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Elston Insights

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# UK Gilts: time to extend duration

- Changing yield-duration trade-off
- Preparing for a BoE pivot
- Term-segmented Gilts ETFs can enable implementation

The trade-off between yield and duration is tipping in the latter's favour. We think it's time to extend duration in anticipation of a BoE pivot in 2024. This can be implemented using term-segmented gilts ETF to achieve a target duration.

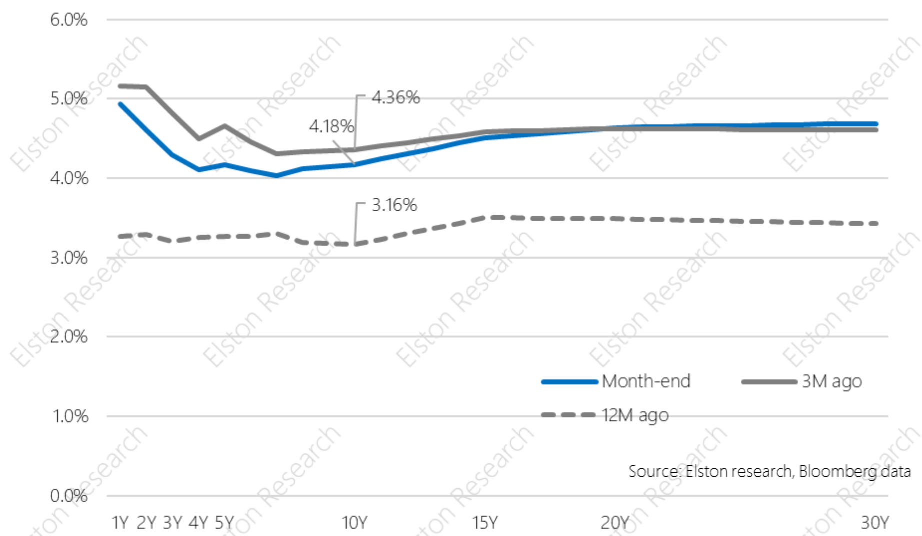
## The changing yield-duration trade-off

In 4q21, before Central Banks started hiking rates, we recommended the advisers and managers we work with to shorten duration within the Bond portfolio using money market funds and Floating Rate Notes to hedge against rate interest rate hikes. In our 2023 Outlook, a key theme was yield was back and so Bonds were getting interesting, but that it was safer to stay at the front-end of the yield curve, putting cash to work using money market funds. In our recent 2024 Outlook shared with clients in December 2023, one of our key themes is "Perfecting the Pivot", with a marker to extend duration the closer we get to a potential pivot in Central Bank policy rates.

So why did we not recommend to go long duration in December? For two reasons:

First the shape of the yield curve meant that yields were still more attractive at the near-end. Taking additional duration risk was not rewarded by additional yield, and whilst the prospect of a rate cut was certain, the timing was not. The shape of the yield curve is illustrated below.

*Fig.1. UK yield curve as at December 2023*




Second, we felt that market was running ahead by pricing in rate cuts as soon as March. Any delay to rate cuts would trigger a reversal in yields, so additional duration would hurt not help. Which is what happened as those hoping for an early cut had to push expectations further back. The resulting decline of benchmark gilts yield (on early-pivot hope) and then uptick (on later-pivot realisation) is illustrated below.

*Fig.2. UK benchmark 10 year gilts yields performance over 12 months to 21-Feb-24*

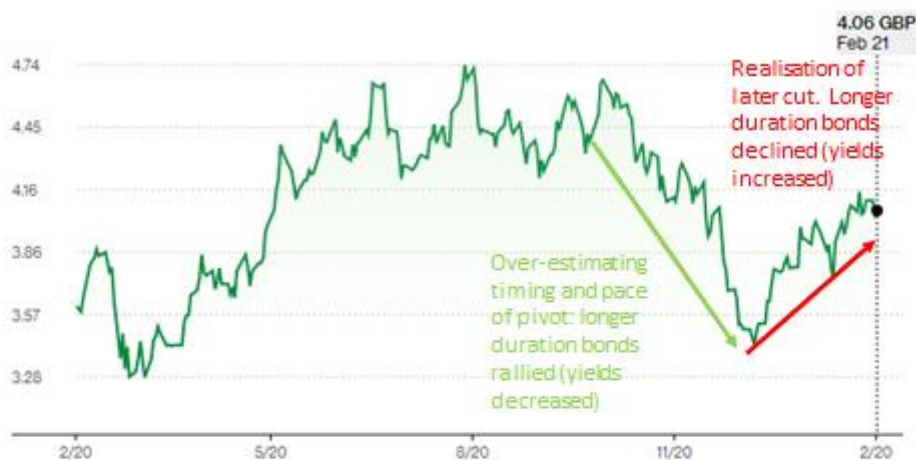



Chart: Blomberg.com; Annotations: Elston research

## Preparing for a BoE pivot

With weaker economic data in the UK, we think we are getting closer to a potential rate cut from the BoE. BoE's own forecasts show that if they hold rates at 5.25%, they could end up with inflation falling below target in 2025-26, because of the resulting slowdown[1].

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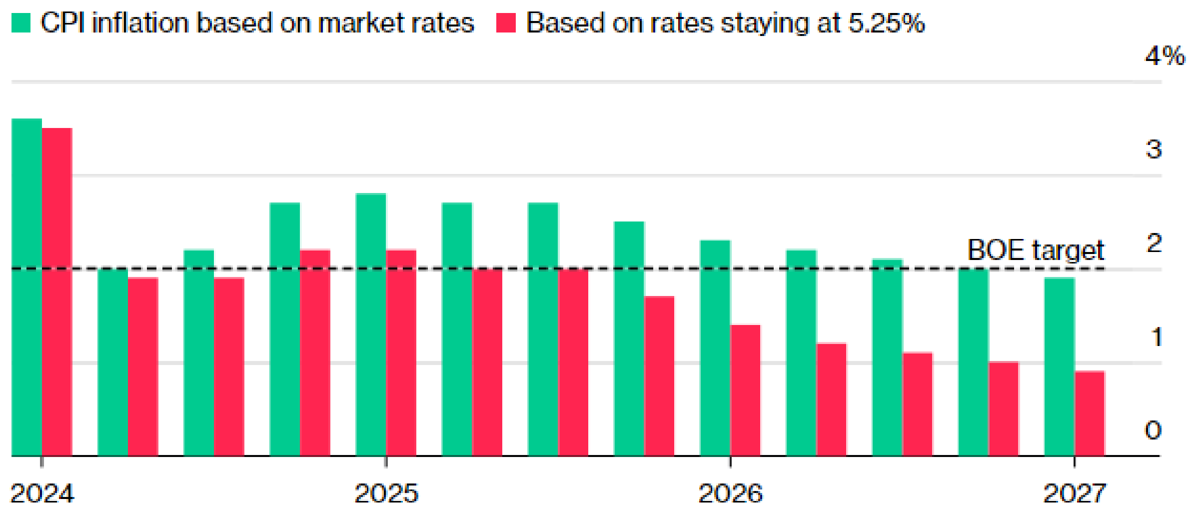
[1] https://www.bloomberg.com/news/articles/2024-02-01/bank-of-england-signals-rate-cuts-possible-once-inflation-eases

*Fig.4. Projected inflation rate falls below target if rates held flat*




Source: Bank of England
Note: Modal estimates

Chart: Bloomberg.com

Furthermore, Governor Andrew Bailey has flagged that the BoE can elect to cut rates before inflation hits the target of 2%[2]. Because of the UK's higher recession risk, it could be that the BoE starts cutting rates potentially before the Fed (just as they were first to move upwards in 2021).

So it's important to ensure your bond portfolio is on the right curve (BoE, not Fed or ECB), not just the right currency (GBP, not USD or EUR).

### Moving to neutral (but whose?)

Whilst we believe it makes sense to move from underweight duration to neutral duration, asset allocators will have their own view of what "neutral" means, and this could also be informed by advisers' and manager's choice of portfolio benchmark. (We can explore this further in a model portfolio asset allocation review, if required.)

### Implementation with term-segmented Gilts ETFs

For advisers and portfolio managers looking to implement a duration shift, this can be done using term-segmented UK Gilts ETFs.

The inverted shape of the yield curve (fig.1.) is reflected in the nominal yields of different key ultrashort-duration bond and gilts ETFs relative to their respective durations.

(Ultrashort duration bonds hold similar instruments to a money market fund, but they are not money market funds because as ETFs they are not governed by the FCA Money Market Fund Regulations: for more on what those regulations our, see our recent CPD).

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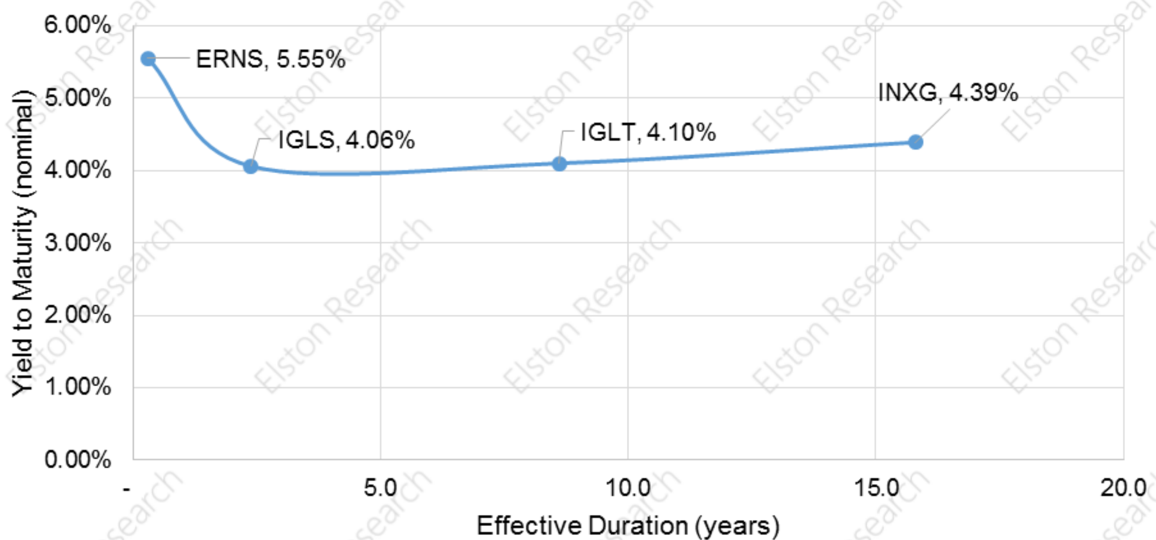
[2] https://www.bloomberg.com/news/articles/2024-02-20/bailey-says-boe-can-cut-rates-before-inflation-returns-to-target

Fig.5. Yield vs Duration of UK ultrashort bond and gilts ETFs




## Summary

Being underweight duration has worked well for a "safety-first" approach whilst the growth and rate outlook was uncertain and the front-end of the yield curve was well rewarded.

But following the back-up in yield, and as the outlook for policy rates changes, we think it makes sense to be adapt and start moving to a neutral duration posture for higher potential capital growth in bond values as interest rates decline.

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## Further Reading

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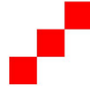

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