current	Price appreciation	Coupons	Total yield	Annualised gross yield	Marginal tax rate	Taxed coupon	Annualised net yield	Required bank interest
2026 1/8% Gilt	0.13%	0.877	12.30%	0.36%	12.66%	5.06%	45%	0.20%	4.90%	8.91%

Source: BofA Global Research estimates, Bloomberg

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Deposit outflows would drive hedge reductions

There has been little movement in deposits thus far, and retail ownership of Gilts is very low. However, the yield pickup for higher (45%) tax rate payers is greater than at any time in 50 years. We have not seen a 'tipping point' in consumer behaviours out of bank deposits into Gilts. However, the financial incentive is now material. Such moves would likely lead to banks reducing their hedges, which could exacerbate the move in swap rates.

Not a credit issue

We discussed in the 23 June 2023 Equity Research report, UK Banks: Attractive returns, unappealing backdrop, how the mortgage market is so much less risky for banks than in previous cycles. It is harder to generate stress in housing without forced sales by banks repossessing properties.

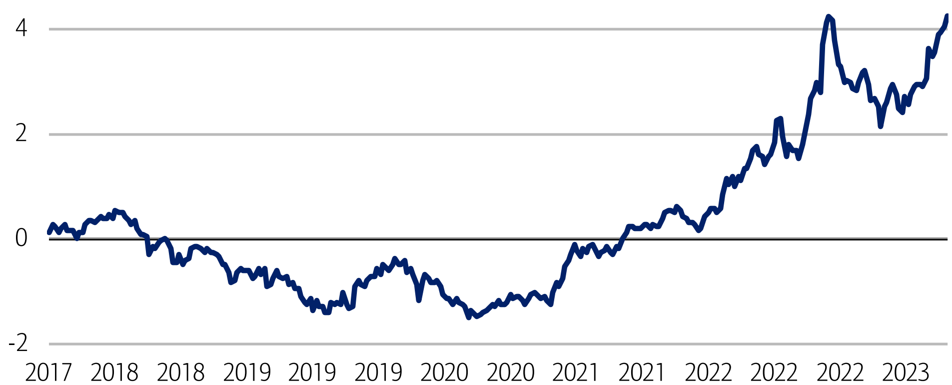
A 7% stress applied

People taking mortgages between 2014 and 2022 were typically stressed to mortgage rates of around 7%, where are we now, or at least where current 6.2% 2-year swaps imply that banks will likely be pricing in coming weeks. Loan-to-income caps provide further comfort on borrower distress. That said, likely mortgage rates are close to pushing above the bounds of those previous stress tests, raising the tail of borrowers in distress and risking sharper changes in household behaviour.

A UK issue rather than a bank one

We think that a move in deposits would be an earnings issue for banks, not a financial stability one. Indeed, as detailed in UK Banks: Rapidly rising savings rates, mid-teens returns (see the 4 July 2023 Equity Research report), we see the more-than-400bp benefit of average yield pickup dominating any reduction in the size of the hedge over time (Exhibit 14).

Exhibit 14: Hedges rolling onto 400bp more than expiries
UK swaps relative to 5 years ago (%), 2017-23



Source: Bloomberg

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We see the issue substantially a discount rate one, perhaps best summarised as "who will buy all these Gilts?". It may actually be the banks themselves – while they do not enjoy the tax benefit of consumers, the risk-adjusted return is now potentially elevated. But this would in turn lead to reduced lending capacity, unless the Bank of England were to ease capital requirements.

What we believe is under way is low growth, low investment and negative convexity in the government debt stack, leaving the UK uniquely exposed to higher yields. The banks will not, we believe, prove compounders of the issue, but the risk premium of the UK may persist.

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