RISK ASSURED
LIFE INSURANCE SPECIALISTS

Two year yields tell a story

Synopsis: Wednesday's sale of two year gilts bodes ill for the Treasury.

Date published: 06.07.2023

On Wednesday the Debt Management Office (DMO) sold a £4bn tranche of an existing 2-year gilt, Treasury 3.5% 2025. In isolation, there is nothing remarkable about that, as the DMO has to keep issuing gilts in substantial quantities, given its sales target for 2023/24 is £237.8bn – not far short of £1bn per working day.

What was noteworthy about Wednesday's sale was the yield level that market forced the DMO to accept for the stock: 5.668%. That yield was markedly higher than on other two year gilts, which ended trading the previous day at around 5.3%-5.4%. It was also the highest yield at which the DMO has sold *any* gilts since June 2007 – before the GFC – according to Reuters.

The two-year gilt yield is important for a variety of reasons...

- Like its US counterpart (yielding 4.96%), the two-year gilt provides a snapshot of market expectations for the average central bank base over the coming 24 months. For the UK, the implication is that Bank Rate will rise and stay elevated.

- The DMO is concentrating its sales on short dated gilts because it does not want to tie the Treasury to high interest rates on longer dated bonds or pay the 1% positive real yields now required on index-linked securities. So far this year, 43.6% (£29.5bn) of gilt sales have been short-dated and the current remit envisages 35.6% (£84.62bn) by next March.

- If the two-year gilt is yielding more than the ten-year gilt, this is generally considered a predictor of a recession. At the moment the gap is a historically wide 0.9%.

- Two-year gilt yields feed into the swaps market and will therefore influence what lenders will demand on 2-year fixed rate mortgages.

Comment

The DMO is in a difficult position. Not only is it aiming to sell 40% more gilts than in 2022/23, it is also facing the headwind of quantitative tightening (QT), which means the Bank of England is also offloading gilts.

In its March 2023 Economic and Fiscal Outlook, the OBR noted that *'…with* [the Bank of England] *now running down its own gilt holdings, the private sector needs to absorb 6.5 per cent of GDP in additional gilts each year over the next five years, the highest sustained levels this century'.*

020 7183 3931
www.riskassured.co.uk

Risk Assured is authorised and regulated by the Financial Conduct Authority This information is based on our understanding of current legislation, regulations and HM Revenue and Customs practice at the published date. This technical paper should not be relied upon as it may be subject to change and should not be construed as advice. We take no responsibility for any advice given or contracts entered into on the basis of this technical paper. This information is intended for professional advisers only.
E&OE