

GBP Rates Report

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Market developments

Latest developments: the past three months

Summarising some key developments in Sterling markets in the past 3 months:

- **OIS rates** have seen a 'round-trip', rallying in June by 25bp and subsequently reversing that move.
- **Sterling** strengthened against the US Dollar in June (while OIS rallied), and then reversed that (as OIS rates sold-off).
- **Gilt yields** rallied (by less than OIS) in June, and that decline has been more than reversed since then and especially at the long-end. 25y Gilt yields end the period a full 40bp higher.
- **Equities** rallied strongly by a cumulative 5% over the period, and concentrated in the period from July to mid-August.

This pattern points to greater fiscal risks creeping into market pricing, especially in the past 2 months. While fiscal slippage boosts aggregate demand directly, some crowding-out from these interest rate responses should also be expected. Fewer rate cuts have been priced in the past month to take place over the next year, and this has tended to weigh on Equity prices. Internationally, these interest rate effects appear to have emanated from the US and UK more than from Japan or Germany.

An increased incidence of negative Supply shocks is part of the broader macro message highlighted.

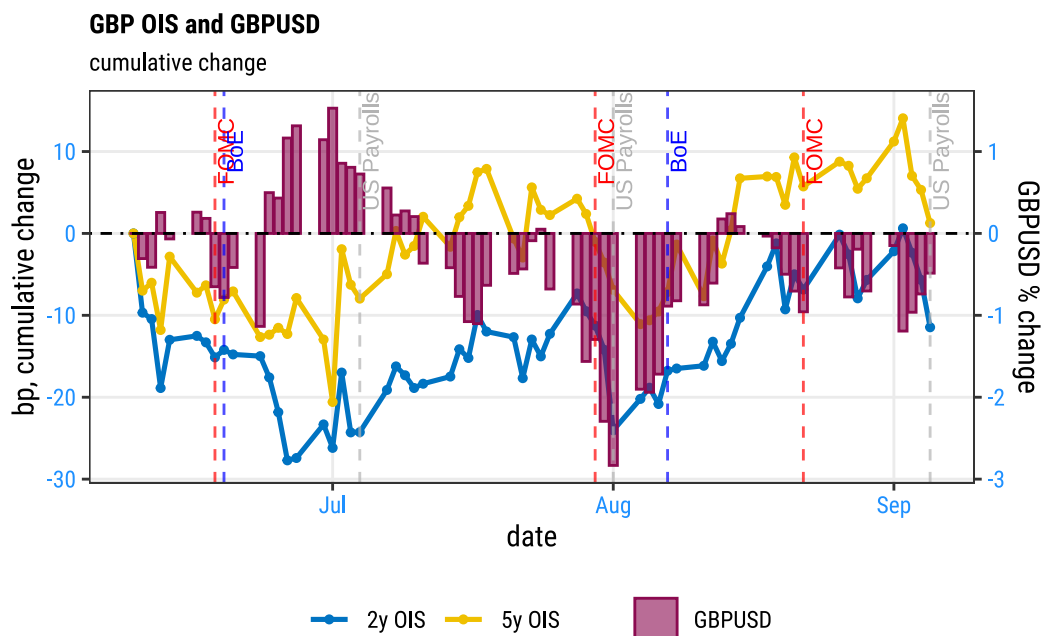


Figure 1: OIS and Sterling

Spreads (term spreads, swap spreads)

Term spreads Setting some historical context for the recent spread of 10y Gilt yields relative to 2y Gilts yields is Figure 3. This shows how a term spread has been restored relative to different periods over the past 10 years and can distinguish several phases over that period.

The 10s25s term spread has widened in recent weeks, and by more than the 2s5s and 5s10s spreads (Figure 4).

Swap spreads shed light on potential effects from bond supply in different markets. Swap spreads have moved more deeply negative in recent weeks and by more in the UK than in the US or Germany.

Fiscal developments have likely played a role in the rise in term spreads and widening of swap spreads. @fig_swsp shows 5y swap spreads (see here for a discussion).

[contribution from OIS and bond yields to changes in swap spreads in UK, US, GER since 2022-01-01]

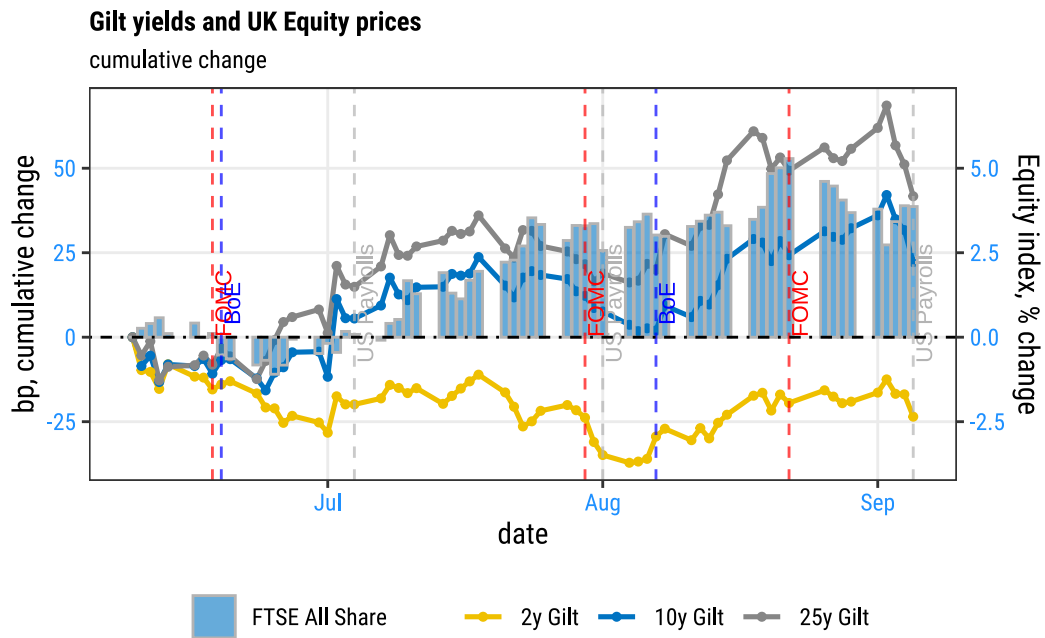


Figure 2: Gilts and Equities

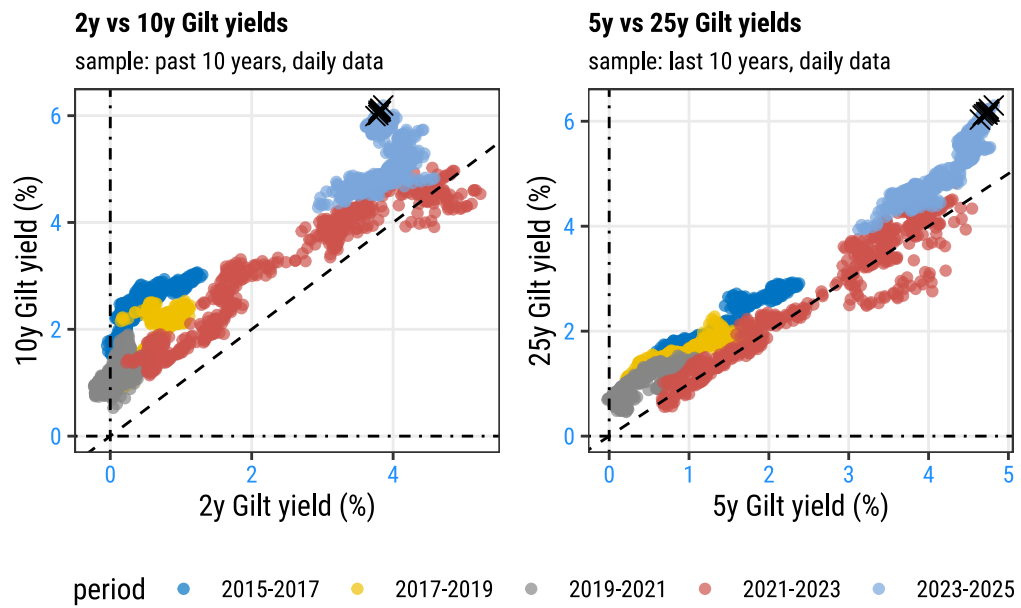


Figure 3: Gilt yields

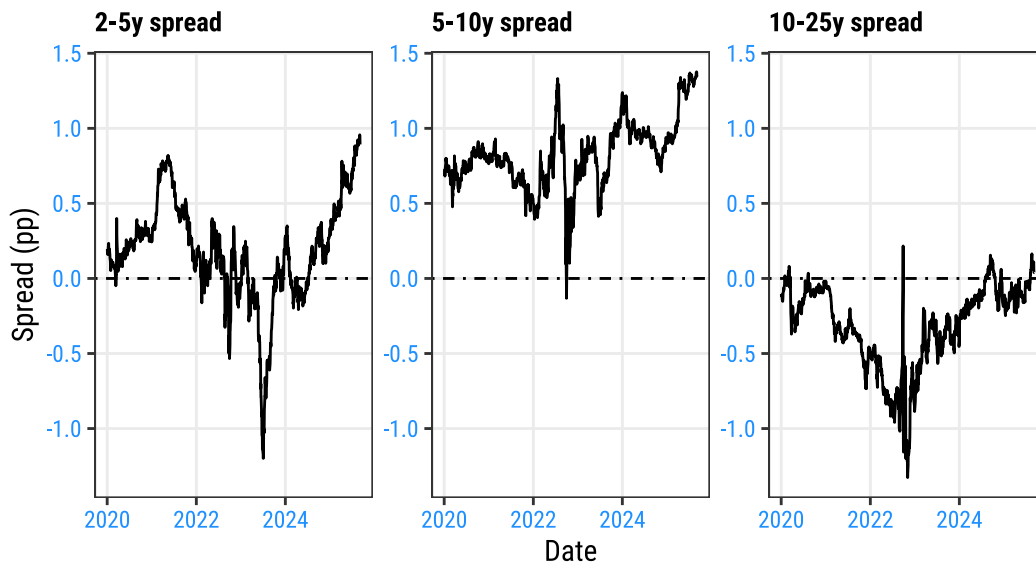


Figure 4: Term spreads in Gilt yields

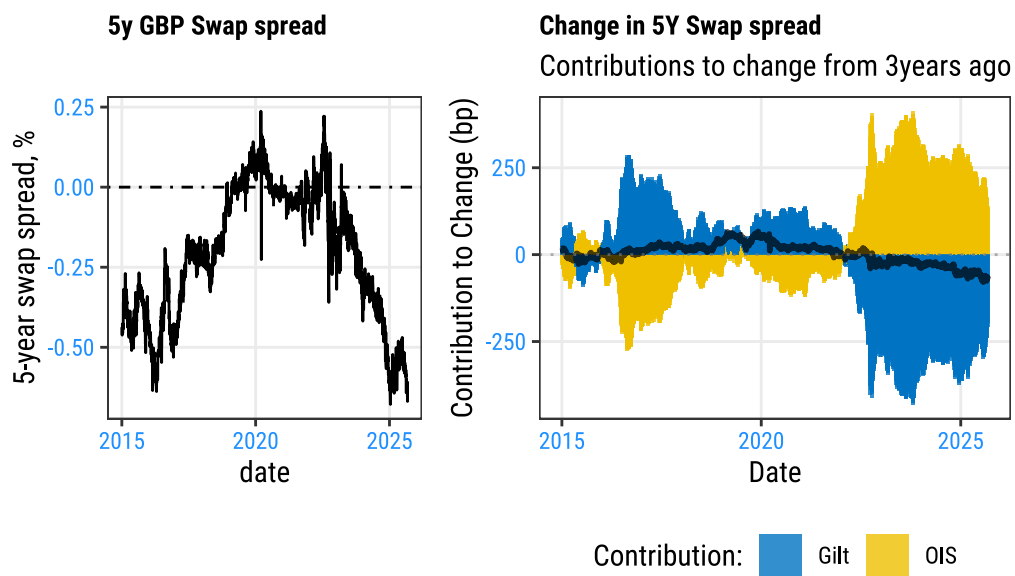


Figure 5: 5y swap spreads

Evolving market pricing and OIS curves

Reflecting related developments over a longer period, Figure 6 shows how GBP OIS curves have evolved over time, alongside the MPC's Bank Rate decisions. Research has shown how the persistent forecast errors shown in this chart reflect a gradual process of learning about slow-moving, medium-term factors such as the neutral and trend productivity growth.

Figure 7 zooms-in on how OIS curves and Bank Rate have evolved over the past year. [check this chart]

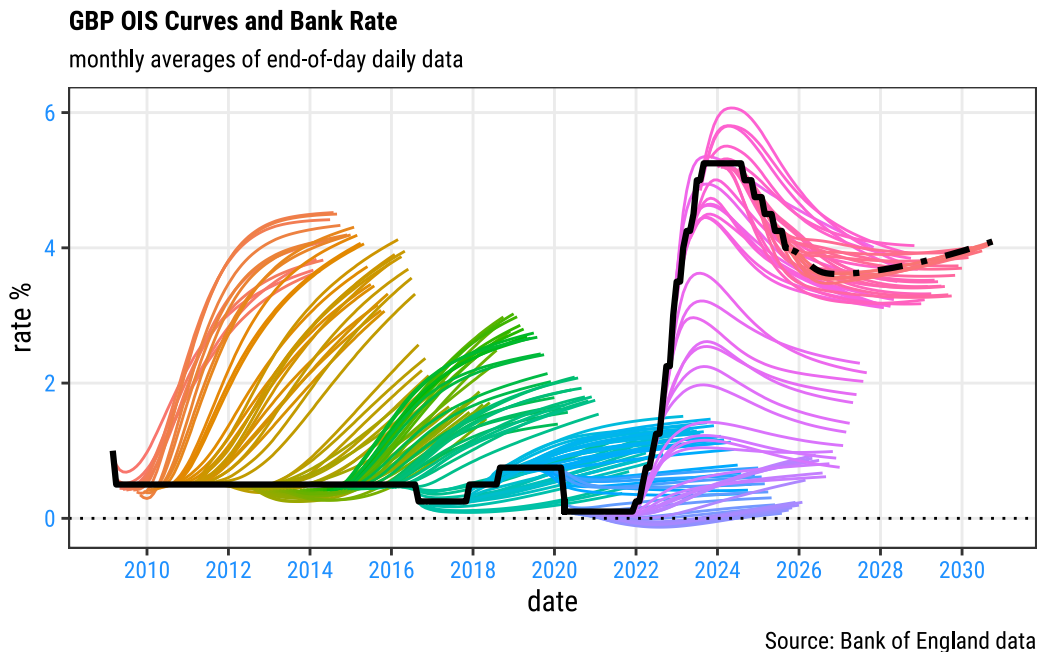


Figure 6: Evolution of GBP OIS curves

Neutral rates We limit our discussion of neutral rates. Figure 8 shows estimates since the pandemic based on a survey of market participants in Sterling markets. In principle, this survey should embody informed assessments of the impact on neutral rates from a broad set of influences. I simulate individual responses based on the reported summary statistics published by the BoE in its Market Participants Survey (MaPS).

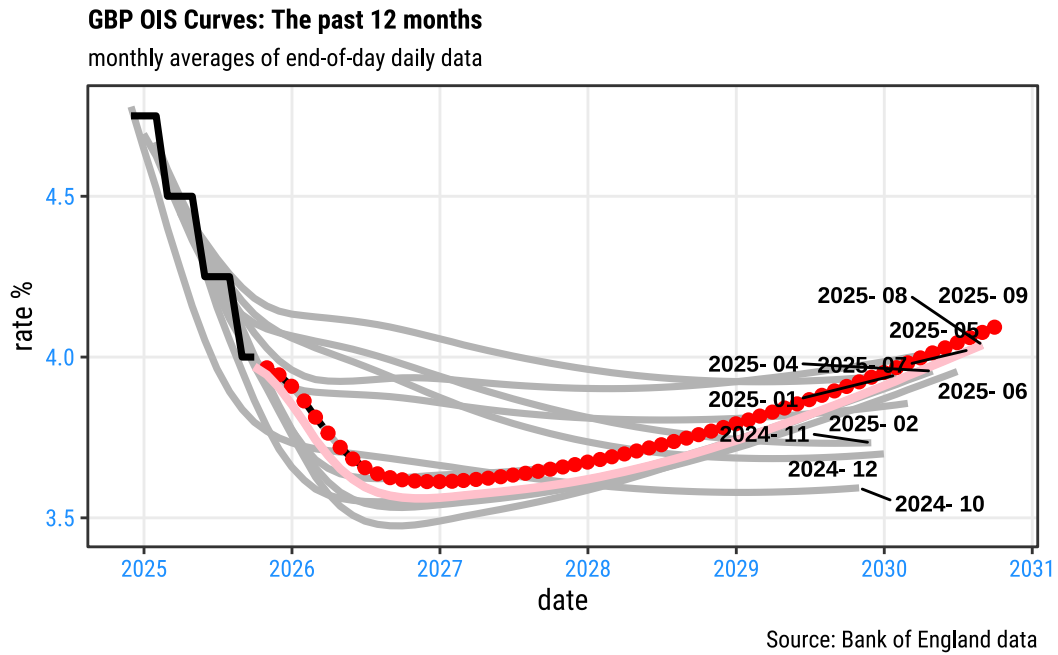


Figure 7: More Recent Evolution of GBP OIS curves

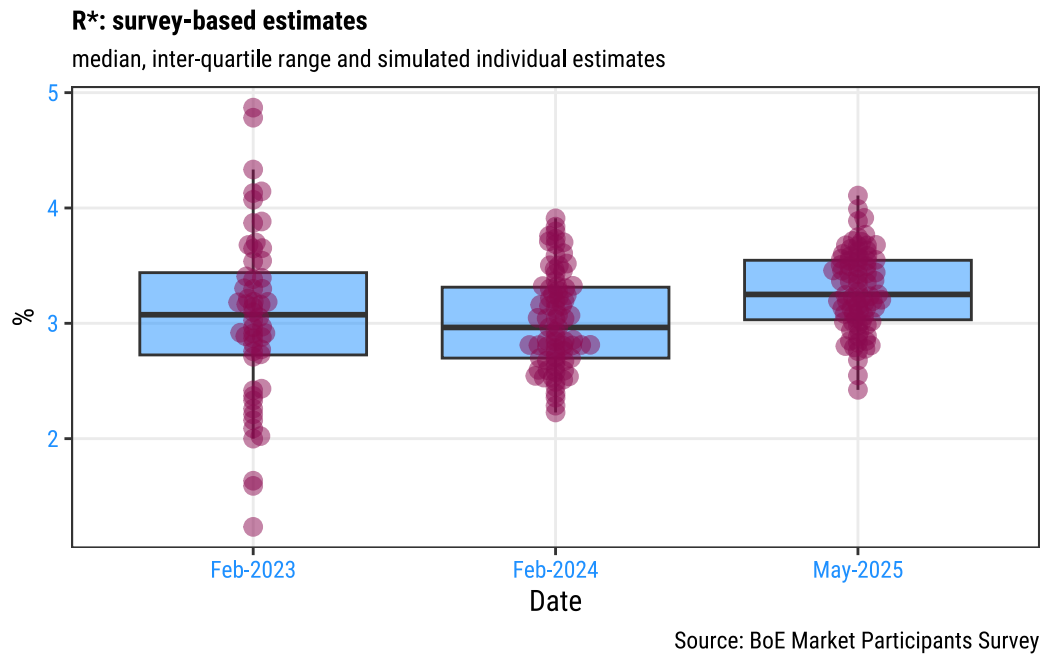


Figure 8: Market Participants Survey: Neutral rate estimates

International spillovers in sovereign bond markets

What of international spillovers in bond markets? Using the Rigobon (2003) methodology, we can estimate the extent to which international spillovers have contributed to fluctuations in 10y Gilt yields. With bond markets ‘spilling over’ to one another, this aims to quantify to what extent different markets were ‘in the driving seat’ at a point in time.

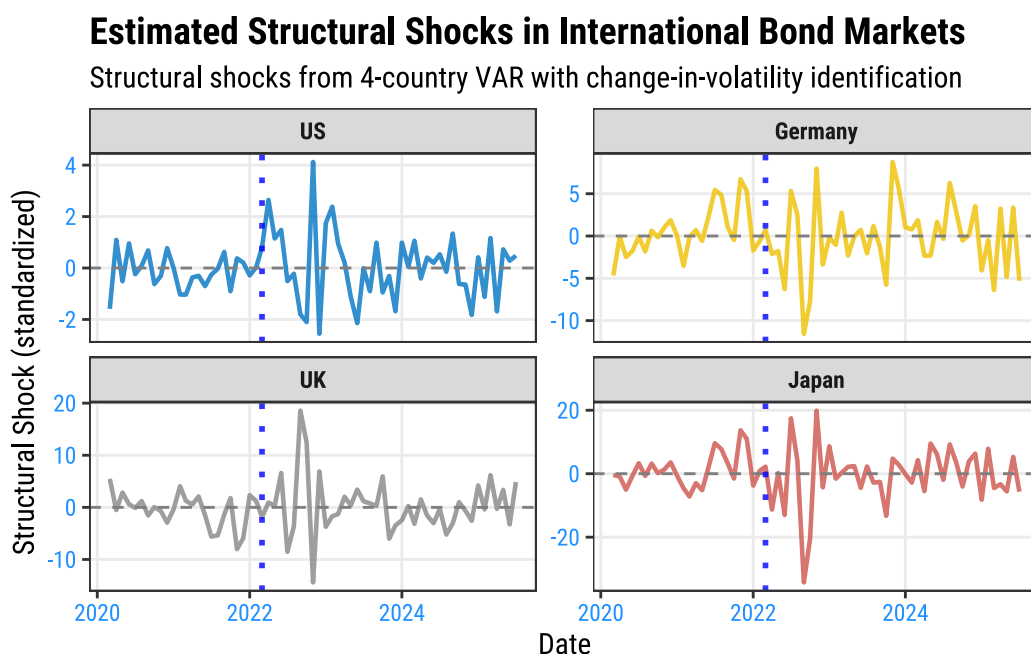


Figure 9: International spillovers

Fiscal risks

The (international) risk of fiscal fatigue

Fiscal fatigue occurs where a further fiscal effort is needed to stabilise public debt-to-GDP, but the political will to implement the necessary tax rises or restraint in public spending wanes.

We estimate the UK still has a required fiscal effort of 3% of GDP to stabilise its Debt-to-GDP ratio. While completing that required fiscal effort is forecast by the OBR, the issue is whether that political

will exist, absent risk premiums being priced by markets. That risk of fiscal fatigue likely lies behind the periodic risk premiums in Sterling markets, including reflected in term spreads and swap spreads shown previously.

Uncertainty in this estimate of fiscal effort means it is worth showing the debt-stabilising primary balance for different combinations of 'r' (effective nominal interest rate on government debt) and 'g' (expected nominal growth rate). Estimates in @tab-dspb suggest the debt-stabilising primary balance would be around 0.5-1.0% of GDP, compared with a primary balance at -2.0% in 2024.

By international standards, this is xxx. [France stands out.]

Populism likely adds to this risk of fiscal fatigue, including in the UK and France.

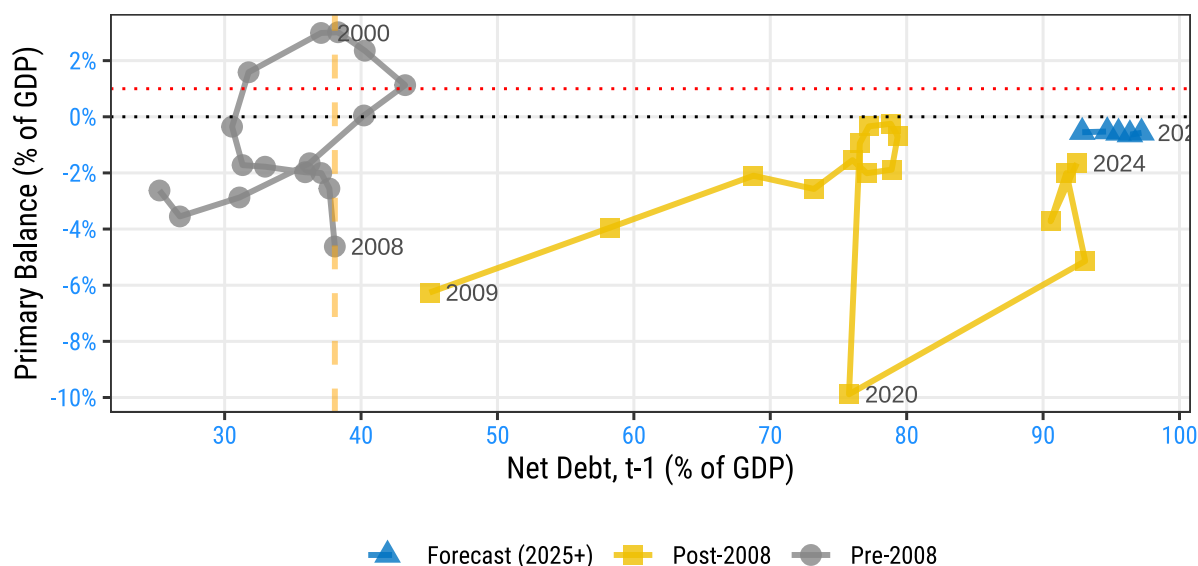
Macro and fiscal news at UK fiscal events

Fig for indiv fiscal events

A fiscal downgrade of 30bn would, based on this relationship, point to tightening of A key issue in the Budget will be how front-loaded is that tightening.

The fiscal reaction

A positive slope implies debt-stabilisation



Source: IMF Fiscal Monitor

Figure 10: Debt-stabilising primary balance

Market reactions and macro news at recent BoE policy events

Analysing monetary policy shocks

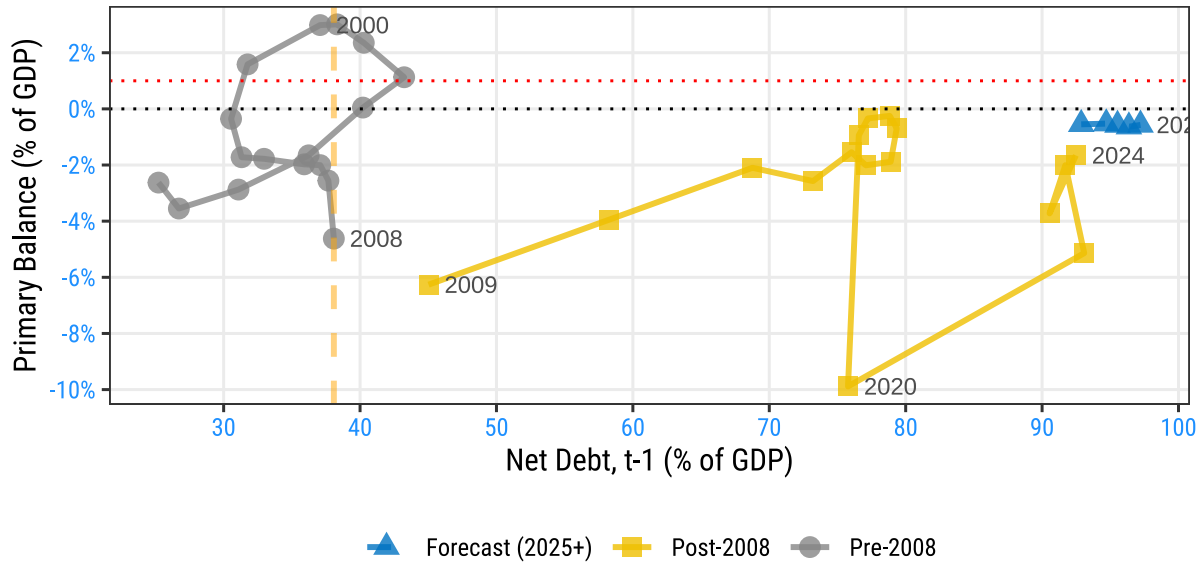
We now review how financial markets – OIS, Gilts, Foreign exchange and Equities – reacted to news at BoE policy events. These reactions are summarised in Figure 13.

Evolving macro forecasts and macro news

Those market reactions may owe partly to the MPC's own assessment of the UK macro outlook, eg. under the so-called information channel of monetary policy.

The fiscal reaction

A positive slope implies debt-stabilisation

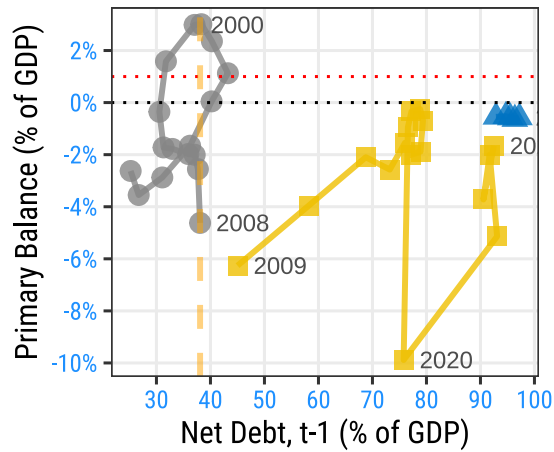


Source: IMF Fiscal Monitor

Figure 11: The fiscal reaction

The fiscal reaction

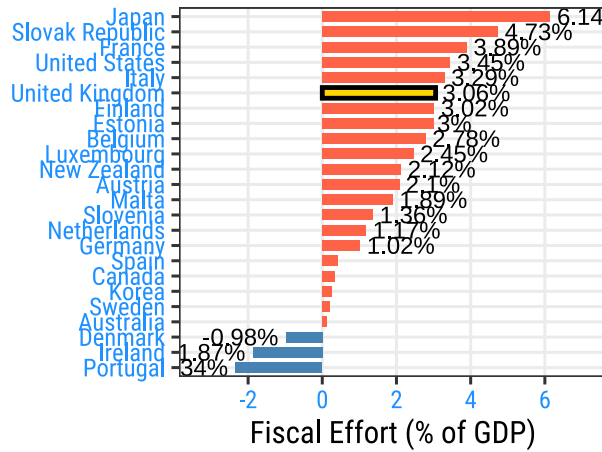
A positive slope implies debt-stabilisation



Source: IMF Fiscal Monitor

Required Fiscal Effort

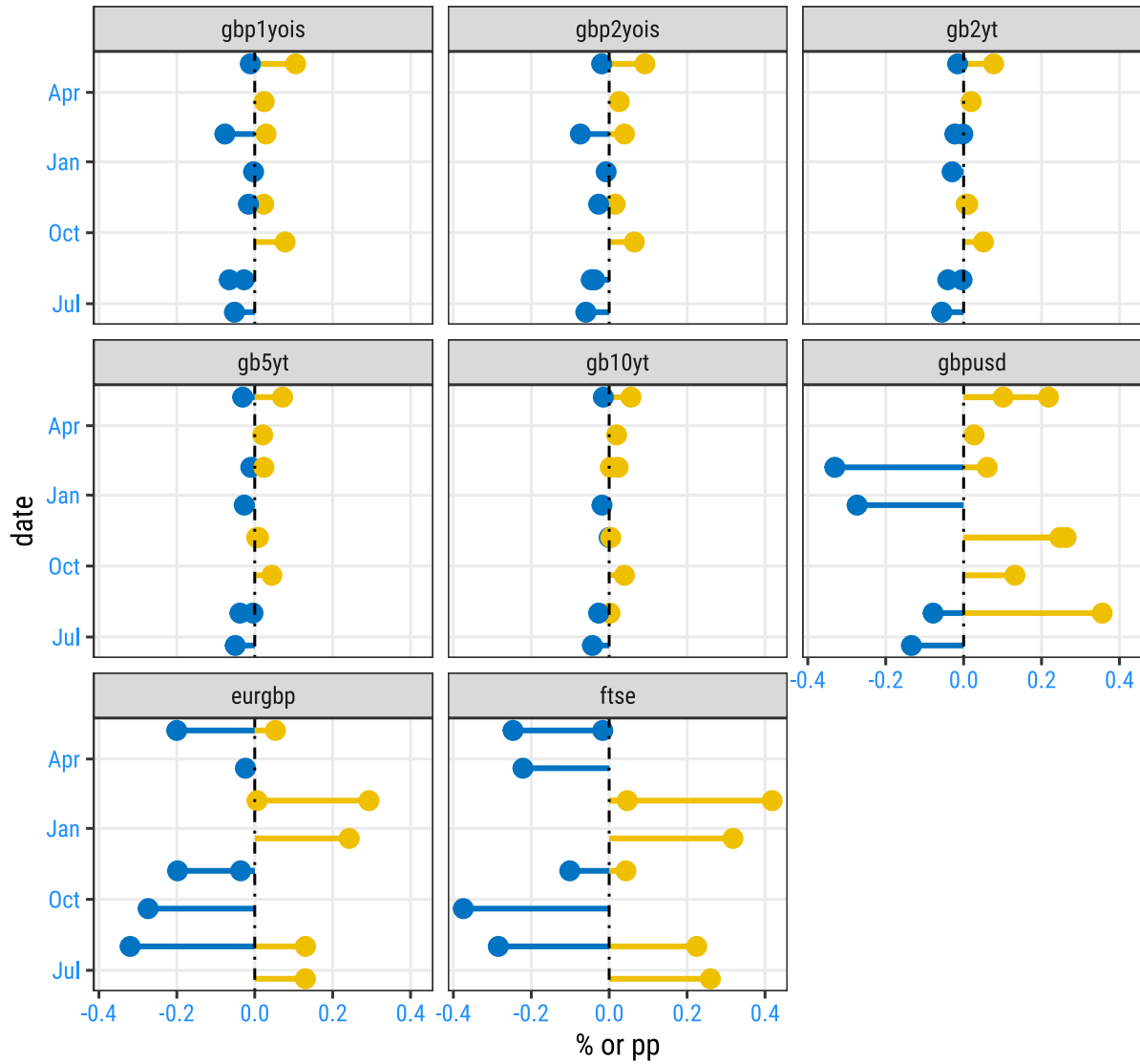
Positive values indicate effort needed



Source: IMF Fiscal Monitor and WEO

Figure 12: The fiscal reaction

Asset price reactions at MPC meetings



Sources: Braun et al (2025) and own calculations

Figure 13: Asset price reactions at MPC announcements

Medium-term Over the past decade or more, the MPC has tended to revise higher its forecasts for inflation, revise its outlook for unemployment lower, without an obvious bias in its forecasts for GDP growth. This points to a pattern of the BoE having had to respond to negative supply shocks, updating its assessments in the light of that repeated pattern.

The weakness of productivity growth, negative terms of trade shocks (e.g. Brexit, pandemic, Ukraine), and the impact of these on real incomes, have all contributed to this pattern of revisions and evolving macro forecasts.

Recent updates Looking over the past six MPC forecasts...

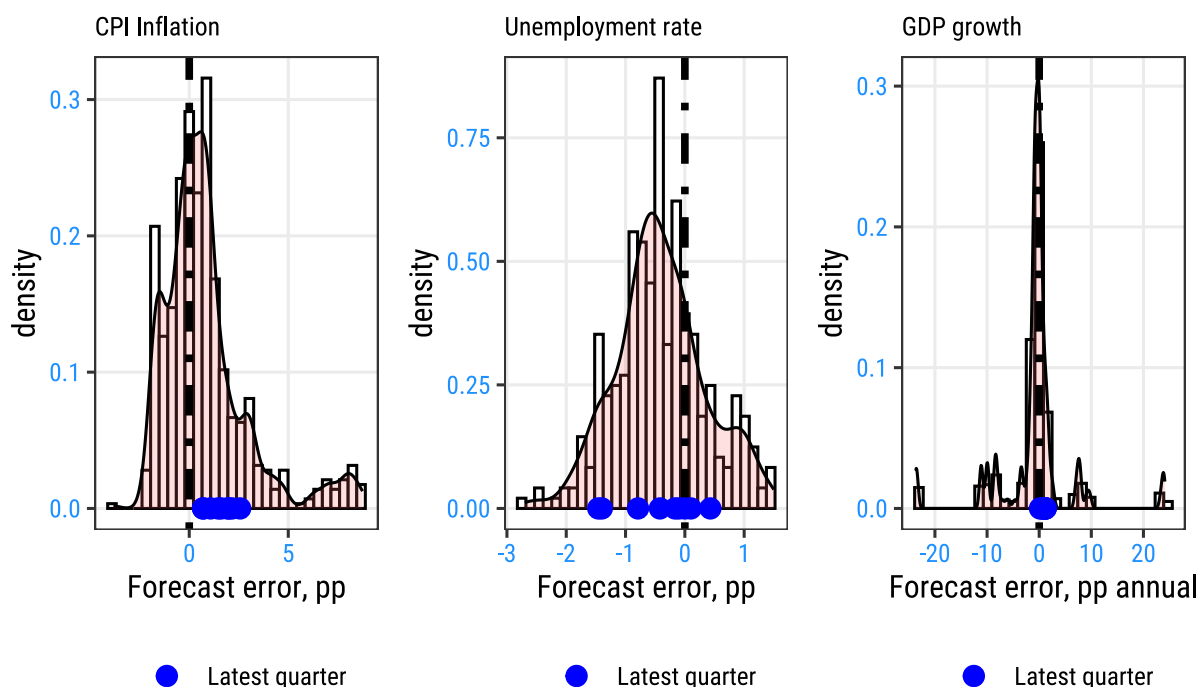


Figure 14: Distribution of BoE Forecast errors

Evolving inflation forecasts

Based on the pattern of past BoE forecast errors, a realistic path to overshooting the 2% inflation target, is that the MPC produces too optimistic inflation forecasts and retaining too little policy restriction to complete the disinflation.

Risk premium episodes tilt hawkish for monetary policy

MPC Voting: increased disagreement

We inspect MPC voting patterns to illustrate two points. First, the rising extent of disagreement among MPC members. Second, how current MPC member voting compares with that of past members.

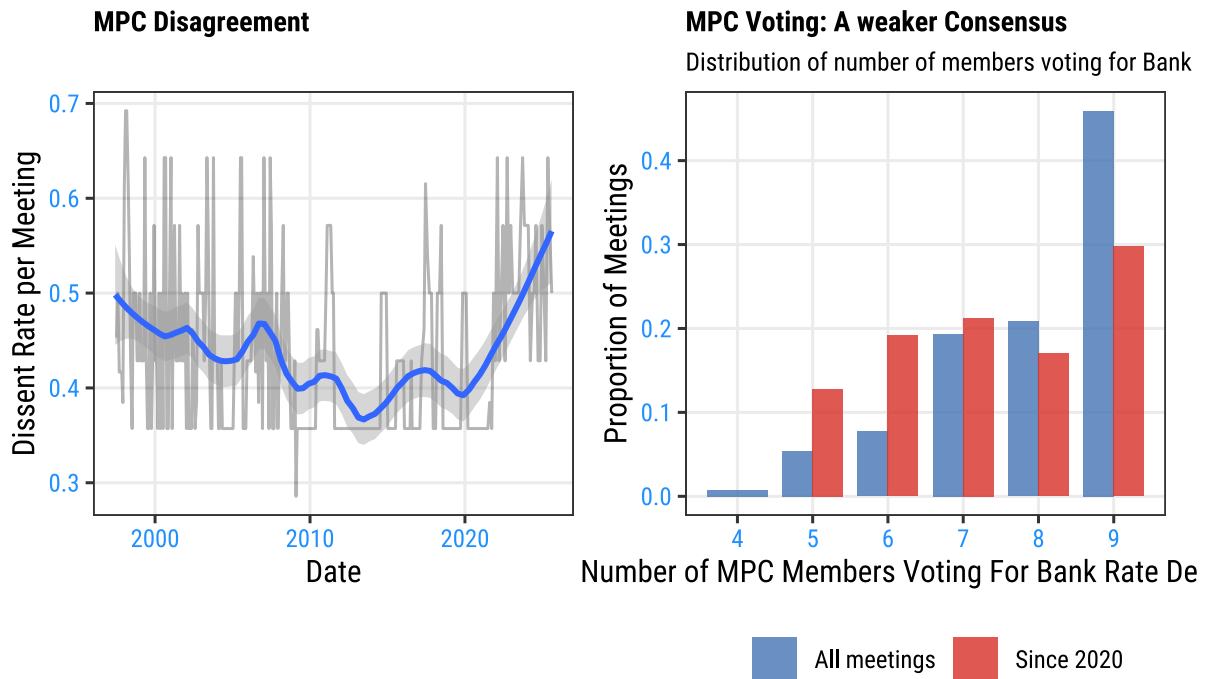


Figure 15: A weaker Consensus in MPC rate decisions

Rising disagreement among MPC members culminated in the August 2025 MPC vote requiring a second vote among Committee members in order to secure a clear majority for the rate cut decision.

2. Historical forecast error patterns suggest the MPC faces material upside inflation risks if it maintains current policy settings. The Bank's tendency to overestimate the pace of disinflation, combined with insufficient recognition of the UK's structural supply-side constraints, creates conditions where inflation could persistently exceed the 2% target despite current monetary restriction.
3. Fiscal sustainability concerns amplify bond market volatility, particularly during data-sensitive periods when investors reassess inflation trajectories. Disappointing economic data, coming from weak supply-side performance, simultaneously raise questions about fiscal capacity and inflation persistence. In these episodes, we should expect yield curve steepening.
4. The authorities can mitigate yield curve steepening through active debt maturity management, specifically by reducing the average maturity of new issuance. HMT should prioritise other forms of spending restraint and taxes that face lower implementation risk. Front-loading offers similar benefits.
5. If the authorities instead prioritise back-loading fiscal adjustment and/or with higher implementation risk, this would contribute to further steepening.
6. Fiscal risk premium episodes tilt hawkish for the BoE. Our sense is that this view surprises most analysts.