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Research Note
Category 1: For Public Release

Bonds – why longer duration?

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Contents

Click to jump

Summary

This note explores why investors might consider longer-duration UK government bonds (gilts) despite their historical underperformance compared to equities. It evaluates four key factors influencing gilt prices and yields:

1. Short-Term Interest Rates

- Base rate movements by the Bank of England (BoE) significantly impact gilt prices.
- Higher rates make existing bonds less attractive, lowering their prices.
- The BoE's QE programme post-2008 suppressed long-term rates.
- Historically, the average UK base rate since 1820 is 4.76%, suggesting current rates (around 4.25%) are not unusually high.

2. Expected Inflation

- Inflation expectations influence bond yields.
- The market expects ~3.1% inflation over the next 10 years.
- Historically, UK inflation has averaged 1.79% over 325 years, suggesting fixed-rate gilts may currently offer better value than index-linked ones.

3. Long-Term Risk (Term Premium)

- Longer-dated bonds carry more risk and thus demand a term premium.
- The UK yield curve shows higher yields for longer maturities.
- Despite rising UK government debt (now over £2.69 trillion), debt as a % of GDP (~101%) is historically average.
- The UK has never defaulted on its debt, supporting its creditworthiness.

4. Diversification Factor

- Gilts have historically had low or negative correlation with equities, making them good diversifiers.
- However, since 2023, this correlation has turned positive, reducing diversification benefits.
- The LDI crisis in 2022 highlighted the risks of assuming persistent negative correlation.

Conclusion

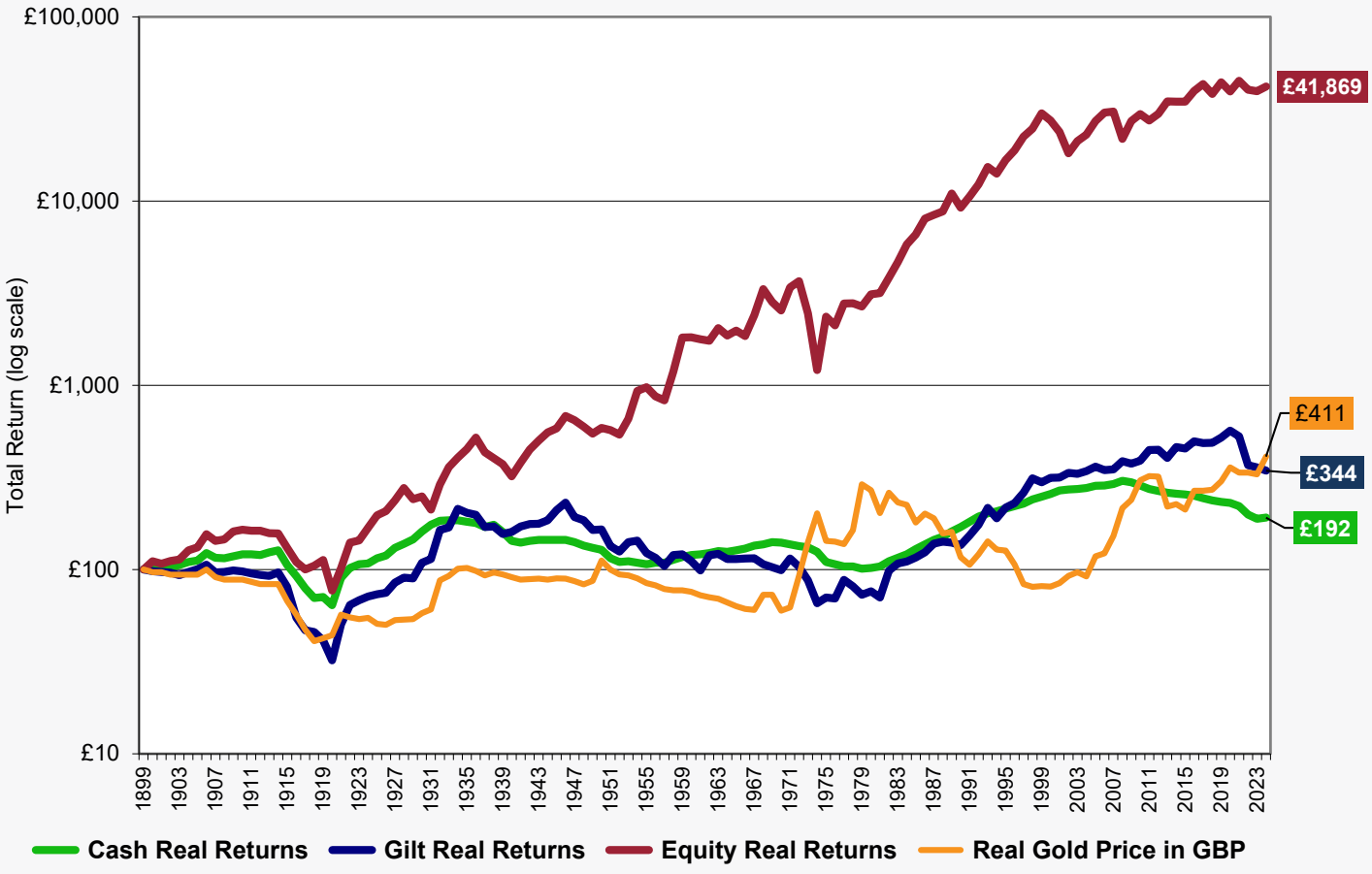
- Longer-duration gilts are now more attractive due to restored term premiums and higher yields.
- The main risk is a strong economic rebound leading to higher interest rates.
- While short-dated gilts offer lower volatility and liquidity, long-dated gilts may offer better returns if inflation remains controlled and rates fall as expected.

Background

As both a baby boomer that started his career in the ultra-inflationary seventies, and a manager of very long-term portfolios, I prefer equities to bonds.

I'm not alone; the data is stacked in favour of equities, as highlighted in the chart below, plotting "real" (inflation-adjusted) returns since 1899.

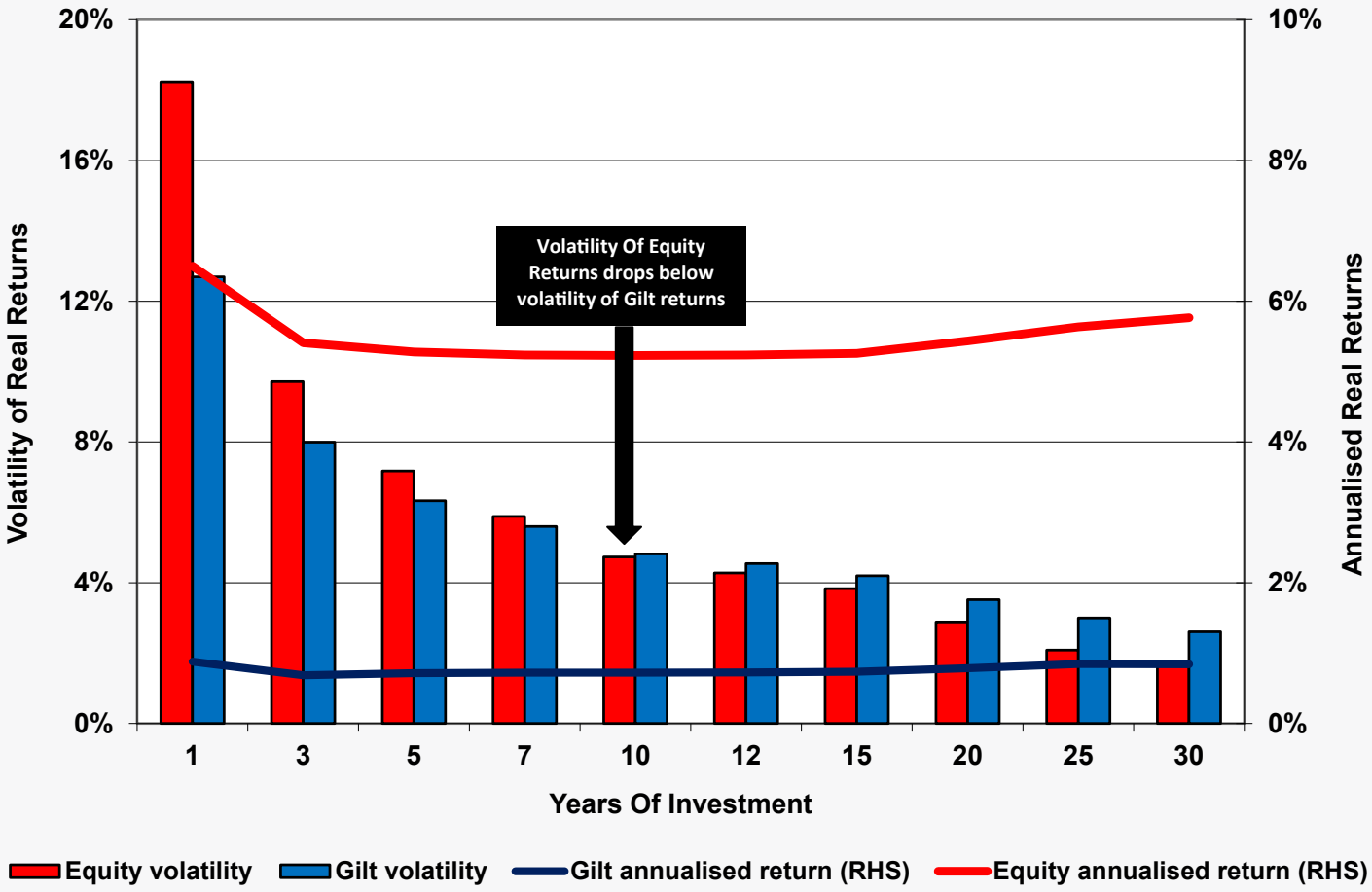
Chart 1: Real Return on £100 invested from 1899 to 2024 – Log Scale



Source: Barclays, Bloomberg & Courtiers

Over 125 years, UK equities turned the purchasing power of £100 into £41,869. Gilts only increased the same sum to £344. Bond investors will defend this underperformance by pointing out that gilts are safer, which is partly true, especially over the short term. However, once the time horizon stretches to 10 years, the average volatility of real equity returns drops below that of real gilt returns, as highlighted by the *Annualised Volatility of Real Returns* chart below.

Chart 2: Annualised Volatility of Real Returns



Source: Barclays, Bloomberg & Courtiers

For returns, equities are the clear winner over the longer-term. They also show the lower volatility of real returns from 10 years onwards, which begs the question; ***why bother with gilts at all?***

The answer is that gilts are, on average, significantly less volatile than equities over the short term. Not everyone has a 10-year minimum investment time horizon, or the stomach to take short-term equity risk. There is no point trying to be heroic holding equities if you lose sleep every time markets wobble.

So, gilts have their place, but in the current markets, should you buy short-dated or long-dated maturities?

What to think about when buying gilts

There are four factors driving gilt yields and, ergo, their price:

1

Short Term Interest Rates

Cash deposits are an alternative to gilts and cash deposit returns are affected by short-term interest rates.

2

Expected Inflation

Holders of gilts, especially long dated issues, need to consider how and if future inflation will erode the purchasing power of interest received and maturity values.

3

Long Term Risk (aka the “term premium”)

The additional return demanded by gilt holders as compensation against the possibility that inflation may be higher than expected, and/or the creditworthiness of the issuer (for gilts this is the British government) may deteriorate and/or an external event may adversely affect gilt prices.

4

The Diversification Factor

How and to what extent gilts act as a risk diversifier when held with other assets, especially equities.

1. Short Term Interest Rates

The Bank of England's base interest rate is a primary driver of gilt yields. When interest rates rise, newly issued gilts offer higher returns, making existing, lower yeilding, gilts less attractive. Consequently, gilt prices fall, and yields rise. Conversely, rate cuts can drive yields down and prices of existing issues up.

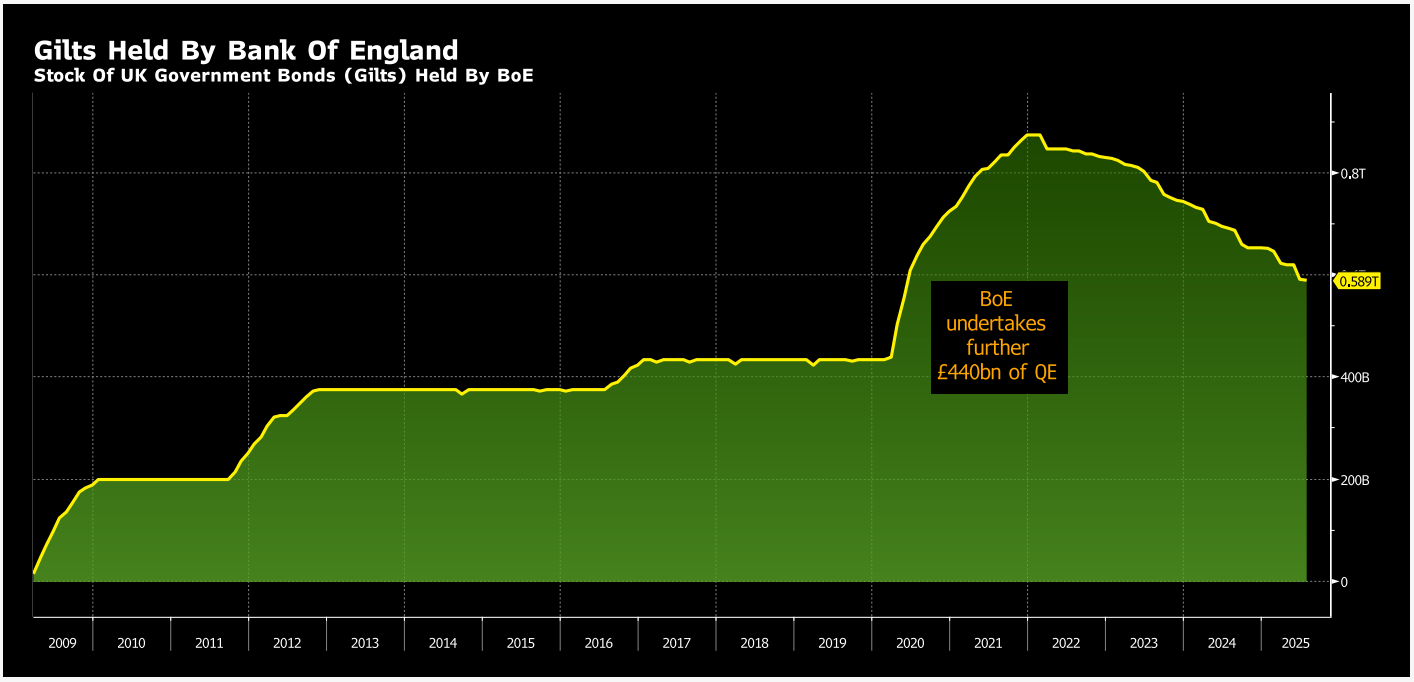
The Global Financial Crisis had a profound effect on base interest rates around the world. In the UK, the Bank of England (BoE) slashed interest rates to counter the adverse effects that government fiscal tightening and a nasty recession were having on unemployment and the economy (as you can see in the *UK Base Rate & Unemployment* chart).

Chart 3: UK Base Rate & Unemployment

Source: BoE, Bloomberg & Courtiers

Aside from keeping the UK Base Rate low from 2009 onwards, the BoE also embarked on a remarkable bout of Quantitative Easing (QE) which involved buying gilts in the open market to drive down long-term interest rates. You can see the effects of this in gilts held by the *Bank of England QE* chart on the next page.

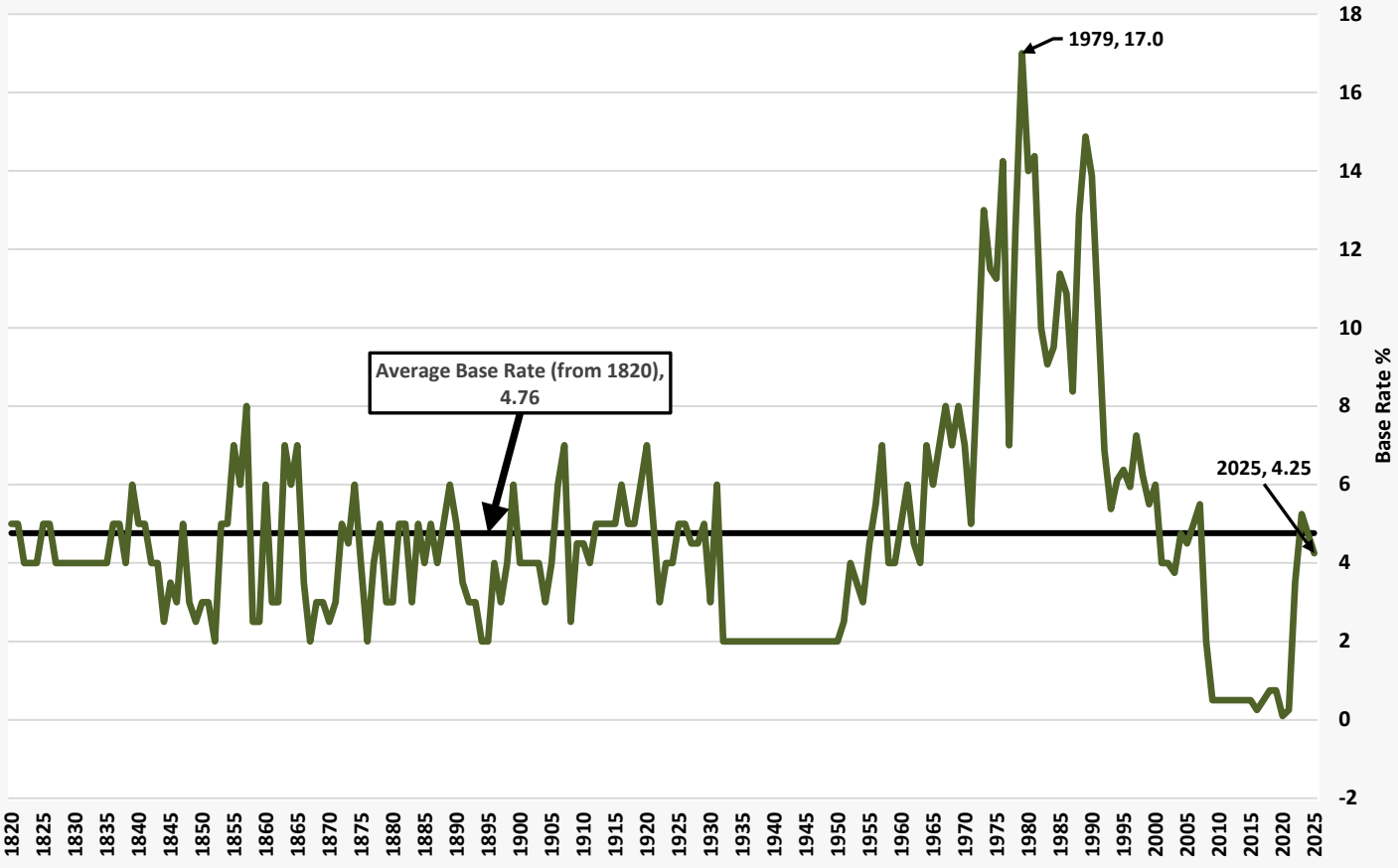
Chart 4: Bank Of England QE



Source: BoE, Bloomberg & Courtiers

To put the current conditions in context, you can see the UK base rate from 1820 to present in the following chart.

Chart 5: UK Base Rate from 1820



Source: BoE & Courtiers

This reinforces the point I have been making for some time: In the 1970s, we experienced the highest ever levels of interest rates, and in the 2010s to 2020s, the lowest. My generation has seen the zenith and nadir of Bank of England base rate policy.

For those contemplating buying gilts, the future path for the UK Base Rate is critical. If it rises beyond expectations, gilt holders will lose money (and they lost shedloads of money in the high-interest seventies). If the UK Base Rate turns out lower than expected, gilt holders can cash-in (as they did in the 2010s).

The big fear for bondholders, especially those who have long-dated issues, is that the base rate will rise substantially above current levels. This fear may be overdone because, as the chart showing the UK Base Rate from 1820 highlights, the Base Rate averaged just 4.76% over the last 205 years. Indeed, the high-interest 1970s were an anomaly based on any period dating back to the 16th century[1].

[1] See Table 76 in "A History of Interest Rates" (fourth edition) by Homer and Sylla.

2. Expected Inflation

Tasked with keeping inflation at a predetermined level, central banks in developed countries set interest rates accordingly. This means that, as inflation rises, investors generally expect interest rates to rise in response.

Central banks don't seek to ensure that inflation never strays from its target, which for most developed economies is 2% p.a., but they do want it to average that rate over the medium-to-longer term, and no leading central banker wants to be known for letting the inflation genie out of the bottle. History is not kind to central bankers who preside over rampant inflation. Arthur Burns, America's leading central banker in the inflationary seventies, became known as "The Worst Fed Chair in History". Andrew Bailey, current governor of the Bank of England, will be keen to avoid a similar sobriquet.

The reason that investors in fixed interest gilts hate inflation is twofold: firstly, because central banks respond to inflation by pushing up short term interest rates, which tends to drive down bond prices, and secondly, because inflation erodes the future purchasing power of gilt coupons (interest received) and capital.

As some gilts have their coupons and maturity values linked to the rate of inflation, it's possible to calculate what the market-expected rate of inflation is into the future. The chart, *Index Linked Spread on 10 Year UK Gilts,* below looks at the present forecast rate of UK inflation.

Chart 6: Index Linked Spread on 10 Year UK Gilts

Source: Bloomberg & Courtiers

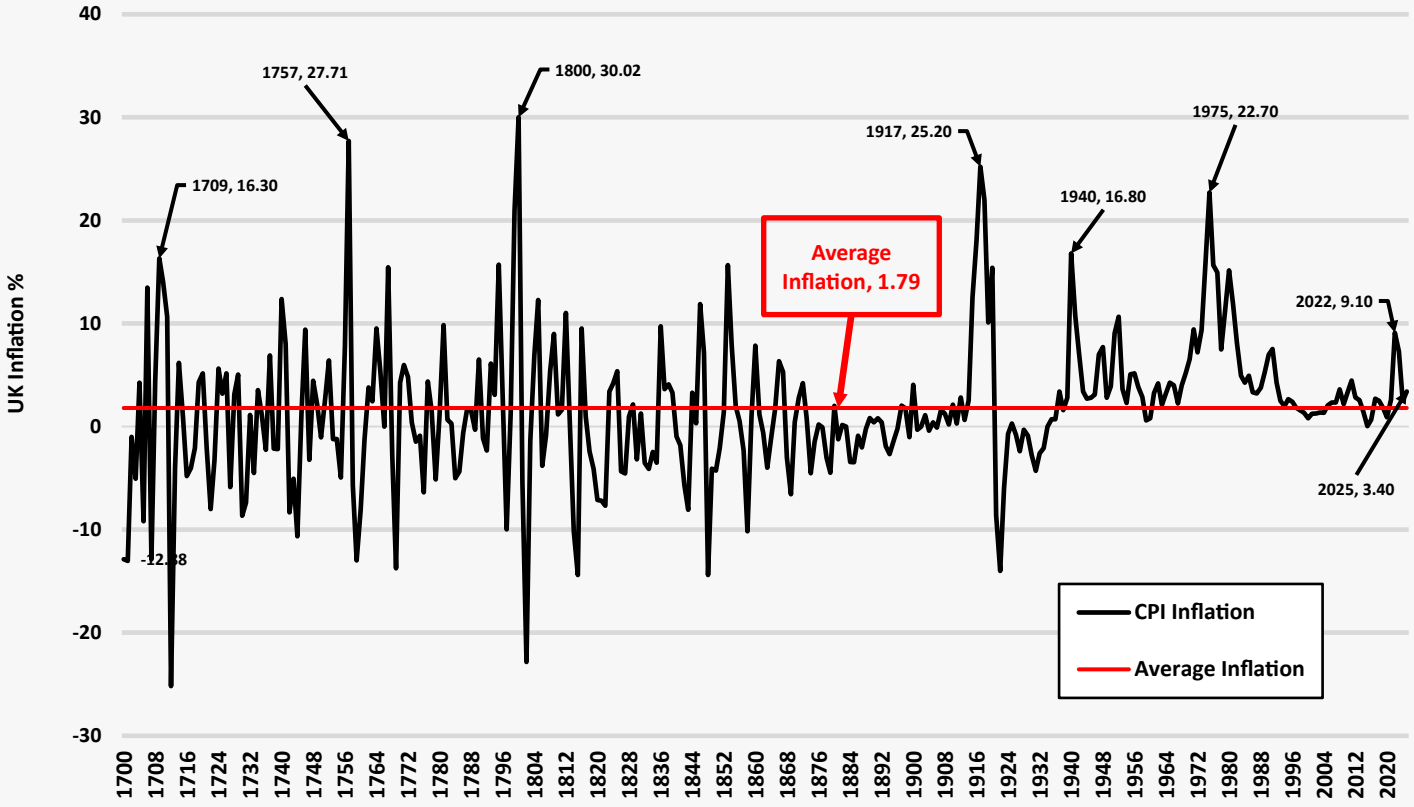
The top graph in Chart 6 shows the current yield on 10-year fixed interest gilts (the green line) as 4.5976% and the bottom graph shows the yield on 10-year index linked gilts, which is over and above inflation at 1.510%.

Also in the top graph, the blue line shows the difference between the 10-year fixed interest yield and the 10-year index linked yield at 3.088%, which is the market-expected rate of inflation over the next 10 years.

Investors that expect UK inflation to average less than 3% p.a. would buy a fixed rate gilt, whilst investors expecting inflation to be higher than 3% would buy an index-linked gilt.

History favours those currently preferring a fixed rate because the actual rate of long-term UK inflation has been much lower than 3% p.a., as highlighted in the *UK Inflation from 1700* chart below.

Chart 7: UK Inflation from 1700



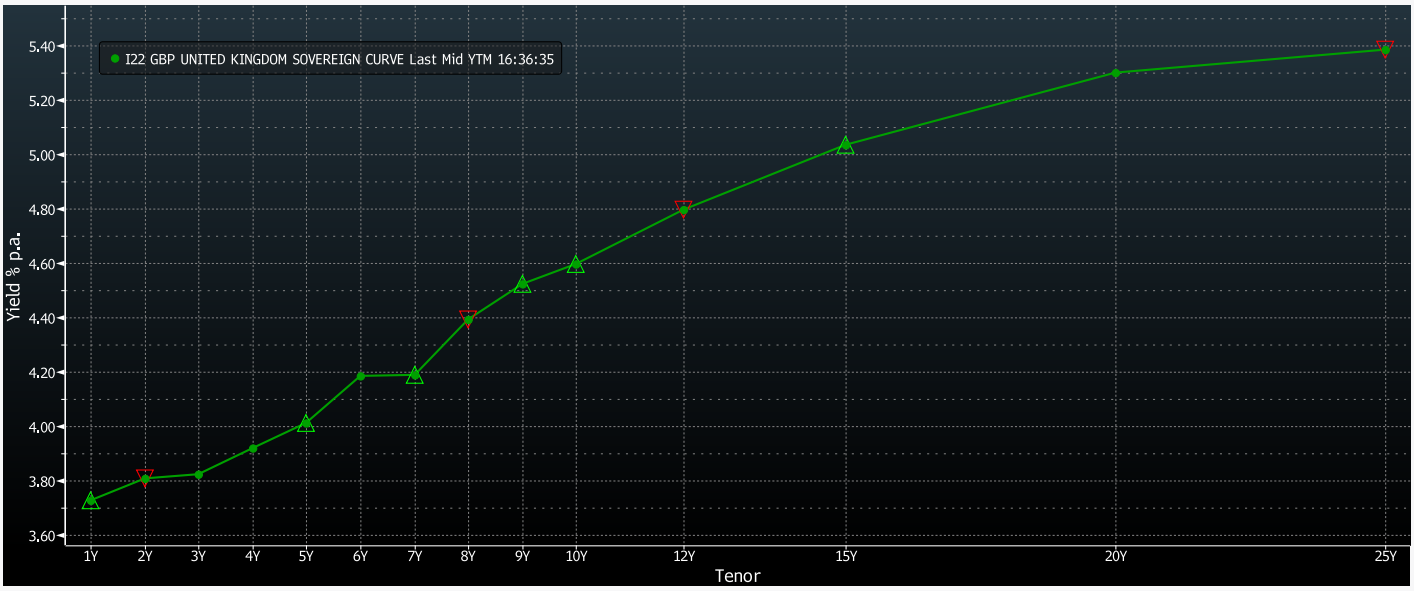
Source: BoE & Courtiers

The above chart shows UK inflation averaging 1.79% over the last 325 years, which means buyers of 10-year index-linked gilts are expecting inflation to run much hotter over the next decade. If they are wrong, it presents a good opportunity for buyers of fixed-interest, rather than inflation-linked, issues to cash in.

3. Long Term Risk (aka the "term premium")

It's intuitive that the longer the period until your bond's maturity, the more time there is for things to go wrong. For this reason, long term investors seek an additional return to compensate for this risk, which is known as the "term premium". You can see this in the *UK Yield Curve at 14th July 2025* chart, which shows the current UK Yield curve for maturities from 1 to 25 years.

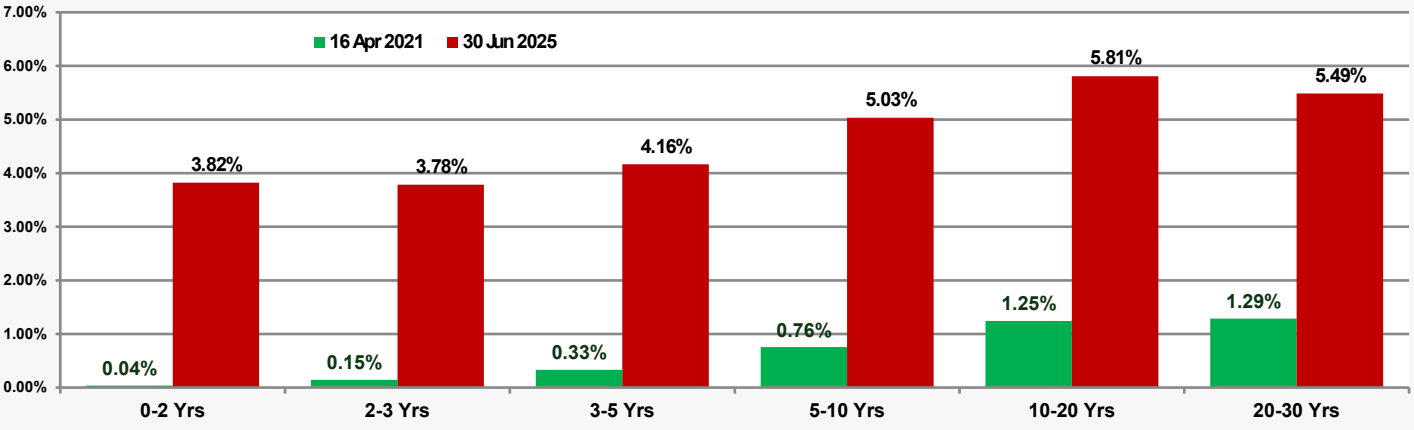
Chart 8: UK Yield Curve at 14th July 2025



Source: Bloomberg

If you further dissect the curve, you can derive future levels of market expected interest rates. You can see this in the *Implied Future UK Interest Rates* chart below, which shows the future expected rates of interest at 30th June 2025, versus the spring of 2021, when interest rates were very low and central banks were fearful of deflation.

Chart 9: Implied Future UK Interest Rates

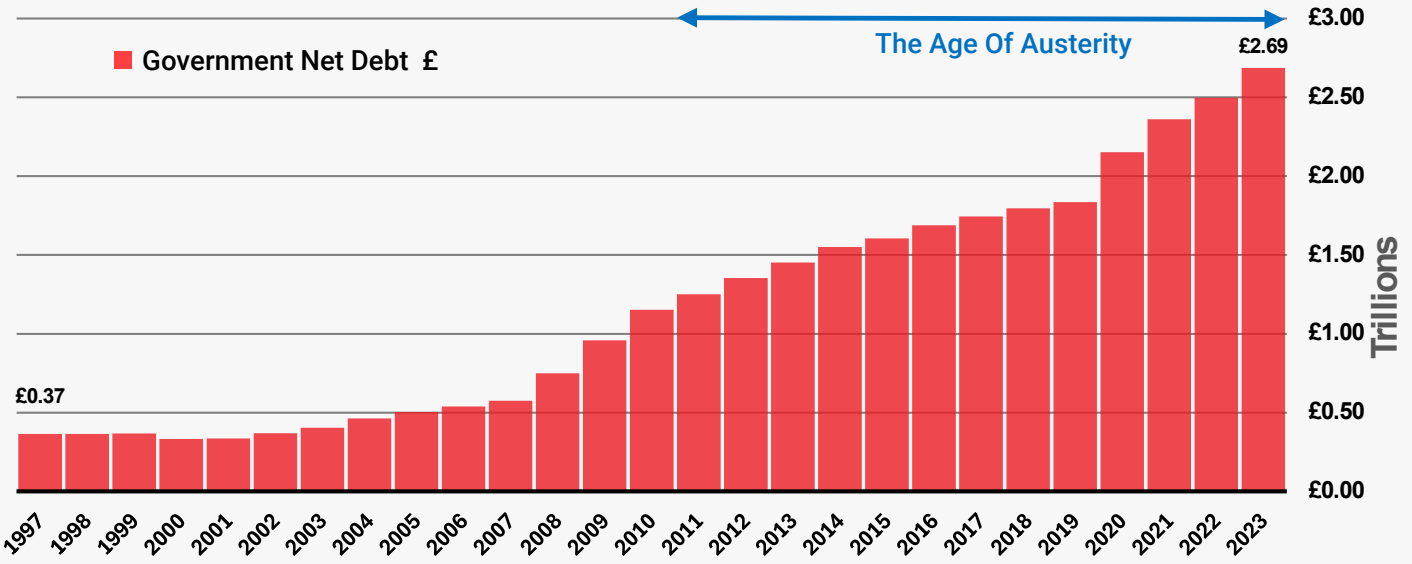


Source: Bloomberg & Courtiers

I find Chart 9 fascinating because you can see that in April 2021 the market expected the UK 10 year interest rate to average just 1.25% p.a. in 10 years' time. Just over four years later the market has adjusted its expectations to 5.81%, which is an over threefold forecast rise. The present market implied rates seem more sensible.

Aside from interest rate expectations, the strength and trustworthiness of the issuer and borrower of the bond (which in the case of gilts is the UK government) is important. There is a lot of talk about unsustainable borrowing by governments, especially those of most major developed economies. The UK government is under constant scrutiny because its borrowing has ballooned over the last 20 years, as highlighted in the *UK Government Net Borrowing £* chart below.

Chart 10: UK Government Net Borrowing £

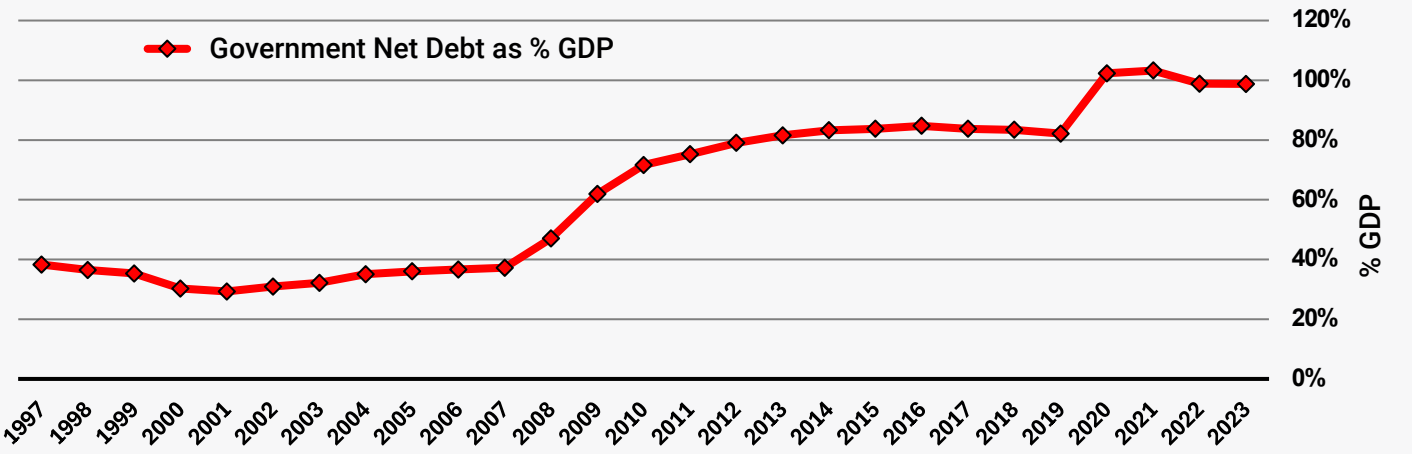


Source: ONS, Bloomberg & Courtiers

The figures are pretty spooky with UK net government borrowing totalling "just" £370 billion in 1997 but rising over seven-fold to £2.69 trillion by the end of 2023.

In the creditworthiness of debt assessment, it's not the amount borrowed that is the most important feature, but the borrower's ability to pay interest and repay capital. So, a better way to look at UK government debt is as a percentage of GDP. Here the outlook improves a little.

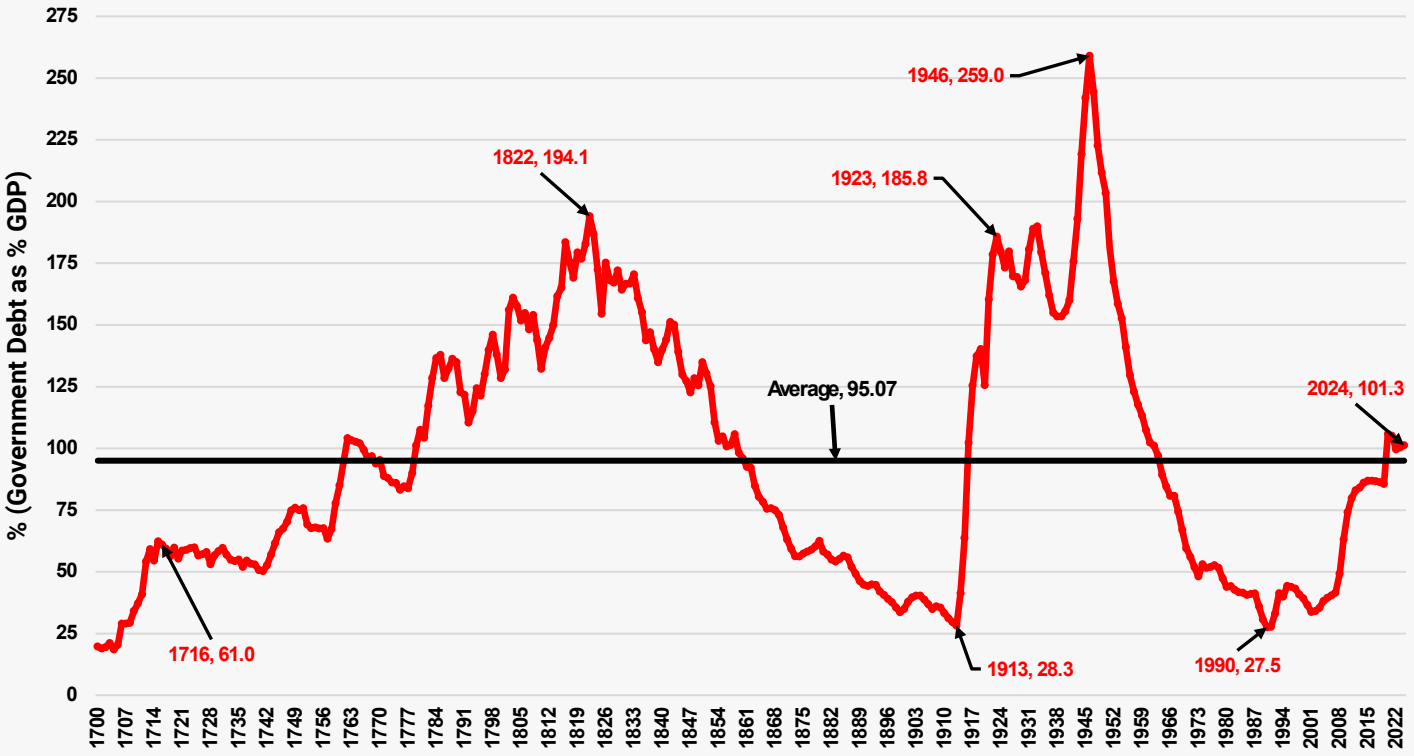
Chart 11: UK Government Net Borrowing as % of GDP



Source: ONS, Bloomberg & Courtiers

Chart 11 shows UK government borrowing as a percentage of GDP rocketing after the global financial crisis, stabilising during the 2010s, and then lurching upward again as Covid hit the economy. In the current environment, with a populace tired of austerity and politicians needing to adjust policy accordingly or lose their seats, no government dares to subject the country to another bout of fiscal hardship. Does this place the UK in a dreadful financial position? No! In the long-term context, Government Debt to GDP is about average (see the *UK Government Net Debt as % of GDP from 1700* chart below).

Chart 12: UK Government Net Debt as % of GDP from 1700



Source: BoE, ONS, Courtiers & Bloomberg

In the last 325 years there have been four secular trends:

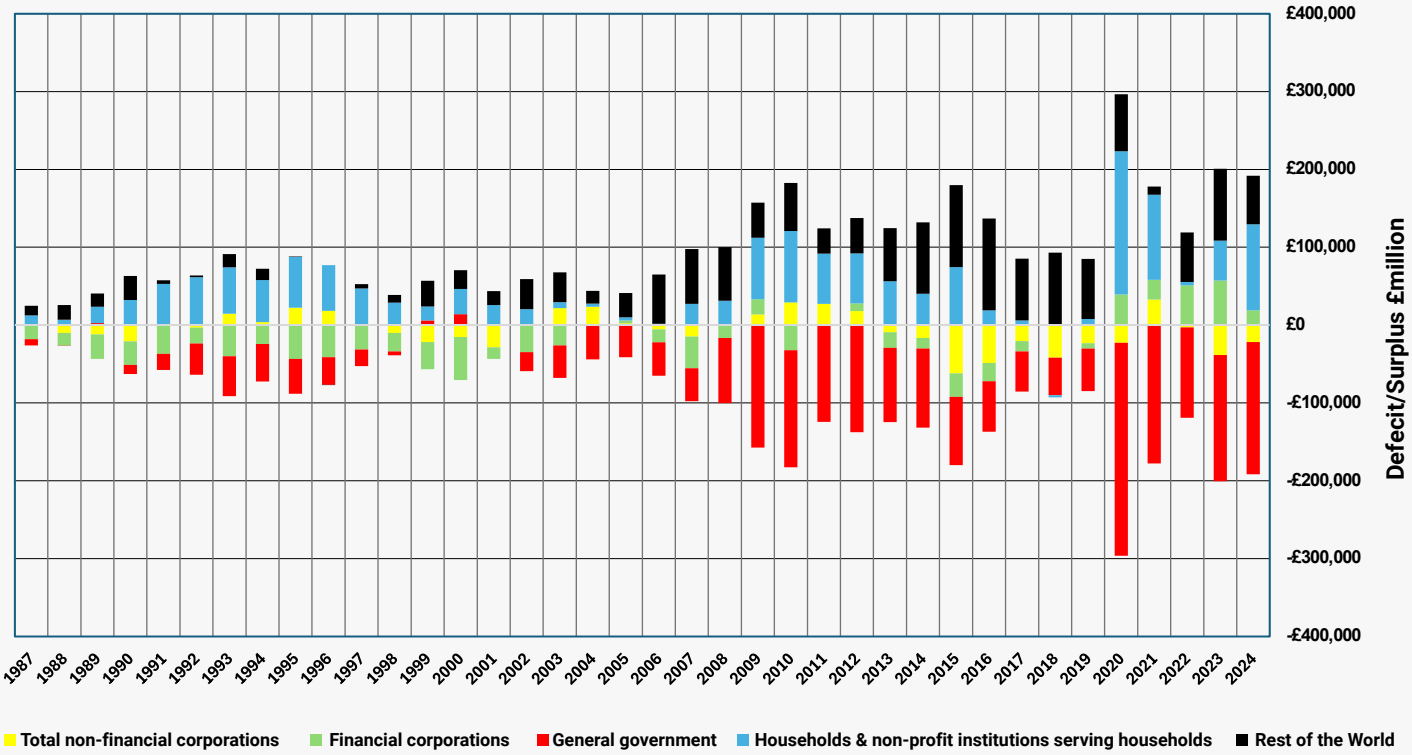
1. Rising borrowing from 1700 to 1822.
2. Falling borrowing from 1822 to 1913.
3. Rising borrowing from 1913 to 1946.
4. Falling borrowing from 1946 to 1990.

In the last 25 years the trend has moved inexorably upwards, punctuated by a few brief respites due to either strong economic growth (the early years of "New Labour") or fiscal austerity (the 2010s). We are now in a fifth phase, where it's likely government borrowing will continue to rise. Is this a problem for owners of gilts specifically, or for the economy in general?

I have said many, many times before that the economy cannot be run like a family household budget. Politicians generally use that analogy to either justify cuts in spending, or to pillory their opponents for fiscal recklessness. The difference between the government and a household is that the government can print money to pay its bills, whereas the family cannot (at least not legally). Of course, there is a consequence to issuing too much money (which is a short-term debt on the government's balance sheet) – it's inflationary, and in its worst form (hyper-inflation) it can destroy output and give rise to anarchy. Contrary to what many media commentators would have us believe, we are a long way from that sorry situation.

From the gilt investors point of view, the key issue is whether rising UK government borrowing will affect its creditworthiness. It's probably now time to dust down the sectoral balance equation which says that if you add up the balances from the annual financial accounts for the private and public sectors, they will come to zero. This is because money must come from somewhere and go somewhere. If the government runs a deficit, then other sectors must be running a surplus, otherwise where will the money that the government needs to borrow come from?

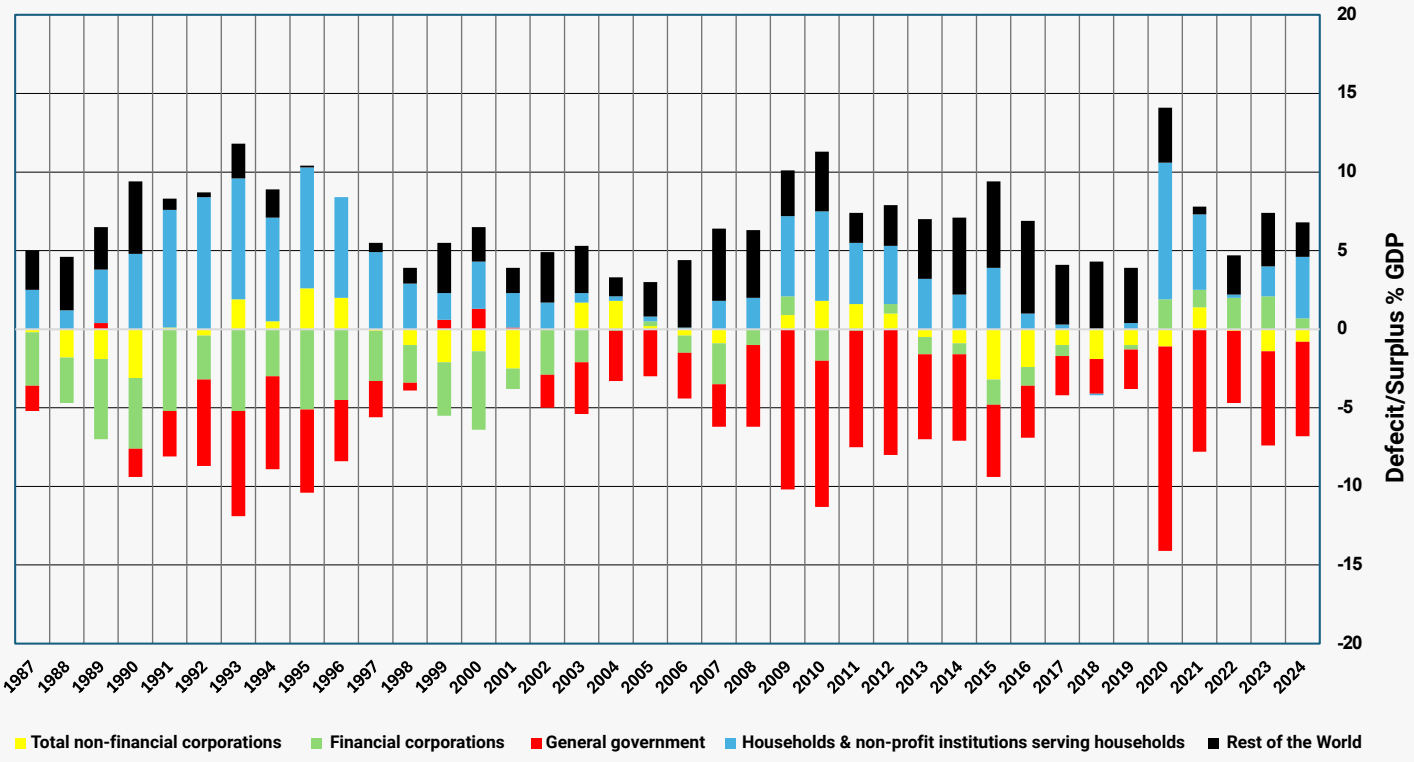
Chart 13: UK Sectoral Balances in £ million



Source: ONS & Courtiers

You can see the bars in Chart 13 are roughly symmetrical (small differences will be due to accounting errors), in other words, one sector's deficit is another sector's surplus.
The chart also shows that government borrowing rose in the period, but the figures are not normalised, making no allowance for inflation. Showing the sector balances as a percentage of GDP gives a clearer picture of the changes since 1987, as highlighted in the following *UK Sectoral Balances as % GDP* chart.

Chart 14: UK Sectoral Balances as % GDP

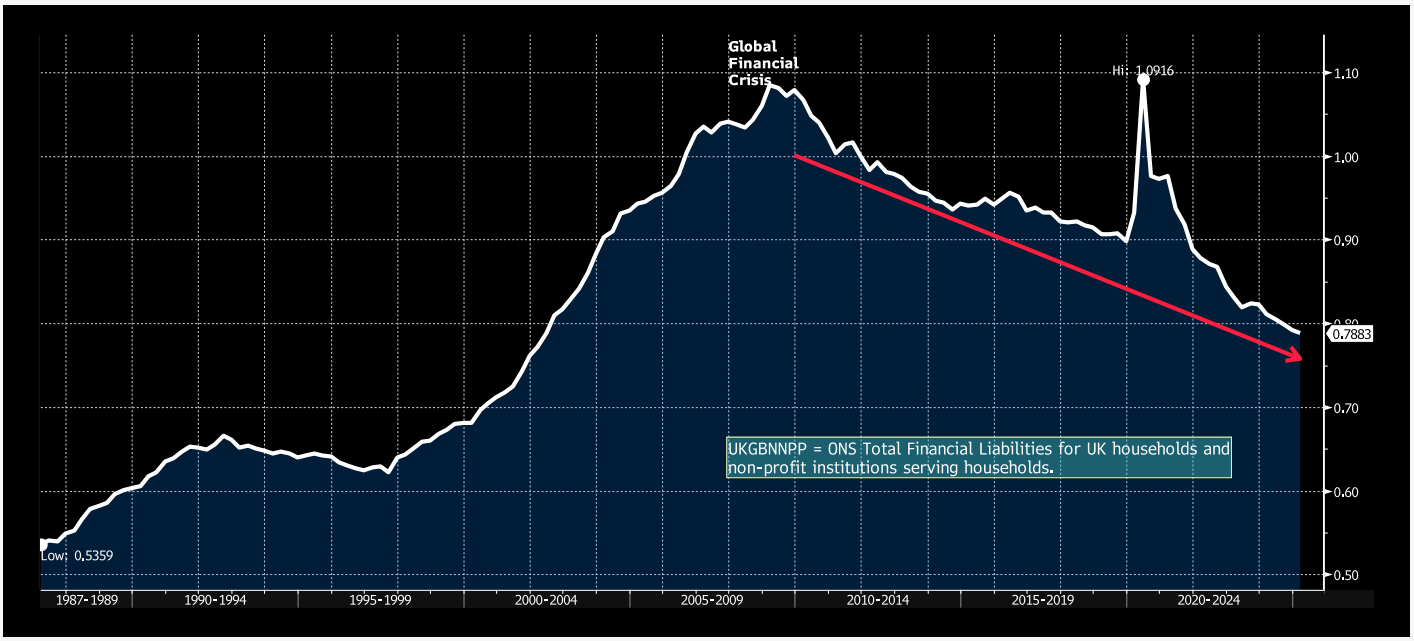


Source: ONS & Courtiers

Chart 14 shows households (in blue) running a largish positive balance through the nineties and after the 1991 recession (recessions tend to push up precautionary savings), running a much smaller positive balance in the noughties as unbridled optimism swept around the world in an era of easy credit, and dialing up savings again post the global financial crisis (a typical precautionary response).

Aside from the early years of Tony Blair's administration (1998 to 2001), the UK government runs quite a large deficit throughout, especially in the aftermath of the global financial crisis and at the start of the Covid pandemic, which it needed to do to mop up excess private sector savings (as I mentioned previously, sectoral balances MUST sum to zero). Conversely, whilst UK government debt to GDP has been rising, Household debt to GDP has been falling.

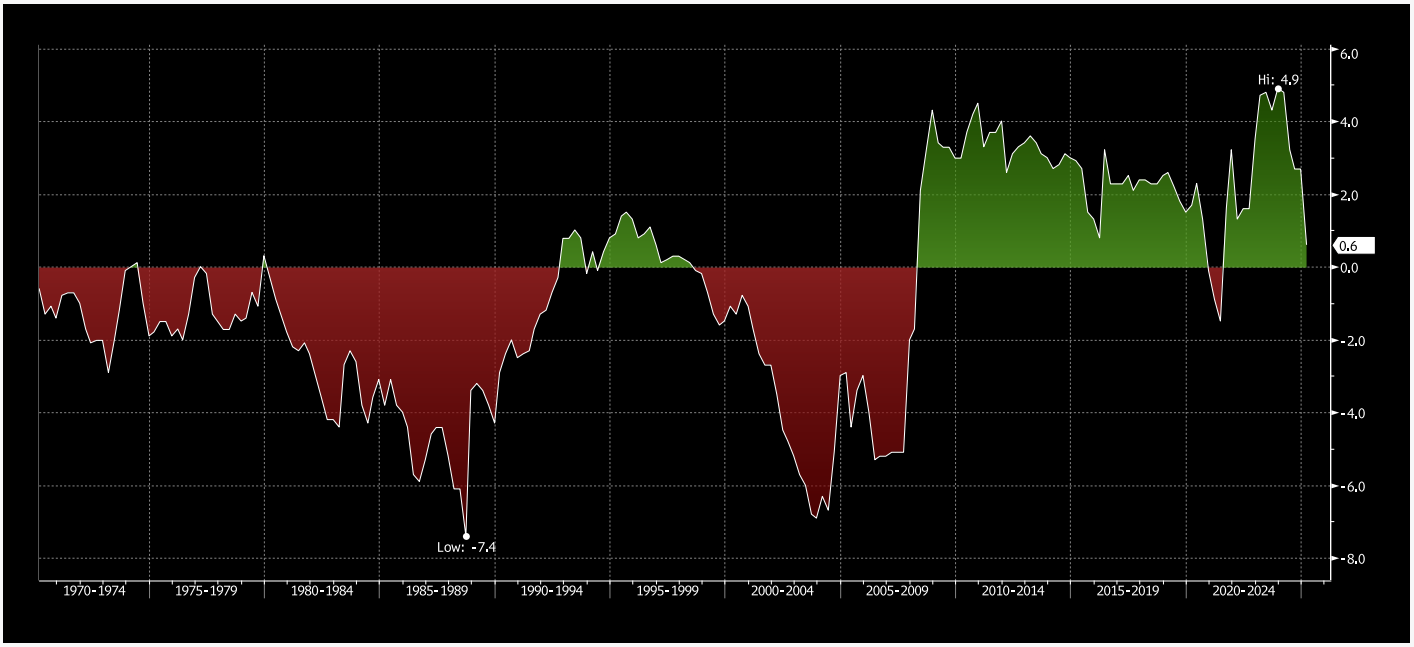
Chart 15: UK Household Debt to GDP



Source: Bloomberg & Courtiers

UK household debt rose from 54% of GDP in 1987 to 108% in 2009, but as households tightened their belts post the global financial crisis, they paid-down debt so that the present rate of household debt to GDP is 79%. In other words, households have reduced their collective borrowing, over the last 16 years, by the equivalent of 29% of GDP. This represents a sea change in the average UK family's approach to borrowing, which shows up in the mortgage equity withdrawal figures, i.e., the net change in home-related borrowing.

Chart 16: UK Household Mortgage Equity Withdrawal as % of Post-Tax Income

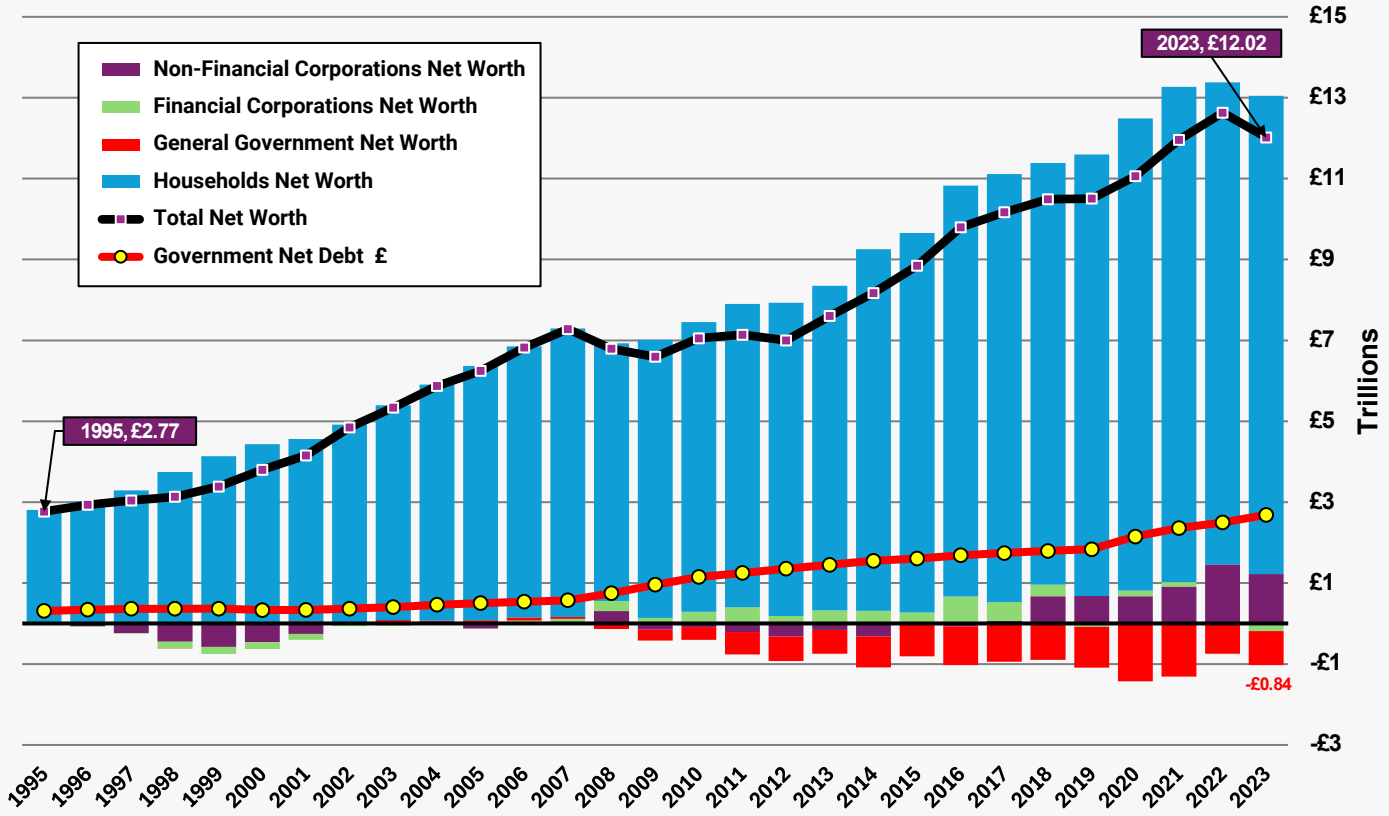


Source: Bloomberg & Courtiers

Apart from a short period post the 1991 recession, during which households repaid mortgage debt, from 1970 to 2009, British families were happy arranging mortgages to buy and extend properties, or simply to spend on other things. The global financial crisis dramatically changed this approach, since when borrowers have been paying down mortgage debt, massively contributing towards the steep fall in household borrowing.

Bringing all this together, Chart 17 looks at the UK's combined balance sheet from 1995 to 2023. Net worth hit record levels in 2022, dipped a little in 2023 as house prices slipped, but likely recovered in 2024 (the figures for last year are not yet published). All in all, none of the data suggests that the UK is heading for a debt crisis, so the creditworthiness of the UK government, which has never defaulted on a debt, should not unduly affect anyone's decision to buy gilts.

Chart 17: UK Combined Balance Sheet

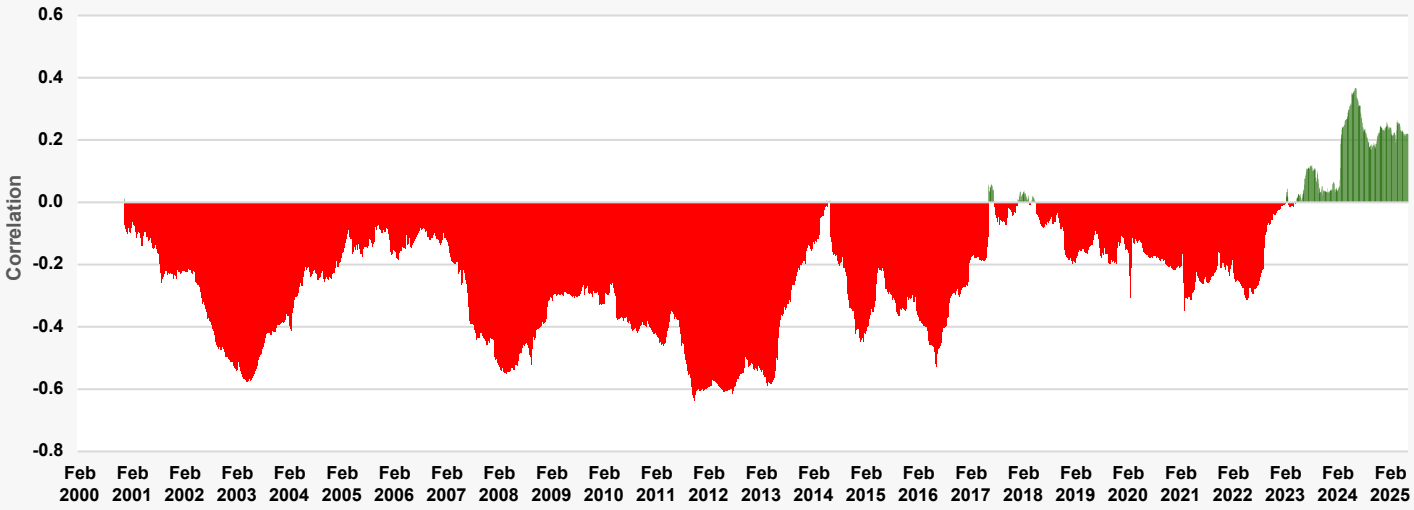


Source: ONS & Courtiers

4. The Diversification Factor

The best risk diversifiers are the ones whose returns are not highly correlated to the returns from the assets forming the rest of a portfolio. Bonds are seen as risk diversifiers when added to equity portfolios, as for most of the last 25 years the annual (annual meaning 260 trading days) correlation between bonds and equities has actually been negative.

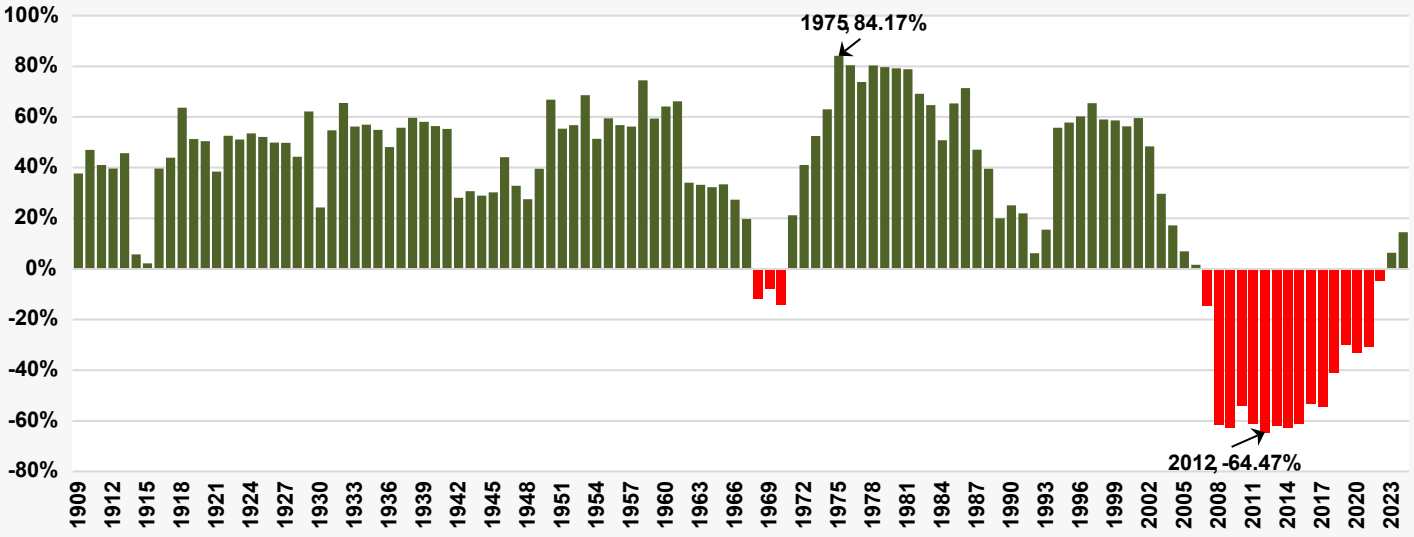
Chart 18: Rolling 260 trading day correlation of UK Equities & Long Dated Gilts



Source: Barclays & Courtiers

The *Rolling 260 trading day correlation of UK Equities & Long Dated Gilts* chart shows the long period of negative correlation between equity and gilt returns, which only flipped positive in 2023. I get the impression that some investors consider this recent positive correlation between equity and bond returns unusual whereas, in fact, it's normal. The correlation of annual returns between UK equities and gilts is positive (+0.46) over the last 125 years and, for most of this period, the correlation of rolling 10-year returns was also positive, but it turned negative in 2007 and remained so until 2023 (see the *Rolling 10 year correlation of UK Equities & Long Dated Gilts* chart).

Chart 19: Rolling 10-year correlation of UK Equities & Long Dated Gilts



Source: Barclays & Courtiers

Using a negative correlation in a portfolio that holds both equities and gilts creates hugely positive distortions in the risk/return trade off. Theoretically, if two assets are negatively correlated but both have positive expected returns above the risk-free rate, it would be possible to massively leverage the portfolio and achieve high returns for low risk, thus scoring spectacular Sharpe[2] ratios. In effect, this is exactly what promoters of liability-driven investment (LDI) were doing for years, until it spectacularly blew up at the end of 2022. When the correlation switched back to positive, it caused a 45% reduction in the value of long-dated gilts and required the Bank of England to step in to stabilise the market.

Over the long-term, ratios tend to mean-revert, which is what has started to happen with the correlation between equity and bond returns. When you think about it, these two asset classes should be positively correlated, because the values of both shares and bonds are based on the discounted value of their expected future cash flows. When discount rates (another name for interest rates) rise, present values fall, and when discount rates fall, present values rise. It's as old as the hills, despite what the LDI alchemists would have you believe.

Bond prices have already started to react to the reality that bond and equity returns are positively correlated, so the risk of a big fall in gilt prices due to a market wake-up on the reality of correlation is behind us. If anything, I think the shock of what happened in the autumn of 2022 has given investors a severe case of psychological snake bite (i.e., scared of getting bitten a second time even if the possibility is remote) that has pushed prices down. If some salesman convinces investors that bond and equity returns will once again become negatively correlated, it will push up prices, and at that stage we should rethink our strategy. But we are far from that point, and I suspect unlikely to encounter it again in my lifetime. RIP to LDI!

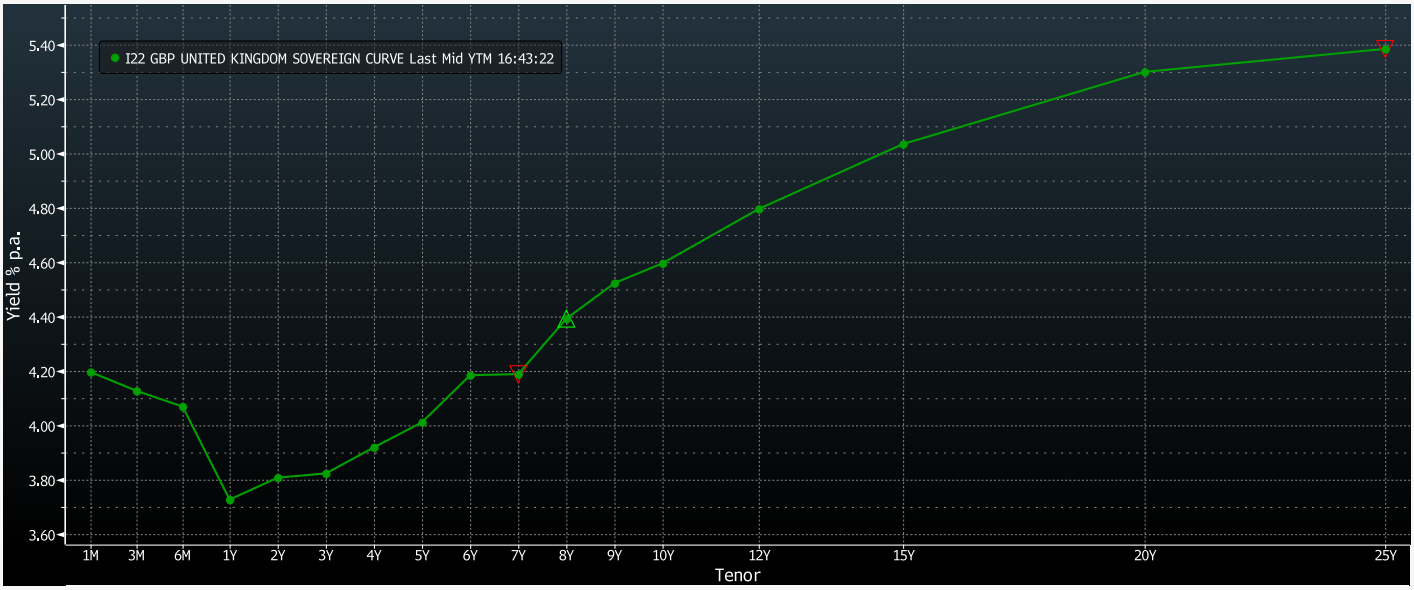
[2] The Sharpe Ratio is a measure of the return from a portfolio, from each unit of risk (volatility).

Conclusion

Holders of bonds have discovered that they are not the investment panacea they were cracked up to be, which, together with rising interest rates and increased government borrowing, has restored the gilt risk/term premium and pushed up yields. Contrary to what seems to be presently spooking the market (the end of positive correlation and the UK government becoming over-indebted) I think the main risk for holders of fixed interest gilts is that the economy takes off, the labour market tightens, and the BoE responds by pushing up rates to curb excessive animal spirits and control inflation. That's a situation Millennials have yet to encounter because all they have experienced are massive economic shocks with low growth and equally low interest rates.

As for which maturities to pick, it's tricky. Staying at the short end of the yield curve provides lower volatility and great liquidity, but you give up return, as highlighted below.

Chart 20: UK Sovereign Yield Curve at 14th July 2024



Source: Bloomberg

Three years ago we were bemoaning the low yields and lack of term premium from bonds, whereas today, they are obviously worth considering with fixed rate bonds providing a margin above inflation, and index-linked issues guaranteeing it.

The curve suggests the UK Base Rate will drop below 4% over the next year, which makes long-dated maturities attractive, assuming inflation doesn't settle higher and force the BoE to react.

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