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How well do bond markets predict interest rates?

Spoiler: not that well, and this matters for gilt investors

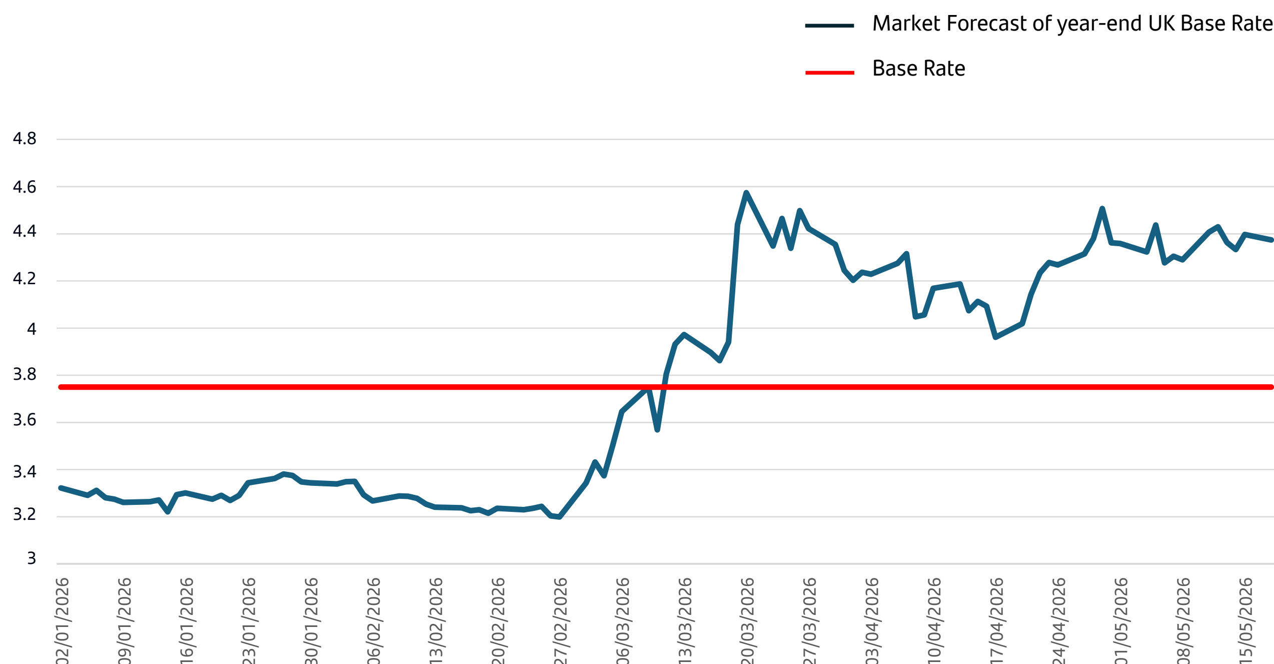
Bond markets are poor forecasters of future policy rates. Yields reflect far more than macroeconomic expectation, they also embed risk premia, institutional constraints, liquidity conditions and compensation for uncertainty. High gilt yields today may therefore represent attractive compensation for risk rather than a reliable signal of structurally worsening fundamentals.

One of the first books I read when I entered the bond markets shocked me: The Random Character of Interest Rates argued that, despite the confident predictions of all the commentators I followed at the time, the path of interest rates was unknowable beyond the very near term. Markets constantly absorb new information that reshapes the yield curve, leaving yesterday's view obsolete.

Today's gilt market has exhibited plenty of that randomness. While the Bank of England base rate has sat unchanged at 3.75% for six months, the market's implied path for future rates has whipsawed violently as investors attempt to price war in Iran, inflationary pressure from higher oil prices, and extreme domestic political instability surrounding the government's future. At the end of February, the curve implied 2 to 3 UK rate cuts by year-end, now it implies 2 to 3 hikes. Over 2026, the UK has become the highest-yielding sovereign market in the G7: ten-year gilt yields have pushed well above 5%, while thirty-year yields have broken 5.8%, levels not seen in decades. In many ways the UK now trades more like an emerging market.

Graph 1: Implied year-end bank rate expectations have swung violently this year

Source: Bloomberg and SAM calculations



Confronted with so much volatility, it is still tempting to look at the yield curve for an updated forecast of where rates are heading, and to base one's tactical investing decisions on whether this seems right or wrong. Most finance textbooks teach some version of the expectations hypothesis: long-term yields reflect expected future short-term rates plus a term premium compensating investors for uncertainty. Elegant in theory, the framework has performed badly in practice.

Academics have repeatedly struggled to find evidence that bond markets reliably predict future policy rates. Campbell and Shiller famously found that yield curves often predicted rate moves in the wrong direction. Later work by Fama, Bliss, Cochrane and Piazzesi showed that forward rates contain far more information about future bond returns than future policy rates. Put differently, today's yield curve is often a better predictor of the return investors will earn from holding bonds than of what central banks will actually do.

Yields are prices, not forecasts. They clear markets rather than predict the future. Part of that price is the term premium, compensation for uncertainty, which New York Fed estimates show has varied widely and turned negative during the QE era, an extraordinary inversion in which bond investors paid to assume risk rather than charging for it.

Part of this is simply who is forced to buy. I once commented to a client that nobody knowingly invests for negative returns. He ran a UK pension scheme and corrected me: that was exactly what they did, buying index-linked gilts at huge scale with guaranteed negative real yields, not from conviction but to hedge liabilities. They were price-insensitive buyers, and for years their demand helped pin long real yields below zero.

That buyer has since stepped back. Pension schemes are better funded and de-risking, central banks are shrinking their balance sheets, and government issuance is heavy. The UK's Liz Truss mini-budget crisis of 2022 was the clearest example: long-dated yields exploded higher because leveraged pension hedges were forced sellers into a falling market (not because investors suddenly revised their expectations for the Bank of England Base Rates.) Yields and policy expectations came completely unstuck.

Graph 2: A profound shift in gilt-buyer dynamics, as QE and liability-driven pension demand fade

Source: Bloomberg and SAM calculations

That distinction particularly matters today. Elevated gilt yields price in the uncomfortable possibility that the BoE may intentionally slow down the UK economy to fight the effects of higher global oil prices. But more than this, they also reflect political instability, inflation uncertainty, fiscal anxiety, heavy issuance, and the disappearance of the price-insensitive buyers that dominated markets during the QE era.

Are today's risks greater than those investors faced during the financial crisis, the eurozone crisis, or the pandemic era? Far from it. The difference is that today's market structure, with central banks shrinking balance sheets, pension demand fading, and heavy sovereign issuance returning, results in investors being generously compensated for bearing uncertainty. This should be seen as good news for UK multi-asset investors with a strategic allocation to gilts. For the first time in years, gilts once again offer them meaningful real income, credible diversification, and genuine duration upside in an economic slowdown.

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