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Soaring gilt yields are a bigger problem than the pound’s slide

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Forget about sterling; the real action is in the bond market, which has suddenly caught fire. Yields on 10-year gilts have almost doubled to 1pc; they were just 0.52pc on 12 August. Investors are reeling, and for good reason.

So what is happening?

For years now, gilt yields have been going down, and further down, in common with fixed income markets in all developed countries.

The cost of long-term borrowing has fallen to ridiculously low levels; in many cases, people have been paying in real terms for the privilege of lending to the Government.

There are cons as well as pros to this.

We’ve seen the emergence of a giant bonds bubble, a false market in gilts fuelled by quantitative easing and the belief that central banks are now the gilt buyer of first resort; asset prices have surged, bolstered by lower discount rates; pension funds have become almost unviable; and an excessively bearish view of long-term economic growth has taken hold, with forecasters confusing artificially low bond yields with the market’s assessment of long-term GDP growth.

The main advantage of cheap money is that it has slashed the cost of government as well as private sector borrowing.

Fixed rate mortgages have tumbled, and companies have been able to borrow more cheaply, which means that the hurdle rate for capital projects has fallen, boosting corporate investment.

Yet the trend in the UK has suddenly turned, for now at least. In the last week alone, yields have jumped from 0.73pc last Monday to 1pc today, going hand in hand with sterling’s drop from $1.30 to $1.24.

Some institutional investors are licking their wounds: since 12 August, the 10 year gilt price is down 3.7pc, the 20 year gilt by 6.6pc and the thirty year gilt by 9pc, according to Hargreaves Lansdown.

So much for a supposedly safe, non-volatile asset. On top of all of this, the gap - or spread - between gilt yields and the yields on German government has increased, rising to almost a whole percentage point. Philip Hammond’s borrowing will be more expensive and his deficit greater; by contrast, pension fund deficits have fallen sharply in recent days.

The jump in gilt yields could prove to be a headache for Philip Hammond, the new Chancellor CREDIT: REUTERS

It’s amusing how justifications for the post-Brexit price movements have changed. At first, the drop in gilt yields in the weeks following the referendum was attributed to markets assuming that GDP growth would fall over the next few decades, compared to what would otherwise have been the case; now general, inchoate fears of “hard Brexit” (whatever this may actually mean) combined with a hypothetical “major fiscal policy loosening” are cited.

Angst in the City is indeed one explanation for the mini-surge in gilt yields; the government’s unorthodox, confused communications over what trade deal it is seeking with the EU and the orgy of business-bashing hasn’t helped.

The mood is fearful and febrile; very few actually understand what the government wants to achieve, for the simple reason that the government itself will understandably take time before it settles on its favourite course of option. The error is taking too seriously what the various ministers and officials have to say, and drawing excessively firm conclusions from their pronouncements.

The same holds for Mr Hammond’s supposed public spending spree: I doubt that the minor adjustment he appears to have in mind would spook the bond vigilantes.

The government’s clumsy language was a bad mistake; it needs to make it clear that Brexit does not mean bashing foreigners or introducing anti-growth policies.

The mainstream view in the City, shared by about 90pc of economists, that Brexit means lower growth is wrong: with the right policies, and global free trade, the UK could be richer in a decade’s time than it would otherwise have been.

But there are lots of other reasons too for the higher gilt yields. Inflation expectations have now shot up over the next few years: the pound’s slump will push up the prices of imports.

Given that monetary conditions are loose across the board, and the money supply is growing quite fast, this is plausible, though it should be manageable.

An even bigger reason is Theresa May's comments about the "bad side-effects" of the Bank of England's low interest rates and renewed policy of quantitative easing (QE).

The Bank's bond buying is a central reason for low yields, so the prospect of that ending inevitably sent them upwards.

Even worse, many wrongly believe that she intends to replace monetary policy, currently the main tool for short and medium term demand management, with fiscal policy, a Keynesian approach that has failed disastrously whenever it has been tried.

Fiscal policy is not about building a few more roads: when understood properly, it would imply extreme moves such as increasing spending by £50bn or £100bn a year, or slashing VAT to 10pc, and massively increasing or decreasing the budget deficit, another red flag to the bond markets.

May is right: QE and ultra-low rates have gone too far, and are causing havoc and fuelling asset bubbles with untold distributional consequences.

But her speech was for effect: nothing much will change, though savers may be given some help. Yet loose words are always dangerous; and the markets over-interpreted the PM's speech.

They began to worry that the independence of the Bank of England would be terminated, and some started to speculate again about the future of Mark Carney, the Bank's Governor. Monetary policy needs to be readjusted – but it needs to be done calmly and slowly, and not at the same time as a major sterling depreciation.

What I don't understand is why this wasn't obvious to the government last week.

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