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Market Insights

The gilt curve: Steeped in steepness

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Agenda

- Yield curve context
- The outlook: Yield curve drivers
- Conclusions

Section 1

Yield curve context

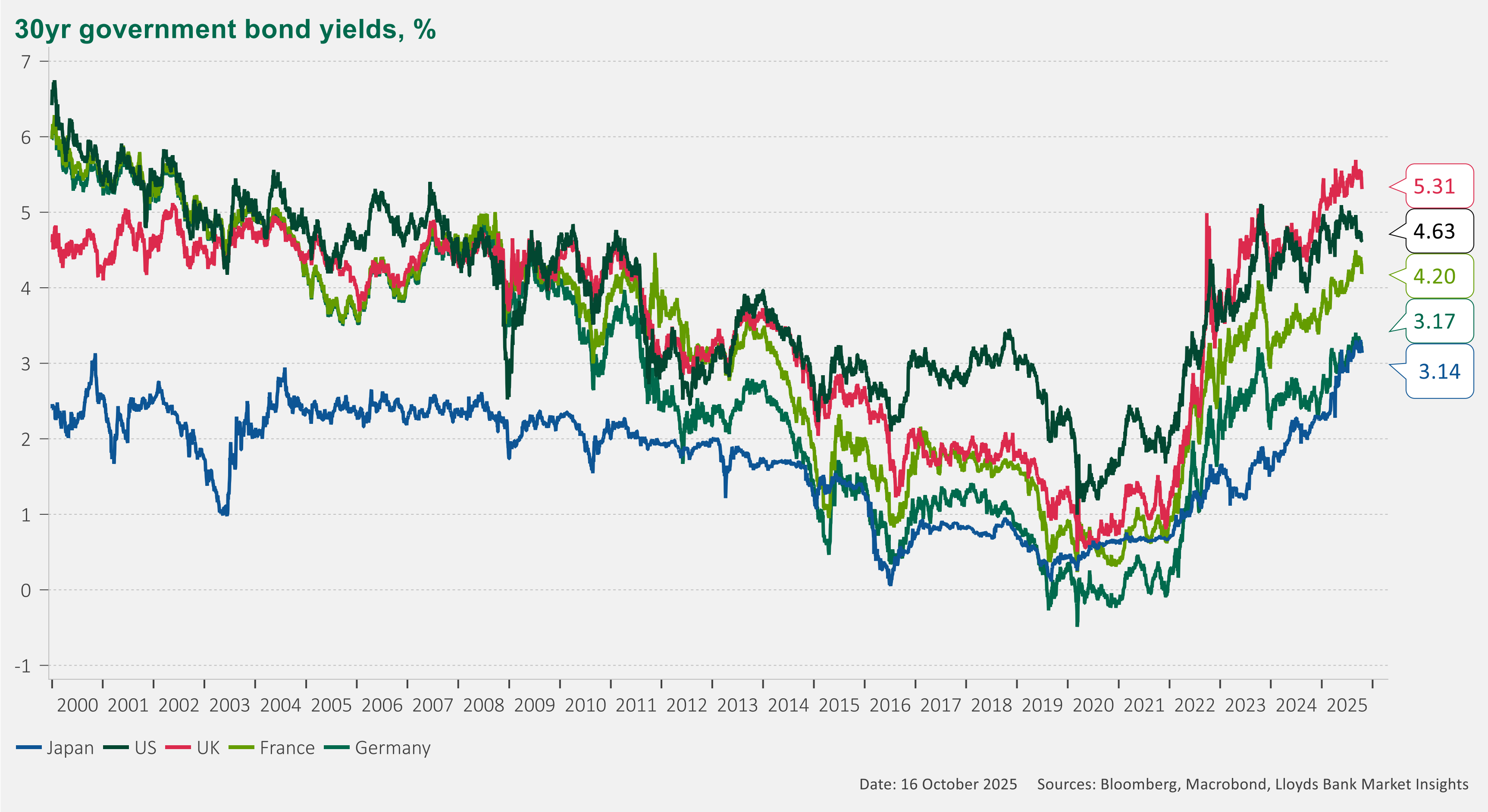
Context (1): Outright yields are elevated

Before looking at yield curve shape, note that the outright level of long-dated gilt yields is relatively high in the context of recent history.

Anything above 5% is relatively unusual following the equilibrium established following BoE independence in 1997.

As we will explore, expectations for policy rates, QT, inflation, fiscal sustainability, international dynamics, demand and supply and changes in market structure are all amongst the key factors driving yield levels and curve shape.

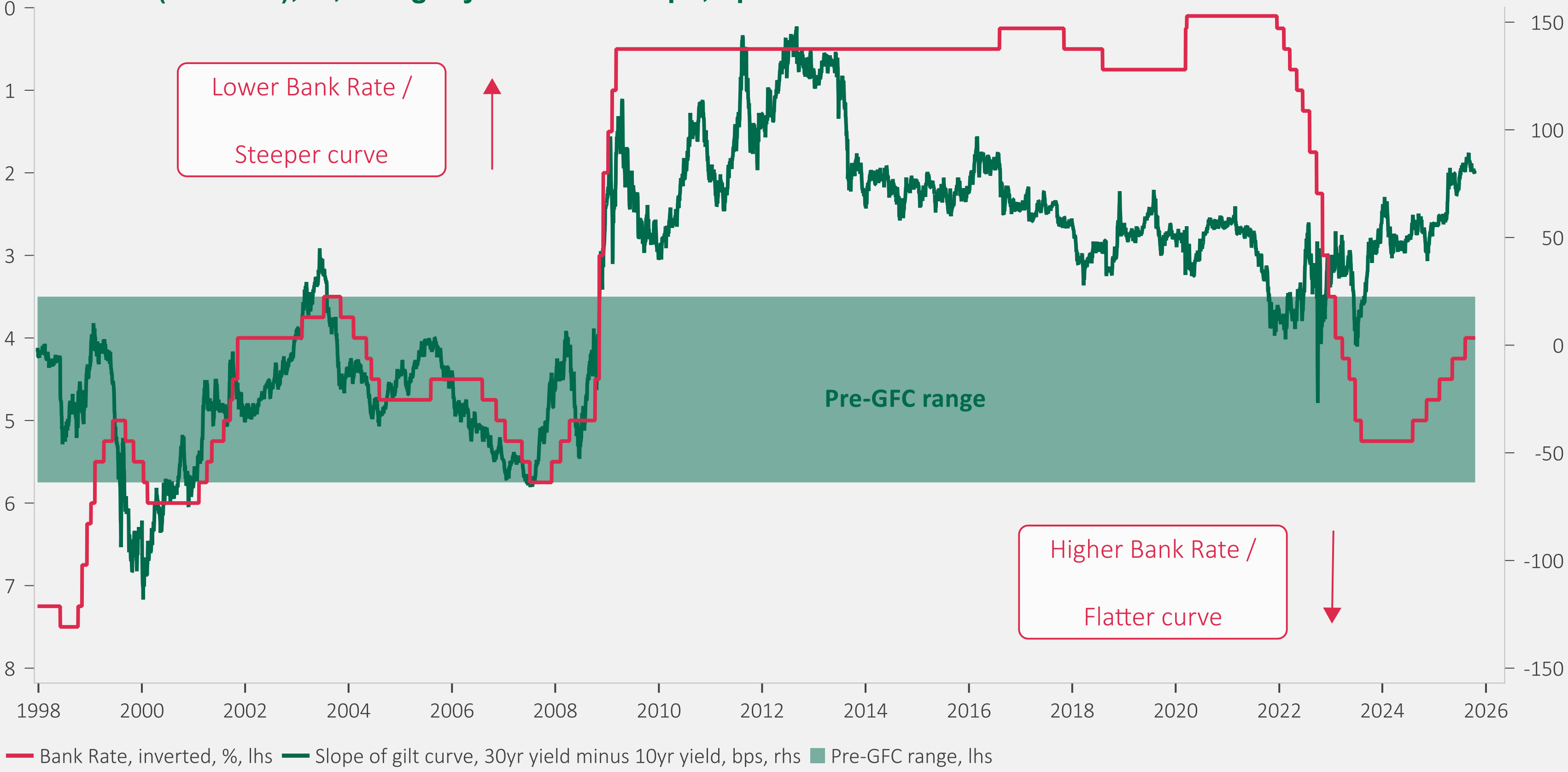
Context (2): Gilt yields above comparator nations



The upwards trend in outright yield level for long-dated government bonds is not just a UK phenomenon, but the absolute yield is now higher for 30yr gilts than a range of comparator markets.

Context (3): Curve steeper relative to Bank Rate

Bank Rate (inverted), %, and gilt yield curve slope, bps



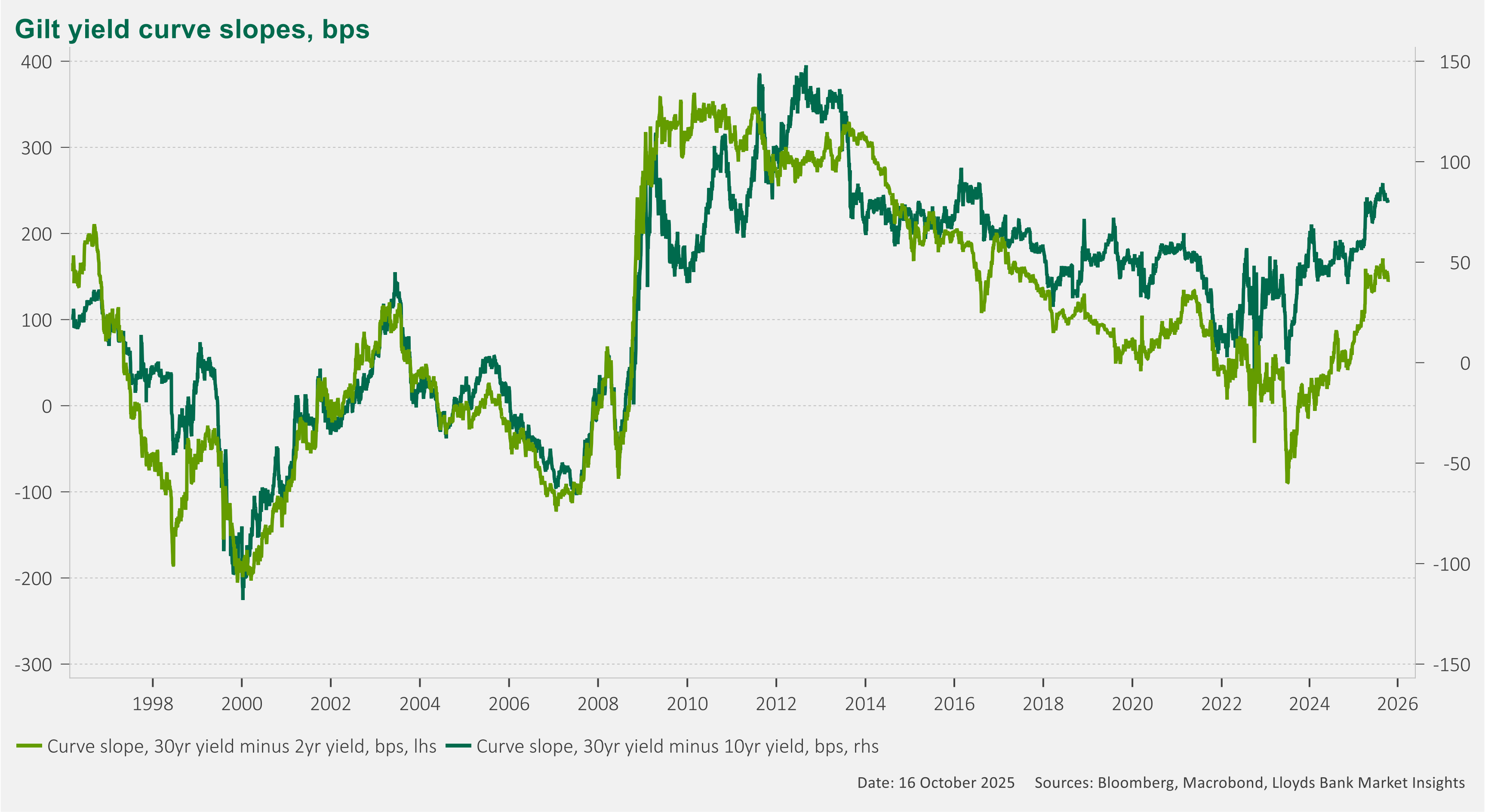
Date: 16 October 2025 Sources: BoE, Bloomberg, Macrobond, Lloyds Bank Market Insights

The inverse relationship between the level of policy rates and curve slope is important.

Normally when policy rates are low the yield curve is steeper, and when Bank Rate is high the curve is flatter.

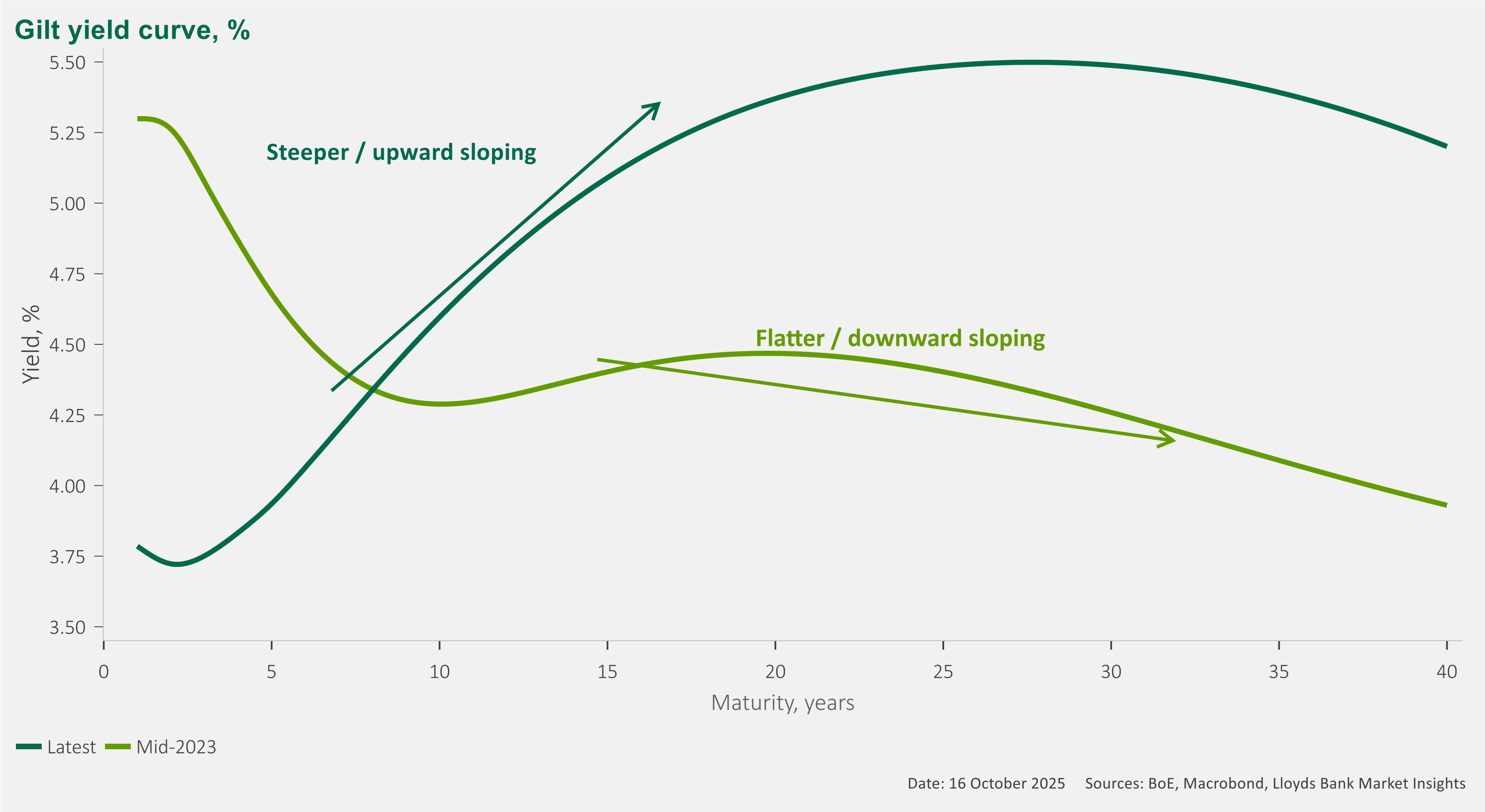
That simple relationship looks somewhat out of line currently. Bank Rate is back in the pre-GFC range, but the curve slope is not, it is steeper than it was back then.

Context (4): Different curve segments



Whether you look at the slope of the curve between 10yr and 30yr maturities ("10s30s") or between 2yr and 30yr maturities ("2s30s") the message is the same: yield curve slope is relatively steep versus the pre-GFC period when Bank Rate was at a roughly comparable level.

Context (5): Policy rate expectations matter

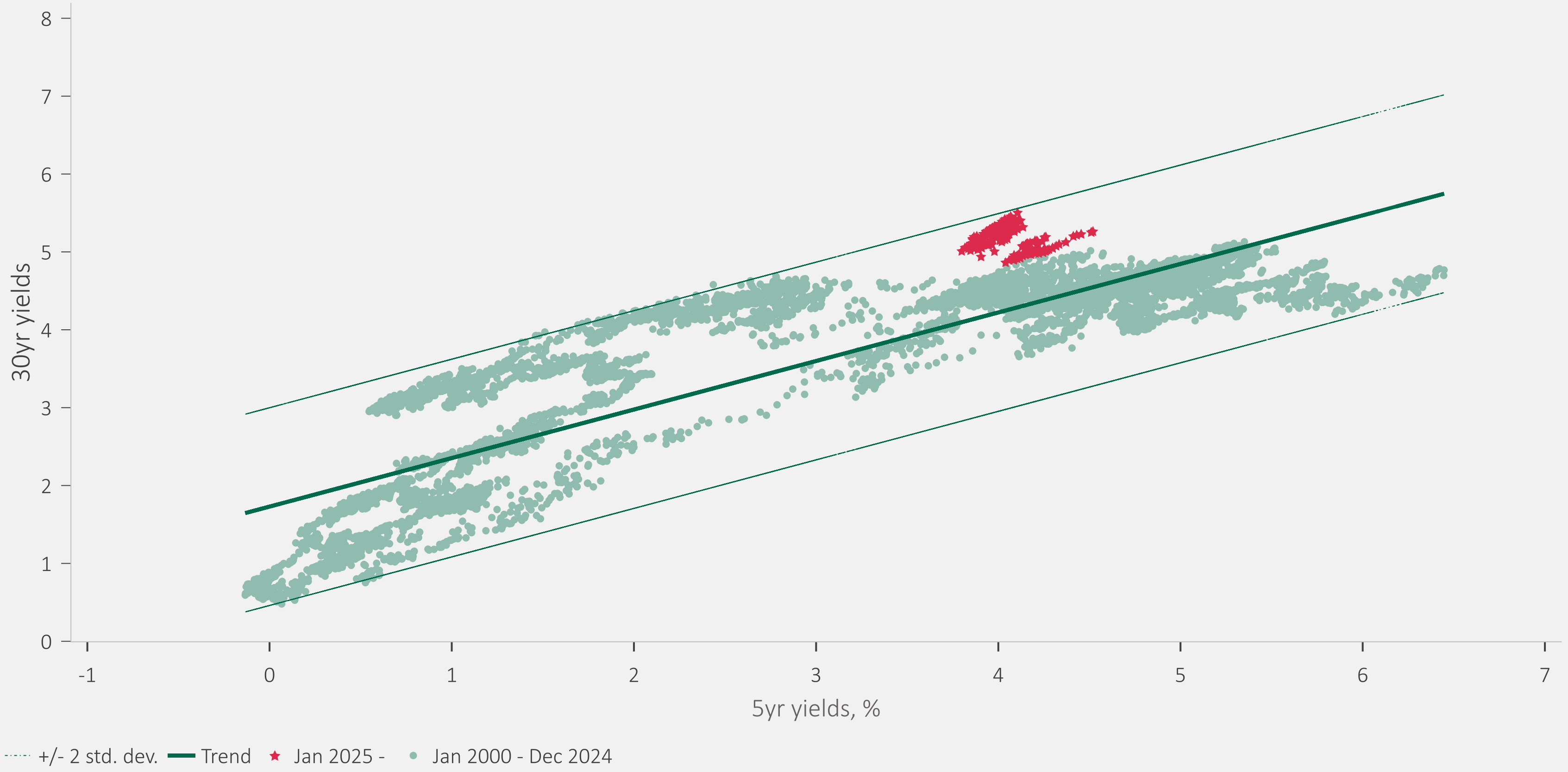


Above all, taking a view on expectations for the evolution in the yield curve slope is dependent on a view of the outlook for policy rates.

A lower trajectory for Bank Rate is usually consistent with a steeper yield curve and higher path for Bank Rate should see a flatter curve.

Context (6): Curve steep given level of short rates

Scatterplot of 5yr and 30yr gilt yields, %



Date: 16 October 2025 Sources: Bloomberg, Macrobond, Lloyds Bank Market Insights

What is observed in recent times though is that even allowing for the directional relationship between the level of short rates and curve slope, the gilt curve looks relatively steep in the context of recent history.

In other words, we can't just explain the steepness of the gilt curve by saying that Bank Rate has been cut and is expected to come down further. There is a residual steepness observed.

This is a dynamic we will explore in the following section.

Context (7): Correlation breakdown

The normal relationship between short-term rates and long-term rates hasn't just weakened, arguably it has completely broken.

Most of the time it would be expected that all yields move in the same direction but just that longer maturity yields move by less than shorter maturity rates.

That hasn't been the case in the period since the BoE started cutting Bank Rate last year. Long-term yields continued to rise despite short-rate expectations falling.

Section 2

Yield curve drivers

Factors affecting curve shape outlook

- Policy rates and expectations
- BoE balance sheet (QT)
- Inflation expectations
- Fiscal sustainability
- Demand for gilts
- Supply of gilts
- Market structure changes
- Cross-market relative value

(1) Policy rates and expectations

UK Macro, annual average	2024	2025	2026	2027
GDP growth	1.1	1.0	1.0	1.5
Latest consensus[1]		1.1	1.1	1.5
Unemployment rate	4.3	4.8	5.0	4.7
CPI inflation	2.5	3.3	2.7	2.4

UK Macro, end year[2]	2024	2025	2026	2027
GDP growth	1.5	1.0	1.4	1.5
Unemployment rate	4.4	5.0	4.9	4.6
Latest consensus[1]		4.8	4.8	4.7
CPI inflation	2.5	3.5	2.4	2.5
Latest consensus[1]		3.3	2.3	2.1
House prices	3.4	2.6	3.0	2.3

Global Macro, annual average	2024	2025	2026	2027
GDP growth	3.1	2.4	2.2	2.5
CPI inflation	6.9	4.6	3.8	3.4

UK Interest Rates, end year	2024	2025	2026	2027
Bank Rate	4.75	3.75	3.50	3.50
2y yields	4.34	3.79	3.81	3.82
10y yields	4.43	4.54	4.49	4.34

Exchange Rates, end year	2024	2025	2026	2027
GBP USD	1.25	1.37	1.38	1.39
GBP EUR	1.21	1.18	1.18	1.18

Global Interest Rates, end year	2024	2025	2026	2027
Fed Funds Upper Bound	4.50	4.25	3.75	3.75
US 10y yield	4.57	4.44	4.51	4.61

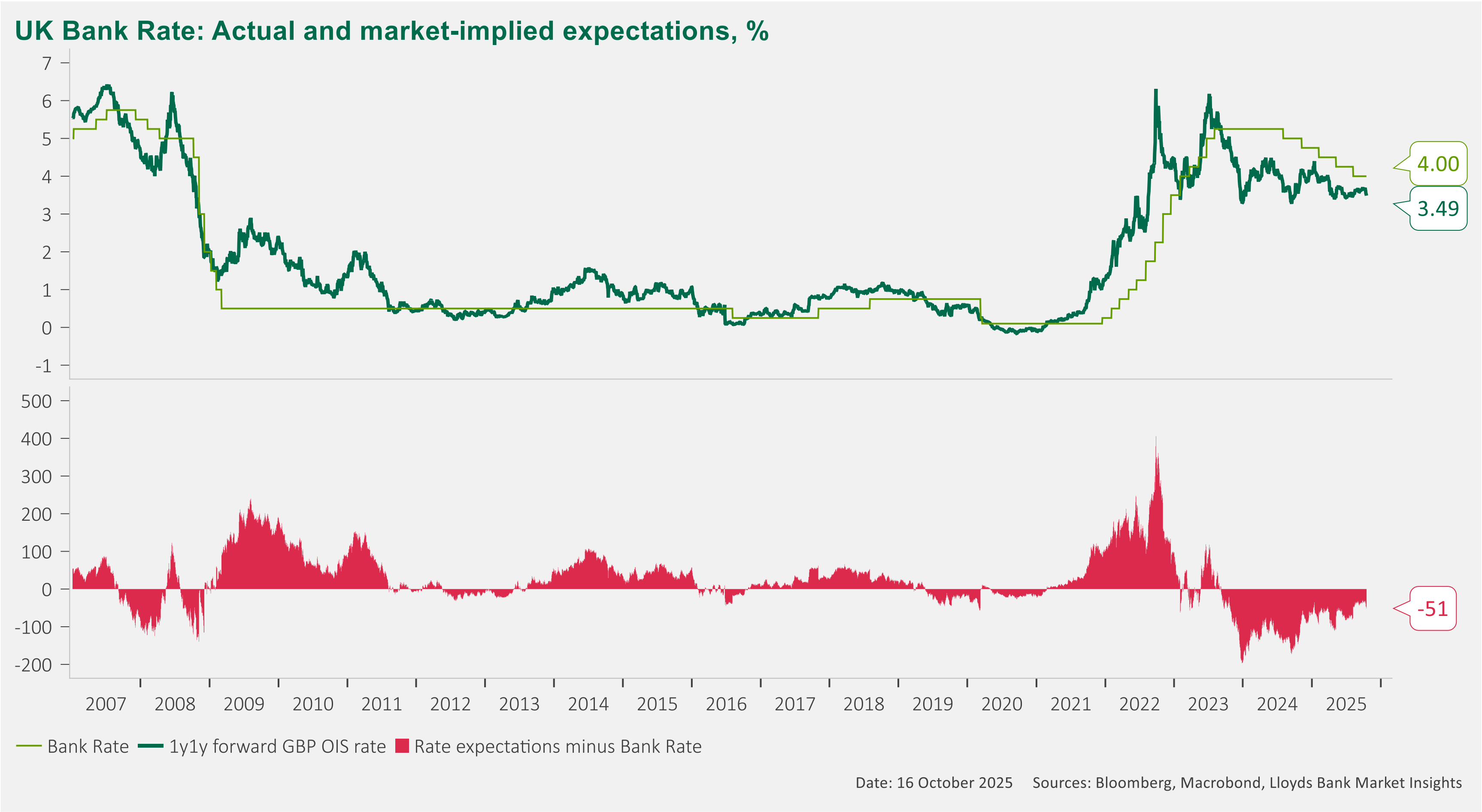
Source: LBG, position as of 30/06/2025 and disclosed in LBG's Q2 2025 financial reporting
[1] Median consensus as of HMT's 'Forecasts of the UK economy', July 2025.
[2] Q4/Q4 for GDP, CPI and house prices; Q4 for unemployment rate.

Lloyds Banking Group economic forecasts are refreshed at each quarterly results publication (next: 23 October 2025).

The current projections show scope for the BoE rate cutting cycle to extend another 50bps down to 3.50%.

That prospect for lower policy rates is consistent with a bias for a curve steepening although this path for Bank Rate is essentially already factored into market expectations anyway.

(1) Policy rates and expectations



Markets are priced for modest further reductions in Bank Rate over the coming year.

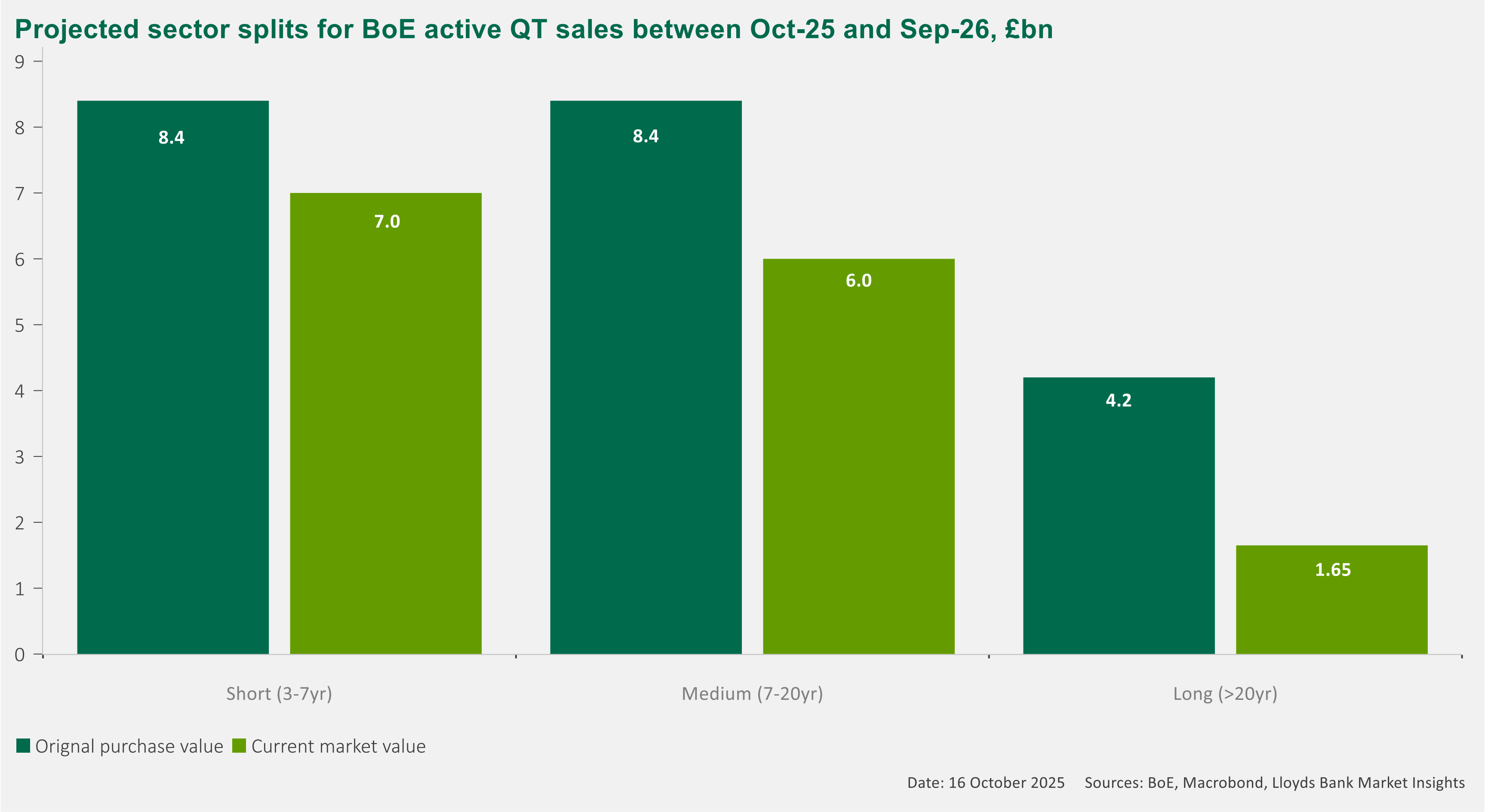
For those who think the BoE will go further there ought to be scope for more steepening.

Elevated inflation expectations and constraints on labour supply, keeping wage growth on the high side, are the barriers to a deeper cutting cycle.

On the other hand, a strong fiscal headwind from the forthcoming Budget could prompt the MPC to decide more offsetting monetary accommodation is appropriate.

Takeaway (1): Current curve slope already captures expectations for another 50bps of rate cuts. Extra steepening influence from this factor would need to come from a deeper BoE cutting cycle.

(2) BoE balance sheet - QT



Earlier in the year market participants were worried about the impact of BoE ‘quantitative tightening’ (QT).

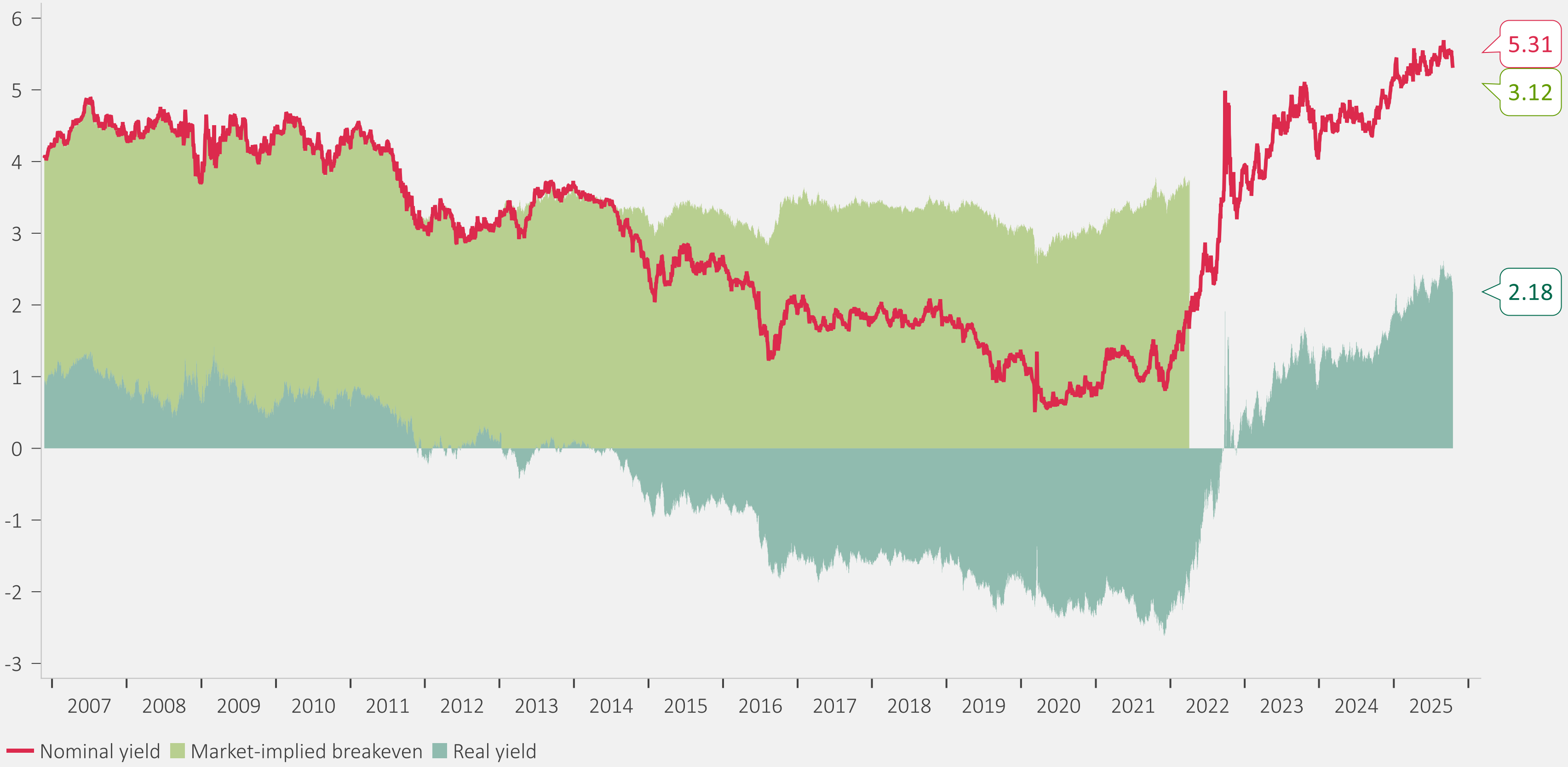
Secondary market sales of gilts by the BoE in addition to high volumes of primary market issuance by the DMO was seen as a potentially unsettling combination, particularly in long maturities.

By setting a moderate target of £21bn for ‘active’ QT in the year from October 2025, and by skewing sales away from long maturities, QT ought not to be a major consideration for yield curve expectations until next summer.

Takeaway (2): QT is a secondary risk for long-dated gilts now, but BoE commitment to unwinding gilt holdings is strong. As such some relative steepness versus other countries (that don’t do active QT) is to be expected.

(3) Inflation expectations

Composition of 30yr nominal gilt yield between real yield and breakeven inflation, ppts



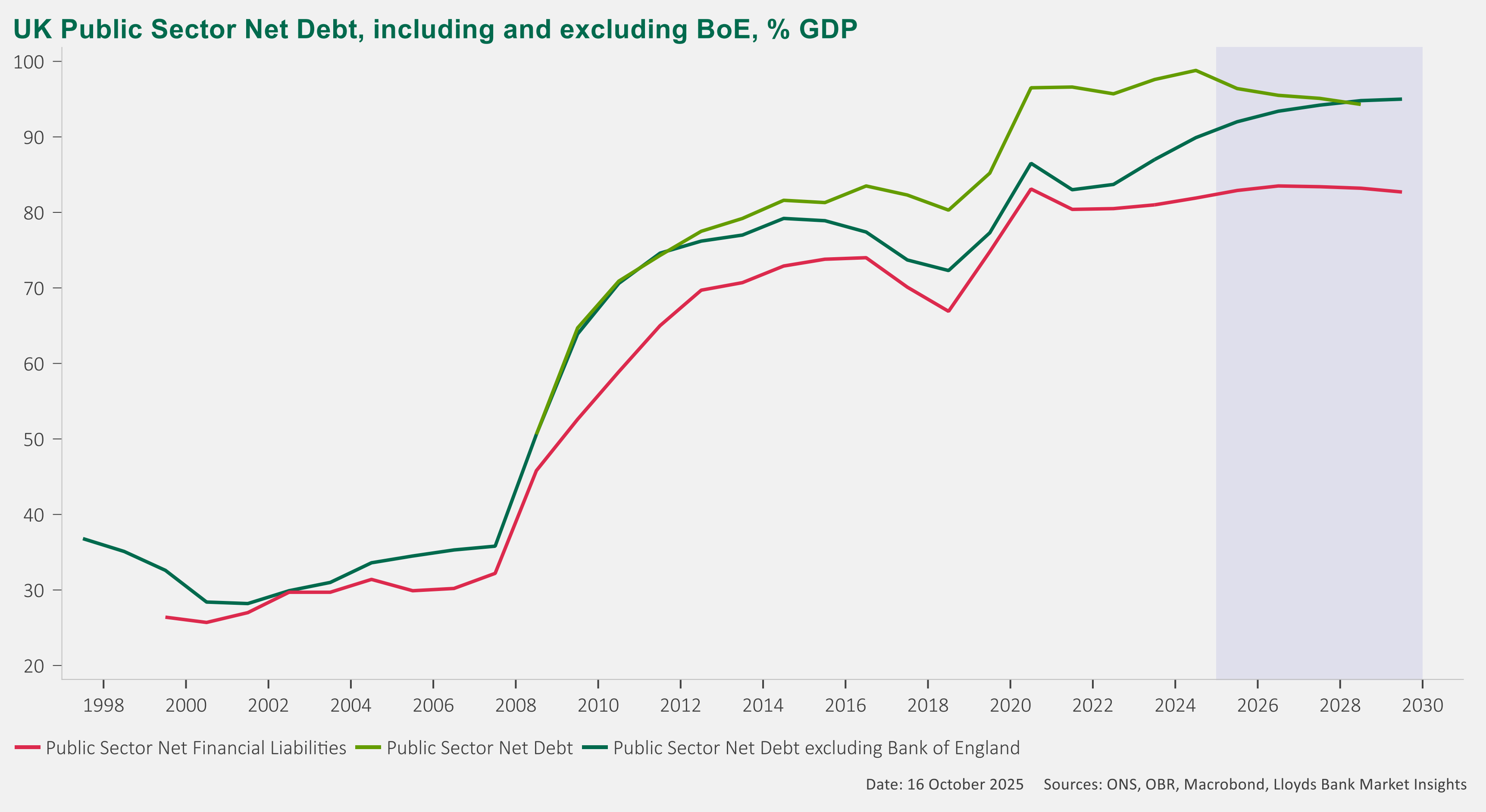
Date: 16 October 2025 Sources: Bloomberg, Macrobond, Lloyds Bank Market Insights

Decomposing (observed) nominal yields into (observed) real yields and (implied) breakeven inflation rates shows that the bulk of the increase can be attributed to rising real yields rather than higher inflation expectations.

RPI reform may be masking some underlying increase in inflation expectations.

Takeaway (3): Survey-based measures of inflation expectations show more concern about the outlook. If market-based measures were to catch up, this could push the curve steeper as inflation compensation pushes long-term yields up.

(4) Fiscal sustainability



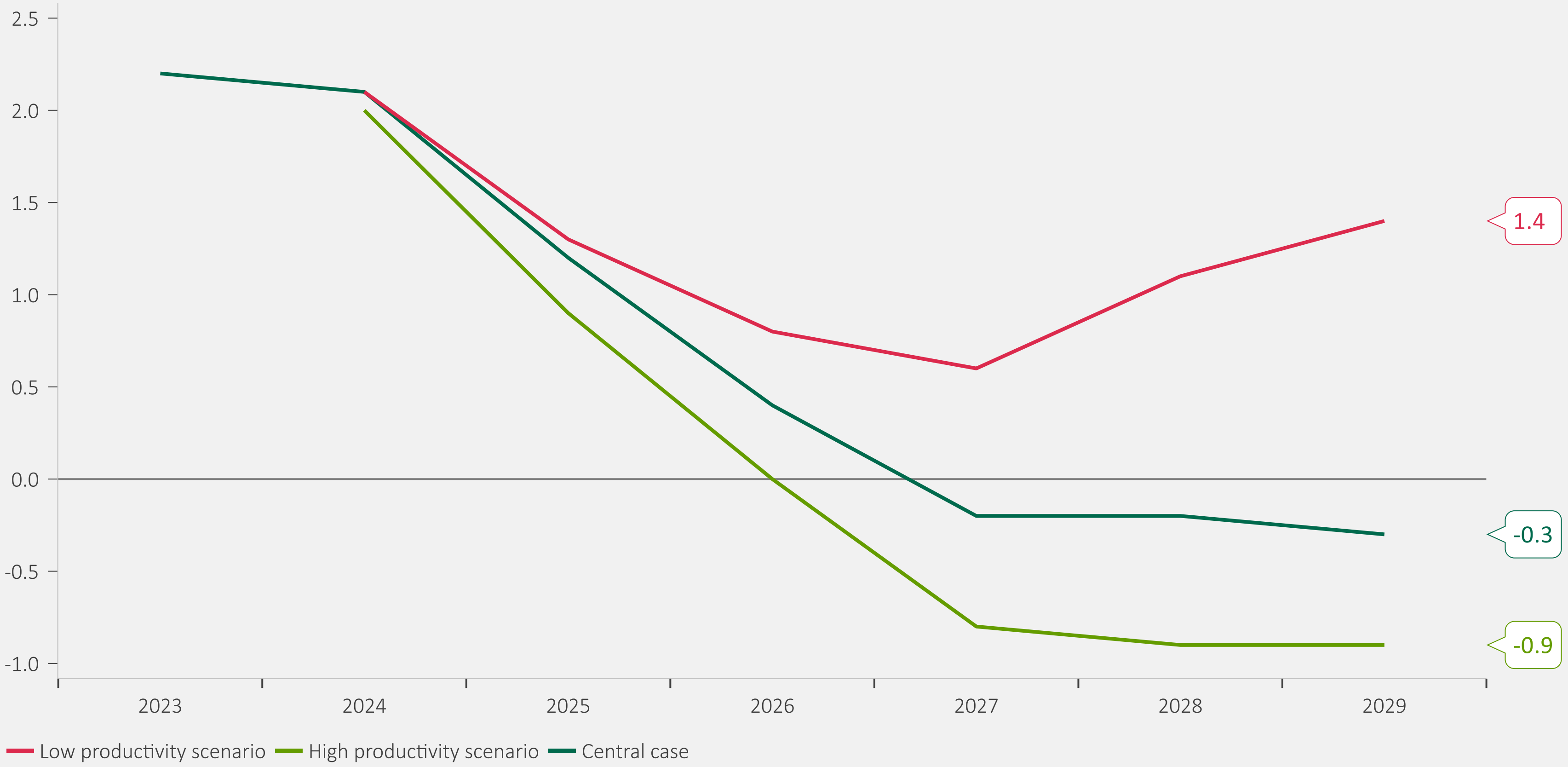
Successive fiscal forecasts have contrived to show projections where fiscal rules are met, but only by the barest of margins, and on the assumption of fantastically optimistic underlying assumptions about economic growth.

A little bit more realism might be introduced into the OBR forecasts for this Budget, but it will still be a tightrope walk for the government to deliver a programme that is palatable both politically and to the gilt market.

In other words, questions over UK fiscal sustainability will not disappear on 26 November.

(4) Fiscal sustainability

OBR projections for the current budget deficit for different productivity scenarios, % GDP



16 October 2025 Sources: OBR, Macrobond, Lloyds Bank Market Insights

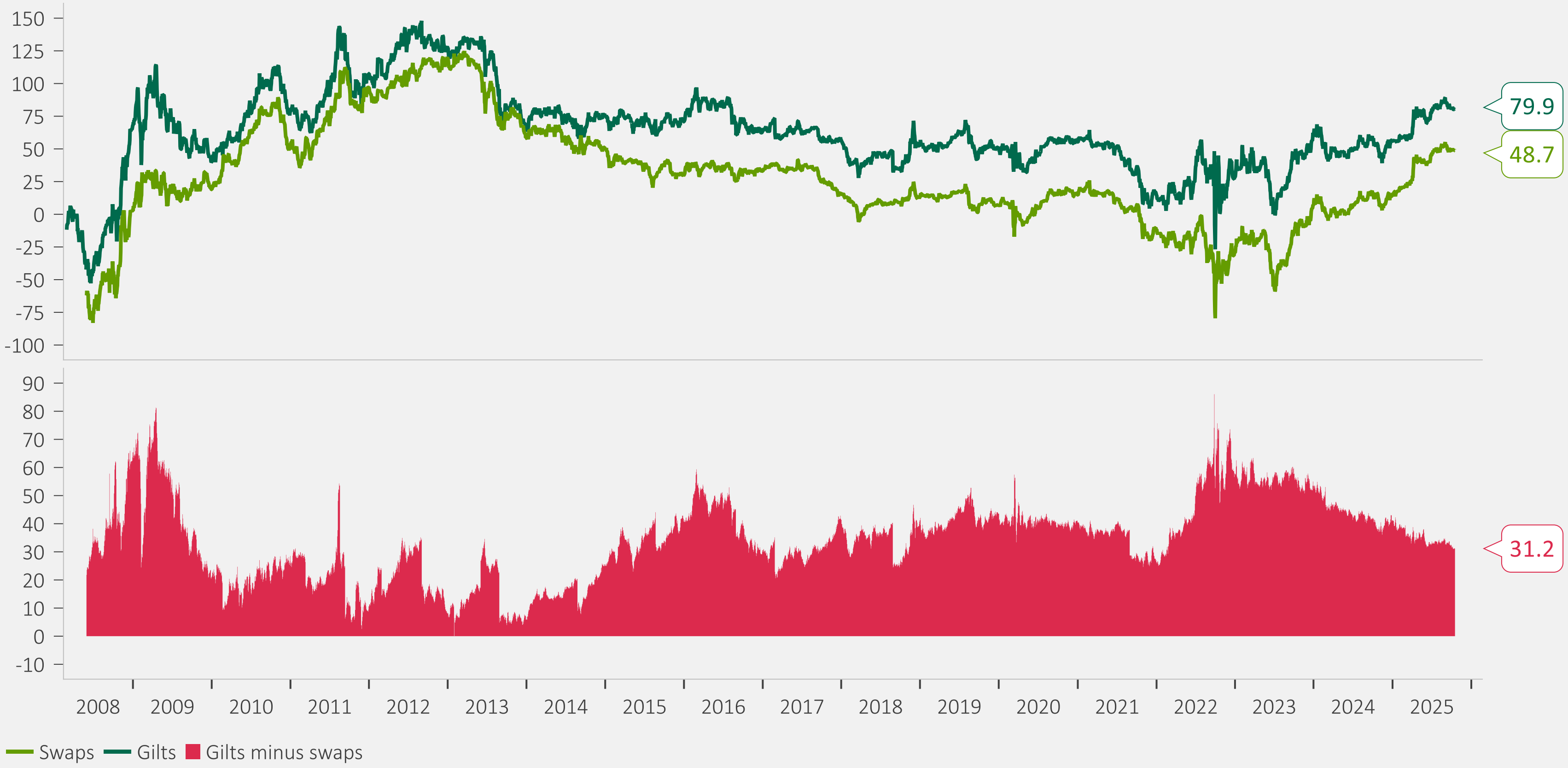
To illustrate the fiscal sustainability problem, consider different scenarios for productivity growth in the economy and how it influences the government's chosen fiscal metric, the 'current budget' balance.

In the central case a surplus of 0.3% of GDP, or £9.9bn, was projected for 2029-30 back at the Spring Statement. But that 'central case' assumed productivity growth picking up to 1.3% per year over the forecast horizon. But productivity growth has averaged more like 0.5% per year post-GFC!

It is only therefore the historic optimism of the economic assumptions that have underpinned projected compliance with the fiscal rules.

(4) Fiscal sustainability

Curve slopes: 30yr minus 10yr for gilts and GBP swaps, bps



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Is there a distinction between a term premium for UK government credit risk and broader perceptions of UK asset quality?

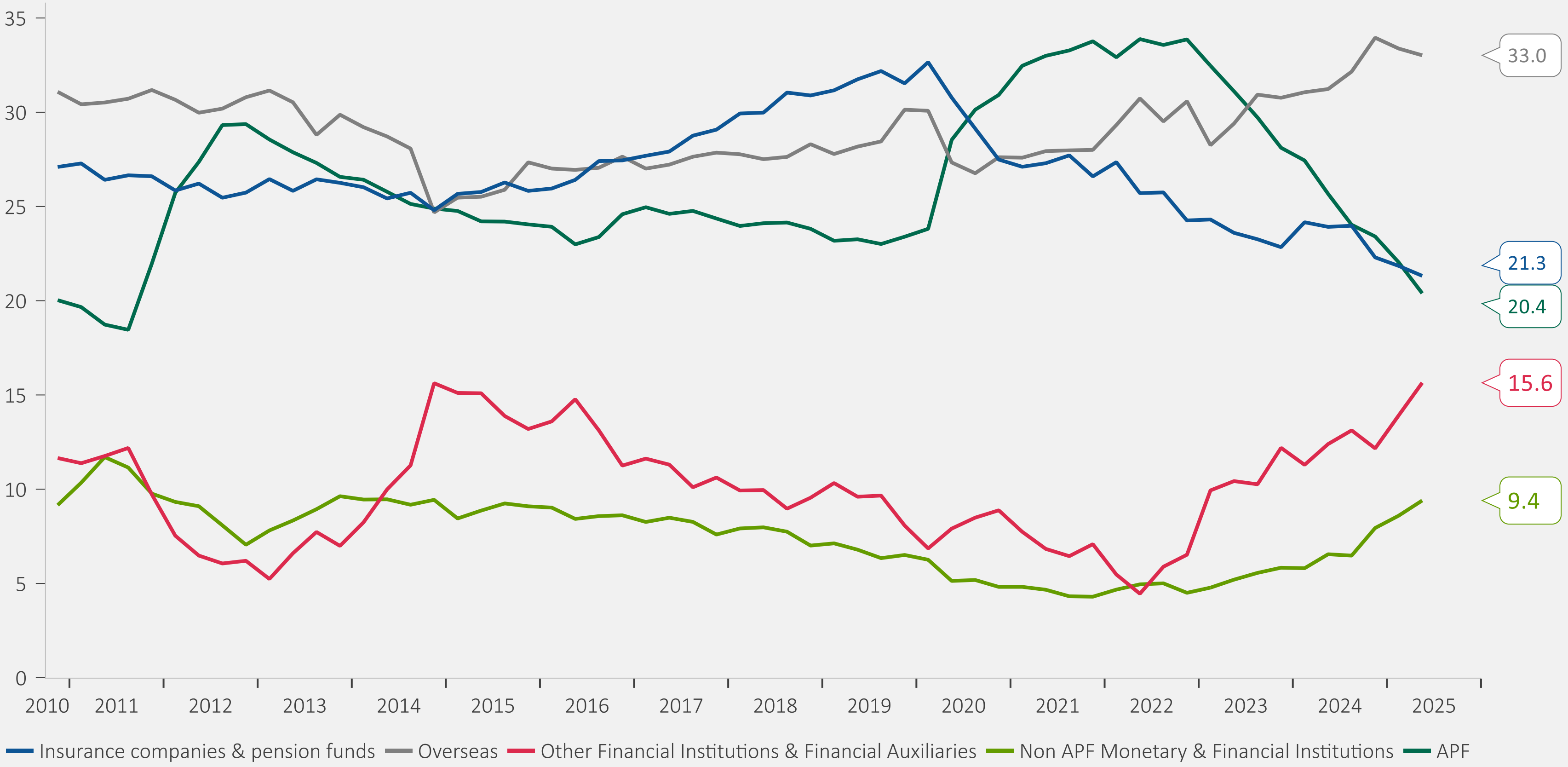
At times (GFC and Truss/LDI) the government curve has steepened up relatively more than the GBP swap curve.

But for most of the last decade movements in the slope of the gilt curve have been fairly similar to those in the swap curve.

Takeaway (4): Fiscal sustainability questions will not be dealt with comprehensively at the Budget and some term premium will still be warranted.

(5) Demand for gilts

Gilt market ownership shares for major institutional sectors, % of market value



Date: 16 October 2025 Sources: ONS, DMO, Macrobond, Lloyds Bank Market Insights

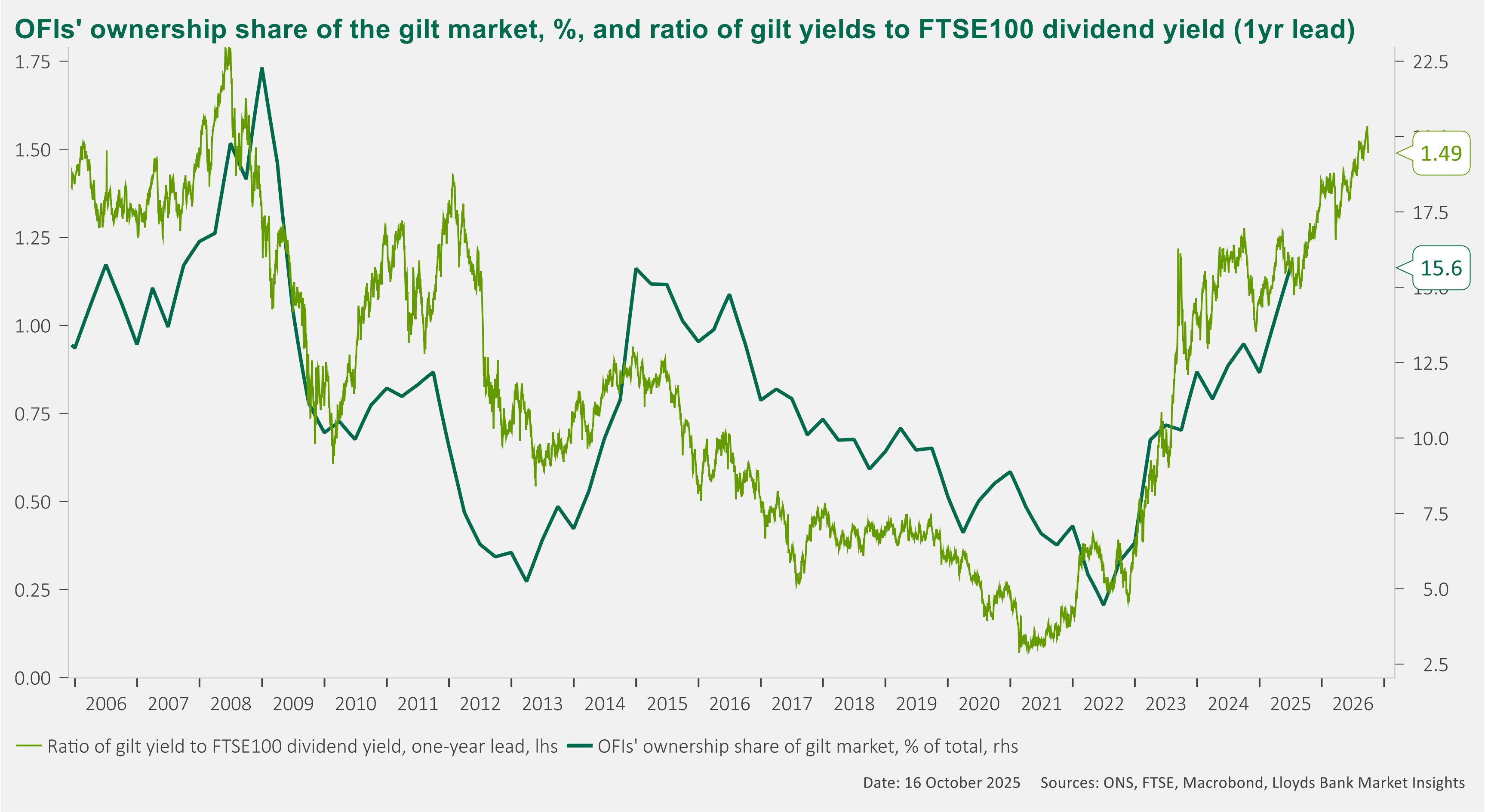
The composition of ownership of the gilt market has evolved.

The BoE is selling and pension fund demand has waned.

By contrast overseas investors have maintained their market share and ‘other financial institutions’ (OFIs) now represent a larger share of a growing market.

The key development here is the fading influence of price-insensitive buyers (BoE and pension funds) and the growing influence of price-sensitive buyers, such as OFIs.

(5) Demand for gilts

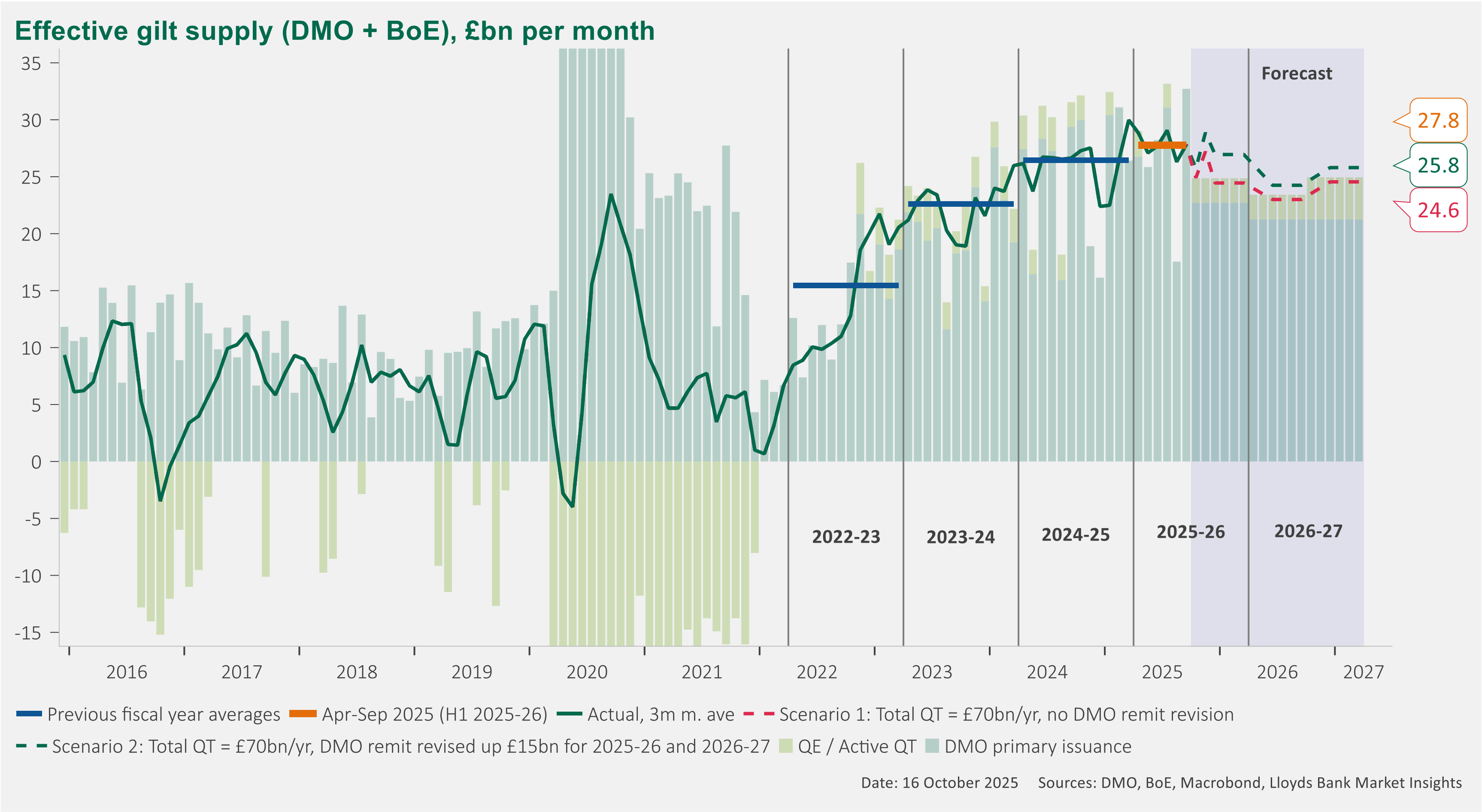


During times of QE and stronger liability-driven investment decisions demand was much more price-agnostic.

Now overseas investors and OFIs make up a larger share of the flow of net buying there is greater sensitivity to yield levels, either outright or versus other assets.

Takeaway (5): Demand for gilts is more price sensitive than it was. Yields and term premium will need to be higher if policy fundamentals deteriorate to attract marginal buyers.

(6) Supply of gilts



On current projections we are at the point where the peak in 'effective' gilt supply is just about in the rear-view mirror.

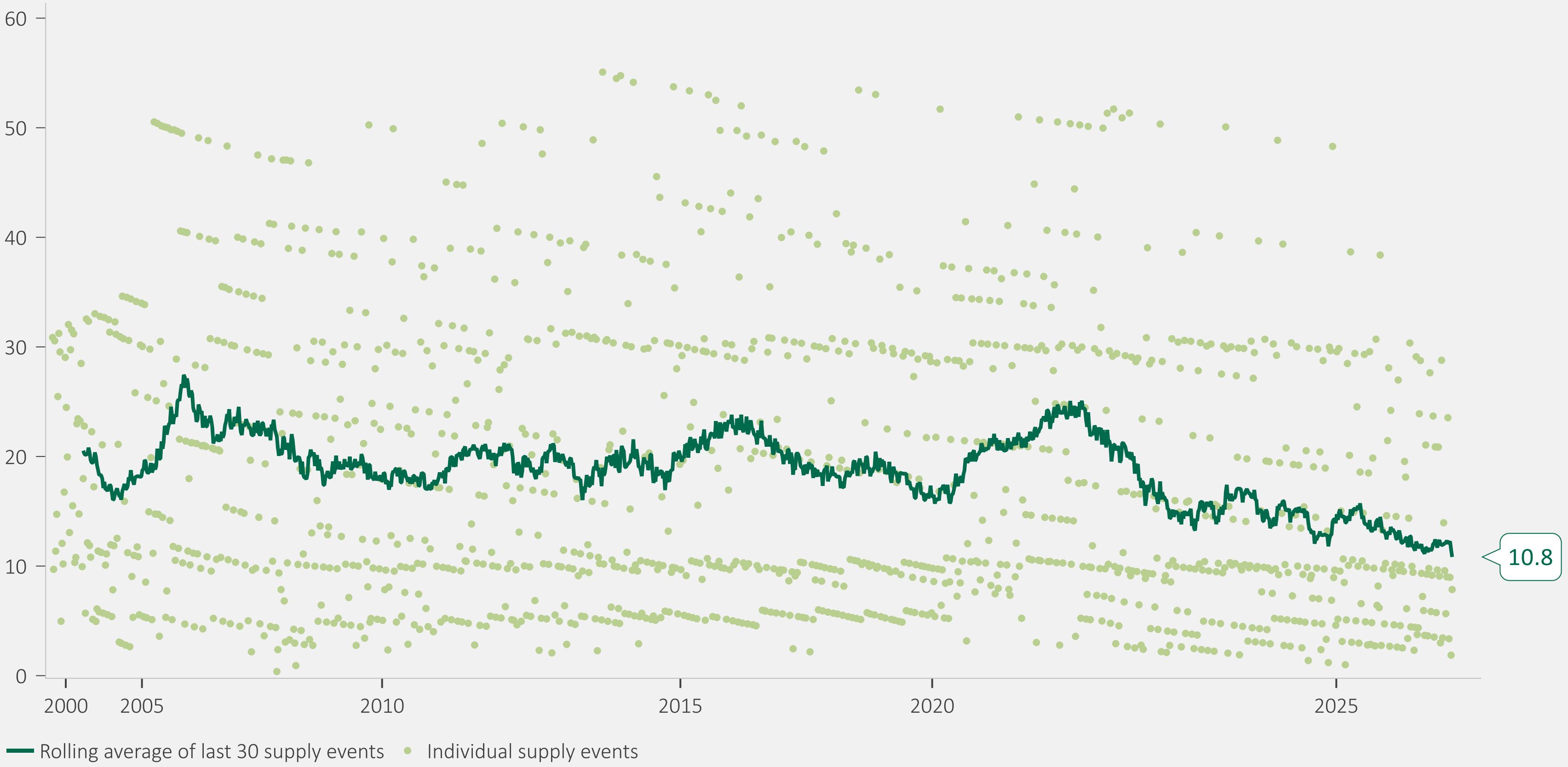
But slippage in the near-term cash requirement at the Budget could alter that forward-looking profile.

If supply continues at the current rate or increases further it might be another argument in favour of longer-dated gilt yields needing to stay relatively high to attract buyers.

Takeaway (6): Short-term dynamics are likely to limit the extent to which effective gilt supply slows. It will therefore be difficult to anticipate too much of a flattening / lower term premium bias from this factor.

(7) Market structure changes

Residual maturity of gilts at time of issuance, years



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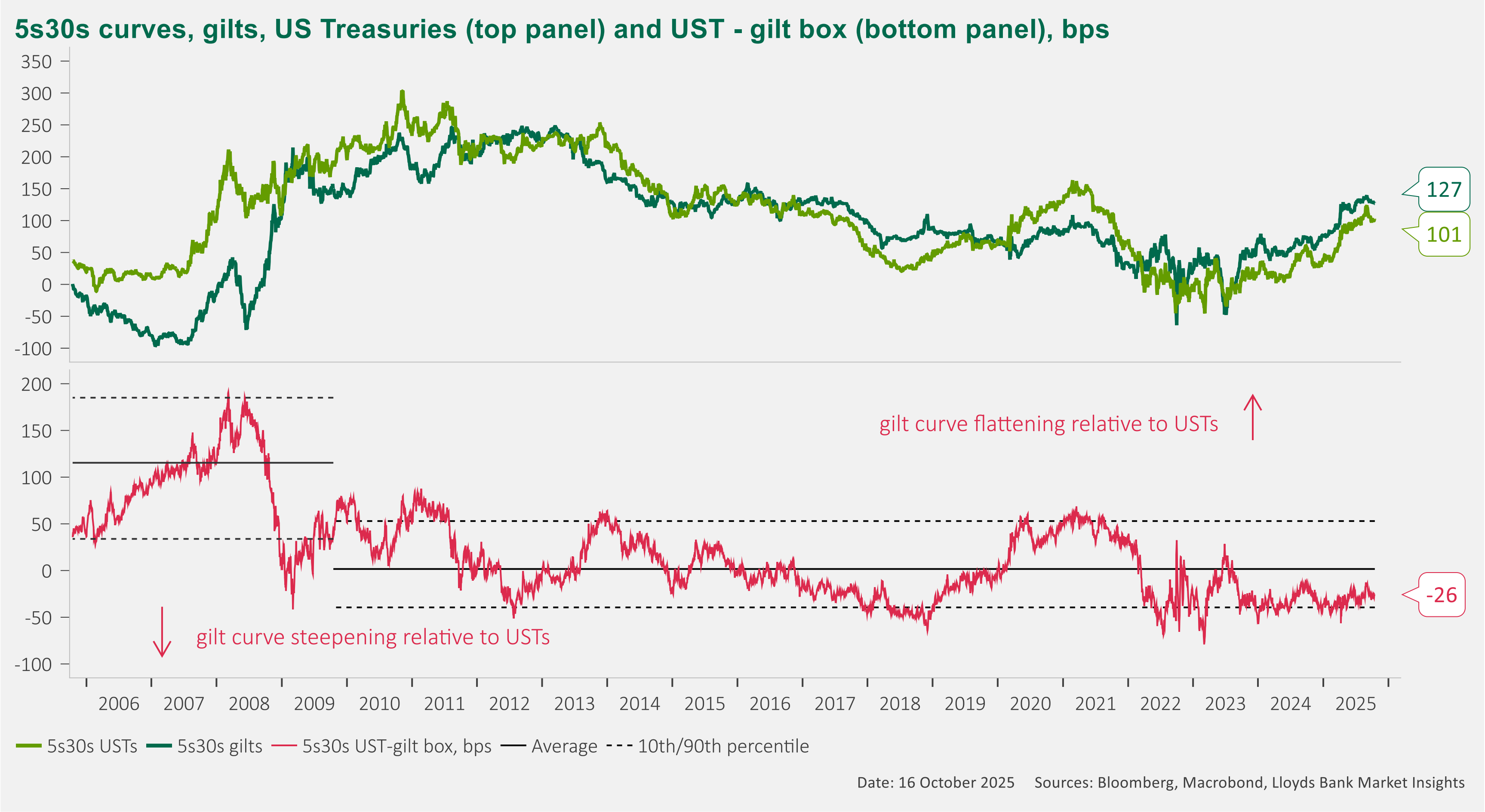
The Debt Management Office has responded decisively to reduced demand for long-dated gilts by cutting the weighted average maturity of supply.

There are limits to this exercise though as continued shortening of the debt portfolio increases refinancing risk for the government.

Takeaway (7): Further shifts shorter in the maturity of gilt issuance could counter curve steepening pressure but there is a limit to how far this dynamic could go.

(8) Cross market relative value



For all the focus on UK-specific factors, developments in other core government bond markets will be crucial, especially US Treasuries.

Since the GFC there has been a reasonably clearly defined range for the relative steepness of the gilt curve versus the US equivalent.

In the context of that range gilts are nearer the steeper end given the current slope of the US Treasury curve.

Takeaway (8): In the end volatility in expectations for Fed policy, Trump policy and the US economic outlook could end up playing a significant role in the future shape of the gilt curve…but UK fiscal sustainability questions will remain.

Conclusions

- The gilt yield curve isn't just steeper because of the normal relationship between policy rate expectations and curve slope. Even adjusting for that it looks relatively steep.

- Survey-based measures of inflation expectations look high relative to market-based metrics. If market metrics catch up, rising inflation risk premium could steepen the curve further.

- Fiscal sustainability issues for the UK will not be resolved by the forthcoming Budget and these vulnerabilities warrant investor compensation at the long end.

- Gilt supply is still at elevated levels, with QT playing a role too, and demand has become more price sensitive and shifted to shorter maturities. That source of curve steepening risk could be countered by further reductions in the weighted average maturity of supply…to an extent.

- Cross-market dynamics are important too. The UK's debt sustainability challenges are shared by the likes of France with Japan and even the US vying for attention. In any case, its yield curve trend will influence gilts too.

Bottom line: Sticky above-target inflation and a weak underlying fiscal situation warrant an elevated term premium for a given level of policy rate expectations.

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