Ostrum ASSET MANAGEMENT

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Market views and strategy

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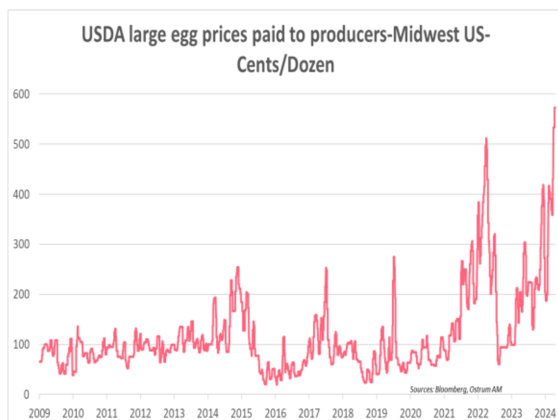
Topic of the week: A word on UK Gilt market turmoil
by Axel Botte

- UK gilt yields have increased substantially so far this year amid a global bond rout. UK 10-Yr yields top the 4.80% mark and 30-year yields now hover about 28-year highs near 5.40%.
- Chancellor of the Exchequer Rachel Reeves will have to convince market participants that fiscal deficits can be reined in. The headroom for public investment spending has been reduced by poor growth in the last few months of 2024. Reeves may seek up to £12 billion in savings to fund investment.
- The Gilt market tensions have drawn comparisons to the 2022 crisis that ended Liz Truss premiership. However, the commitment to fiscal responsibility of the Starmer government is more credible. Kwarteng and Truss had failed to convince markets that sound public finances could be restored.
- Political interference from the incoming US administration may have impacted UK government bonds.
- There is currently no panic selling in gilt markets comparable to LDI-driven fire sales in 2022. The BoE has the means to intervene in markets if need be.

Market review: Tighten your seat belts
by Axel Botte

- Strong US payrolls report send Treasury yields north of 4.75%;
- Inflation expectations on the rise in ISM, UofMich surveys;
- Sterling weakens to $1.22;
- Sovereign and credit spreads weathered equity jitters and higher bond yields.

Chart of the week



Egg prices have been soaring in the United States. The price of a dozen of eggs reached $5.72 last week, surpassing the previous peak level of $5.12 in December 2022. In California, a carton of eggs hit $8.97 earlier this month.

The run-up in egg prices is due to the outbreak of bird flu in the US impacting more than 130 million poultry across the US, the general cost of doing business and some changes in local laws.

Figure of the week

10

Indonesia becomes the 10th of the BRICS group of nations.
Source: Bloomberg

Topic of the week

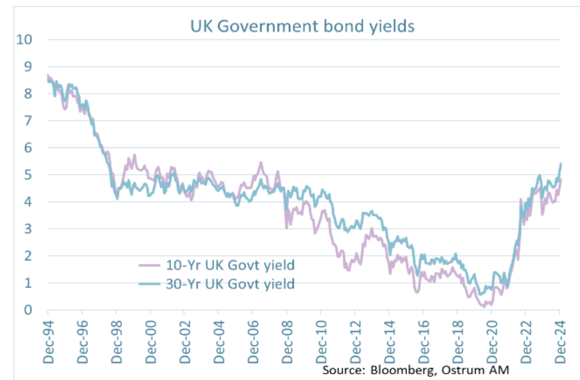
A word on UK Gilt market turmoil

The UK Gilt market is under stress since the start of the year. In this piece, we shed some light on the international and domestic factors behind the Gilt rout.

Not quite a Liz Truss moment

UK long bond yields at 28-year high

The UK Gilt market is undergoing a sharp repricing since the start of the year. The 10-Yr bond yield has risen above 4.8% and the 30-Yr yields hover around 28-year highs above 5.4%. Sterling is also down ($1.22) amid a broad-based U.S. dollar strength. There appears to be some room for further speculative selling of Sterling. To be sure, the UK gilt market is not unique in feeling the heat. The bond rout is global in scope. All major bond markets have sold off so far this year, with the notable exception of Chinese bonds tightly controlled by the PBoC (10-Yr CGB yields at 1.6%). The U.S. 10-Yr note is trading above 4.75% on economic strength and fears of inflation ticking higher. In Europe, fiscal deficits in France, heavy sovereign bond supply in January and upside surprises on inflation have pushed long-term yields higher across the board, with 10-Yr German yields reaching 2.6%.



The selloff is reminiscent of market turmoil that ended the Liz Truss premiership in the fall of 2022. At the time, unfunded tax cuts and poor communication from then-Chancellor of the Exchequer Kwasi Kwarteng had fanned market concerns of a fiscal doom loop in the UK. This time around, government officials have maintained their commitment to fiscal prudence and communication blunders from the UK government have not been a factor this time around. Moreover, the Office for Budget Responsibility said in October that it expected the government to borrow for investment purposes only and to aim at reducing the UK's "net financial debt" by 2029/30. The new debt metric introduced by Rachel Reeves at the Autumn budget (replacing Public Sector Net Debt) may be less informative about the government's near-term ability to service its debts than traditional measures. The change may have worked against the government in this difficult market environment. It will be up to Rachel Reeves to reassure investors. The pressure from higher yields still means that Chancellor of the Exchequer Rachel Reeves may have to raise taxes or rein in spending by as much as £12 billion in the current fiscal year. Higher borrowing costs will indeed reduce the narrow £10 billion headroom estimated in October to boost public investment spending. The Starmer government is therefore walking a fine line at a time when UK economic growth appears to have stalled in the last quarter of 2024. The OBR will review its assessment of the fiscal situation in March.

The BoE has tools to mitigate market risks

No sign of panic selling in Gilt markets

One of the key differences with the turmoil in the Gilt market in 2022 is the scale and speed of the bond repricing. In 2022, 30-Yr yields had moved by 120 bps in less than a week. That compares with 80 bps in over two months. The acceleration in the selloff had been caused by a liquidity crisis which forced fire sales of UK bonds by Liability-Driven-Investment (LDI) funds and pension funds. The research from the BoE suggest half of the Gilt meltdown then was indeed traceable to LDI selling. The BoE intervened to restore liquidity in the Gilt market and stands ready to do so again. The Gilt market therefore appears to be more resilient. Pension funds using LDI strategies are required to hold larger liquidity buffers and the Bank can do repo lending with pension funds. The BoE could also choose to amend its quantitative tightening policy. The Bank will shrink its holdings of Gilts by about £100 billion this fiscal year including active sales of £13 billion. Active sales could be suspended should Gilt market conditions worsen.

As concerns the interest rate policy, the BoE is struggling to bring down inflation. The progress on service inflation appears to be stalling about 5% as wage growth (5.2%y in October) have so far failed to normalize. In this context, the combination of a weaker currency and higher energy prices is unwelcome for the Bank. The MPC held rates steady in December at 4.75% though three policymakers wanted to cut. In any case, the global bond trend, set by US Treasuries, may reduce the impact of any monetary easing on the long-term Gilt yields. Furthermore, the high share of gilts held by foreigners (32% of the total) could be seen as a source of fragility. Direct BoE intervention may be warranted, should the gilt market spiral out of control.

U.S. political meddling is a new source of political risk

Political interference from the US is a new source of political risk

There is another reason why the current situation differs from the Liz Truss moment. Political meddling by the incoming U.S. administration is intensifying contributing to the fall in confidence in PM Keir Starmer's leadership. U.S. interference has already added fuel to a brewing political crisis in Canada. PM Justin Trudeau resigned in early January after former Finance Minister Chrystia Freeland left the Canadian government in mid-December. The same is true of Germany as the country prepares for the general elections scheduled on February 23rd, not to mention recent spats with Panama, Mexico and Denmark over Greenland. The political risk premium on gilts and other major bond markets has risen as Donald Trump adopts an aggressive foreign policy stance. That political risk premium is one of the factors behind the sharp underperformance of global government bonds vs. swap rates (i.e. the trend for narrower swap spreads). Indeed, 10-Yr Gilt yields now trade at a 60 bps over GBP swap rates. The margin is even larger on longer maturities as 30-Yr Gilts yield 89 bps over swap rates.

Conclusion

UK gilt yields have risen substantially this year. The bond rout is global in scope but the UK bond market stress has drawn comparisons to the crisis that took down the Liz Truss government in 2022. The political interference from the US has added to market stress but the BoE has the means to stem market tensions.

Axel Botte

Market review

Tighten your seat belts

The global bond rout extended further with strong data out of the US. Equities are feeling the pinch from higher bond yields as the Fed's 100-bp easing since September appears at odds with economic growth.

Yields are moving higher everywhere from the US (4.75% on 10-Yr T-note) to German Bunds (2.6%) or even Japan (1.2%), with the sole exception of China. Equities closed last week on a weaker footing as money markets rolled back Fed easing expectations. The US dollar gained further ground. Equity weakness and higher yields had surprisingly little impact on sovereign and credit spreads. Spread volatility remains a fraction of rate volatility. On top of fiscal and political risks, the rise in yields appears driven by the rebound in oil and gas prices.

The US economic growth may again surprise on the upside. The 4th quarter data will be released at the end of the January. The consumer continues to spend ahead of the expected tariff hikes even as delinquency rates on credit cards and consumer loans are now deteriorating. Job growth came in at 256k in December, much higher than consensus expectations. The household survey paints a similar picture with a broad-based decline in the unemployment rate to 4.1%. Underemployment have declined notably. With the benefit of hindsight, the Fed easing worth 100 bps since September seems completely at odds with the economic situation. This is all the more the case that inflation readings and surveys of households and firms have moved higher. The price paid components of both ISM surveys signal higher input prices. In addition, households are feeling the pinch of higher gasoline prices and even medium-term inflation forecasts are up to a 2008 high of 3.3% in the University of Michigan survey. In the euro area, inflation expectations are also on the rise as the euro is getting closer to parity against the greenback. Brent prices near $80, on tighter US sanctions against Russia, will raise energy costs across the euro area.

The bond market appears driven by both the higher growth and inflation narrative out of the US. The US 10-Yr note yield traded above 4.75% after the release of non-farm payrolls. Bund yields rose slightly less considering the weaker growth outlook in the euro area. However, inflation in the euro area picked up in December (2.4%). The inflation component hence contributed to higher yields. The ability of central banks to keep cutting rates will ultimately depend on their assessment of the impact of US trade policies on their economies. This will become clearer after January 20th. In China, monetary authorities keep pushing rates lower. This is the sole market immune of the higher yield trend. Primary issuance has had little impact on euro area sovereign spreads. Strong demand for Italian bonds (in particular the 20-Yr green BTP) kept spreads within a tight range. The same is true of the deluge of corporate bond issuance, that was well received by markets. Euro investment grade spreads remain stable at 90 bps against swaps. In high yield, spreads are moderately wider especially on lower rating categories.

Strong payrolls took a toll on richly valued US stocks. Nasdaq fell 1% but smaller cap stocks performed even less well. Euro area stock markets benefit with a cheaper euro (+2%). In contrast Chinese markets are off to a rough start of year.

Axel Botte

Main market indicators

G4 Government Bonds	13-Jan-25	1wk (bp)	1m (bp)	2025 (bp)
EUR Bunds 2y	2.29%	+10	+22	+21
EUR Bunds 10y	2.61%	+16	+35	+24
EUR Bunds 2s10s	31.7 bp	+7	+13	+4
USD Treasuries 2y	4.4%	+12	+15	+16
USD Treasuries 10y	4.79%	+16	+40	+23
USD Treasuries 2s10s	39.4 bp	+4	+25	+7
GBP Gilt 10y	4.87%	+26	+46	+31
JPY JGB 10y	1.2%	+7	-13	-2
€ Sovereign Spreads (10y)	**13-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
France	84 bp	+3	+2	+2
Italy	121 bp	+9	+6	+6
Spain	69 bp	+3	+0	+0
Inflation Break-evens (10y)	**13-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
EUR 10y Inflation Swap	2.07%	+5	+10	+14
USD 10y Inflation Swap	2.59%	+12	+10	+13
GBP 10y Inflation Swap	3.68%	+12	+18	+15
EUR Credit Indices	**13-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
EUR Corporate Credit OAS	101 bp	-1	+2	-1
EUR Agencies OAS	61 bp	-2	+1	-1
EUR Securitized - Covered OAS	55 bp	-1	-2	-1
EUR Pan-European High Yield OAS	320 bp	+8	+5	+2
EUR/USD CDS Indices 5y	**13-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
iTraxx IG	59 bp	+4	+5	+1
iTraxx Crossover	319 bp	+20	+19	+5
CDX IG	52 bp	+4	+4	+2
CDX High Yield	324 bp	+25	+27	+12
Emerging Markets	**13-Jan-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
JPM EMBI Global Div. Spread	320 bp	0	-6	-6
Currencies	**13-Jan-25**	**1wk (%)**	**1m (%)**	**2025 (%)**
EUR/USD	$1.020	-1.800	-2.866	-1.4
GBP/USD	$1.215	-2.916	-3.693	-2.9
USD/JPY	JPY 158	-0.063	-2.513	-0.2
Commodity Futures	**13-Jan-25**	**-1wk ($)**	**-1m ($)**	**2025 (%)**
Crude Brent	$81.3	$5.0	$7.2	9.0
Gold	$2 665.7	$28.9	$17.5	1.6
Equity Market Indices	**13-Jan-25**	**-1wk (%)**	**-1m (%)**	**2025 (%)**
S&P 500	5 800	-2.40	-4.16	-1.4
EuroStoxx 50	4 955	-0.64	-0.26	1.2
CAC 40	7 410	-0.48	0.00	0.4
Nikkei 225	39 190	-1.77	-0.71	-1.8
Shanghai Composite	3 161	-1.44	-6.81	-5.7
VIX - Implied Volatility Index	20.39	26.41	47.65	17.5

Source: Bloomberg, Ostrum AM

Additional notes

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