European Rates Watch

UK rates forecasts: taking stock of 2023 so far

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A look-back at the UK rates relative to global counterparts

In Year Ahead 2023: Prepare for landing, 20 November 2022, we emphasized several macroeconomic fragilities that we felt would lead to Gilt underperformance (relative to forwards and to peers):

(1) the increasing dependency on the kindness of strangers (the need for overseas investors to buy even more Gilts than they had been doing),

(2) the negative feedback loop between an increasing shortfall in the Bank of England (BoE) Asset Purchase Facility (APF) Gilt portfolio and the deficit-increasing losses crystalized on sales, and

(3) a burgeoning current account deficit with a deteriorating International Investment Position (IIP).

As September draws to a close, we take a look-back at the UK rates losing then regaining some of the ground relative to global counterparts since the start of the year (Exhibit 1). We then outline our thoughts on what to expect ahead.

- UK rates underperformed during the global bond selloff in December 2022, at least partially due to an unusual Gilt supply dynamic into year-end. Despite the normal slowdown in Gilt sales from the Debt Management Office (DMO) in December, the amount of Gilts supplied to the market actually peaked in December 2022 (Exhibit 2). The culprit was BoE selling – both the disposal of its recently acquired "financial stability portfolio" and the delayed start of its APF "active" Gilt sales programme. Some £32bn of Gilts hit the market in December 2022, compared to just under £2bn when the BoE was a buyer in October.

- Cross-market underperformance gave way to performance in early 2023 with market participants drawing encouragement from the quick unwind of the BoE's financial stability portfolio. Fiscal risks stemming from political developments seemingly moderated, with S&P bringing the UK's credit rating outlook back to 'stable' in late April (Moody's and Fitch maintain a 'negative' outlook).

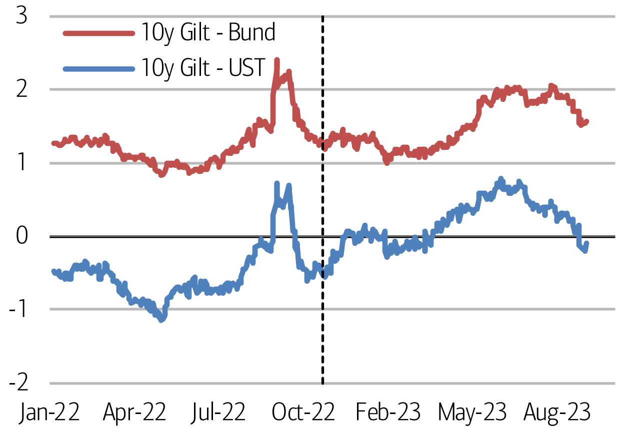
- But performance was relatively brief. The new fiscal year in April brought 'macro fragilities' back to focus, with the effective net supply of Gilts (DMO and BoE combined) projected to equate around 8% of GDP in the new fiscal year. Investor sentiment in Gilts deteriorated relative to sentiment in USTs (Exhibit 3). Inflation exceeded expectations. Overseas' investor demand for Gilts remained weak relative to years prior.

- The downside inflation surprise in September was the latest leg in UK cross-market catchup. 10y UK-US swaps are back to trading flat, as was the case at the start of 2023. *(Continued on next page)*

Timestamp: 29 September 2023 12:00AM EDT

Positioning and sentiment are now long outright and less short relative to the US and Europe. Better than expected public sector finances (Exhibit 4), and back revisions to growth likely aided the outperformance.

Exhibit 1: 10y Gilt performance relative to Bund and UST, %
UK rates losing then regaining ground versus global peers since November



Source: Bloomberg, BofA Global Research
Dashed line marks 20 November 2022, our Year Ahead 2023 publication date.
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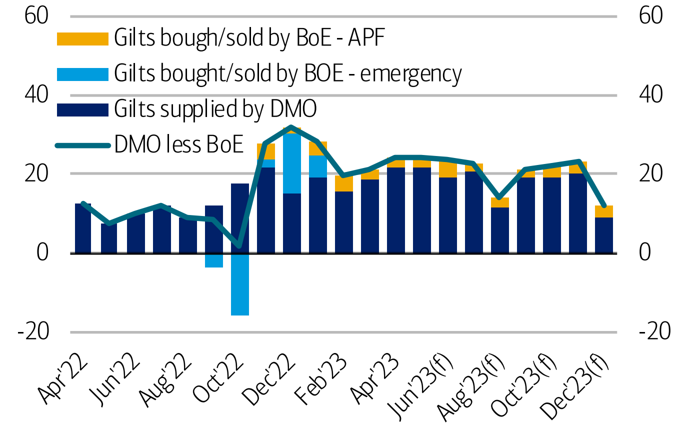
Exhibit 2: Gilt supply from the DMO and BoE, £bn (cash)
Unusual peak in December 2022



Source: Debt Management Office, Bank of England, BofA Global Research
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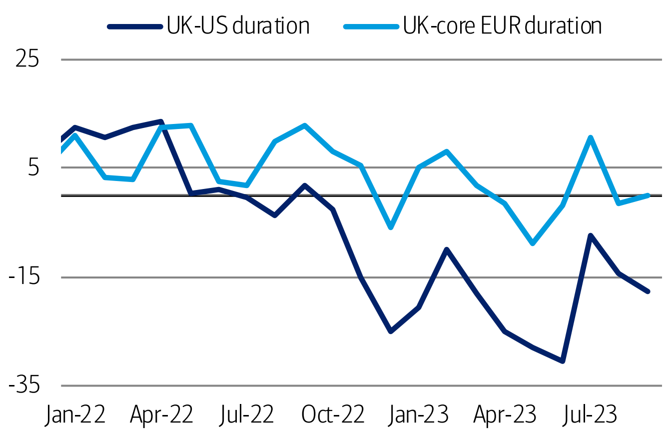
Exhibit 3: UK-US & core Europe duration exposure
UK vs US and Core EUR Bull-Bear rates exposure spread



Source: BofA Global Research FX and Rates Sentiment Survey
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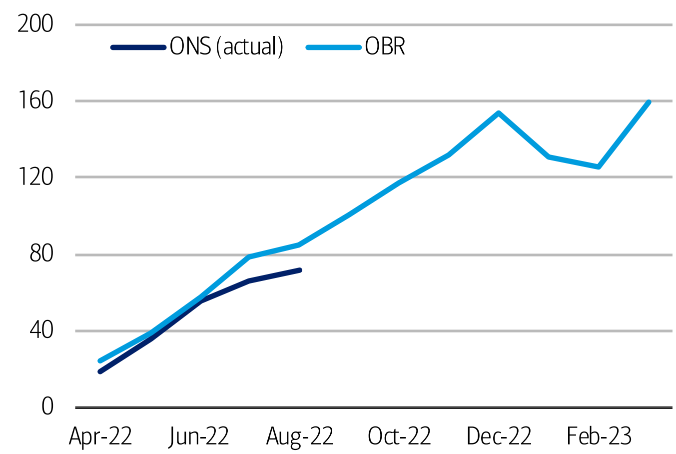
Exhibit 4: CGNCR ex. B&B, NRAM, Network Rail and CCFF (GBPbn, cum)
Nearly £13bn undershoot relative to forecast fiscal year to date



Source: ONS, OBR, BofA Global Research
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Tweaks to UK rates forecasts after last week's changes to our Bank rate call

We have recently tweaked our UK rates forecasts after last week's changes to our Bank rate call (Exhibit 5 and Exhibit 6). Our Chief UK Economist Rob Wood now expects the BoE to keep rates on hold at 5.25% through 2024. Previously we expected the BoE to hold at 5.5% through 2024. We expect four 25bp rate cuts in 2025 versus five previously. Fewer hikes now substitute for fewer cuts later (see Bank of England review: none and done, probably, 21 September 2023).

Front-end: In the near term, "high for long" leaves us slightly more bearish on 2y Sonia than would be implied by the forwards. But over the forecast horizon, the forecast for the 2y rate falls below current market pricing.

Duration: Our 10y Sonia forecast lies in-line with the forwards in the near term but goes above the forwards towards the end of forecast horizon. Relative to US and EUR forecasts, they imply some underperformance on cross-market basis.

Exhibit 5: Gilt yield forecasts, %
We forecast 10y Gilts at 4.25% throughout forecast horizon

	Gilts			
	Now	Q4 2023	Q4 2024	Q4 2025
Bank rate	5.25	5.25	5.25	4.25
2y	4.57	4.50	4.25	3.25
5y	4.24	4.25	4.50	3.75
10y	4.33	4.25	4.25	4.25
30y	4.69	4.50	4.50	4.50

Source: Bloomberg, BofA Global Research

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Exhibit 6: Sonia yield forecasts, %
We forecast 10y Sonia at 4.25% throughout forecast horizon

	Sonia			
	Now	Q4 2023	Q4 2024	Q4 2025
3m Sonia	5.28	5.25	5.00	4.00
2y	5.07	5.00	4.25	3.25
5y	4.48	4.50	4.50	3.75
10y	4.23	4.25	4.25	4.25
30y	4.10	4.00	4.00	4.00

Source: Bloomberg, BofA Global Research

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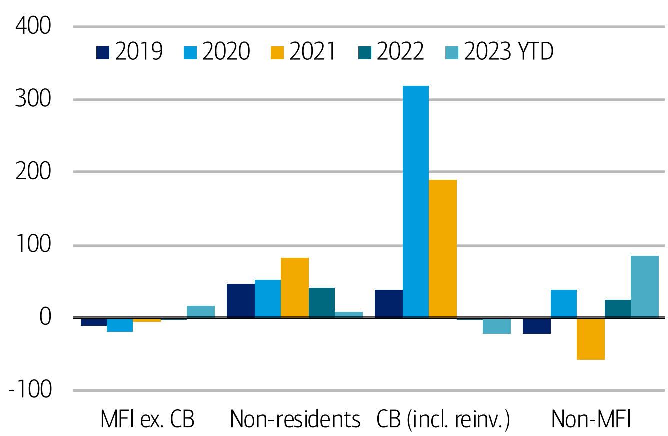
While we do not completely disagree with the recent cross-market price action (reflecting bearish developments elsewhere more than bullish domestic developments, we would say), we lean bearish UK rates over the medium term:

- As expected in late 2022, overseas investor demand for Gilts has been weak YTD when compared to previous years, with domestic non-bank investors the dominant buying year-to-July (Exhibit 7). Based on seasonality, Q4 tends to be strongest quarter in terms of overseas' buying of Gilts. In our view, the issue of "who will buy Gilts" might ease, but will not go away completely.
- The threat of an APF "negative feedback loop" has been contained for now. The Gilt sell-off and the shift higher in the Sonia curve will mean that negative carry and crystalised losses on active sales translate into larger transfers from the Treasury to the APF than we were expecting. However, so far, the likelihood that this will lead to an increased Gilt funding need has been reduced by an underlying improvement in the public finances (thanks to fiscal drag).
- The interaction between the current account deficit and IIP position is still a long-term concern for the UK, we would argue. However, material back revisions to net external assets and liabilities data does make the picture less threatening than it seemed a year ago.

Swap spreads:_If we are right that the BoE might skew "active" Gilt sales shorter early next year, this should aid cheapening of short-dated Gilts relative to Sonia (see Rates – UK section of High & tight, 22 September, and Exhibit 8). DMO issuing even larger proportion of Gilts in the short-end than this fiscal year would be another potential catalyst, likely in Q2 2024. We reflect that in our front-end swap rate forecasts.

Exhibit 7: Net buying of Gilts per investor type per year, £bn
Very weak non-resident buying of Gilts relative to previous years



Source: BoE, BofA Global Research

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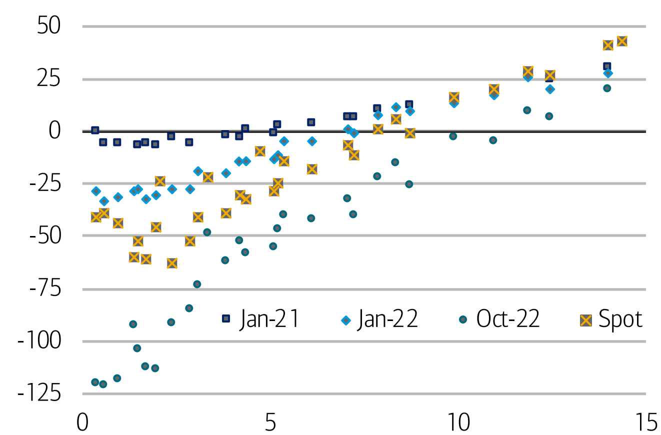
Exhibit 8: Gilt z-spreads to Sonia versus duration, bp
Less expensive than in late 2022, but still expensive relative to Sonia



Source: Bloomberg, BofA Global Research

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