

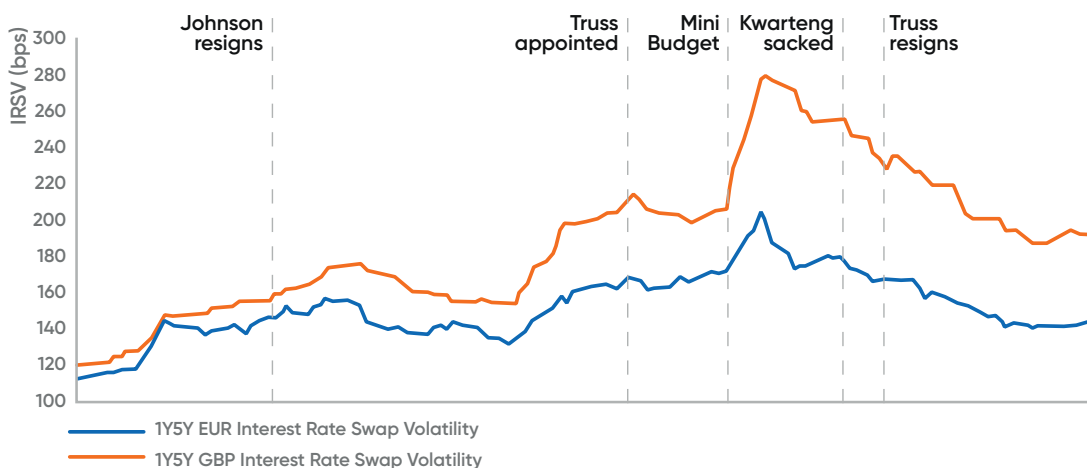
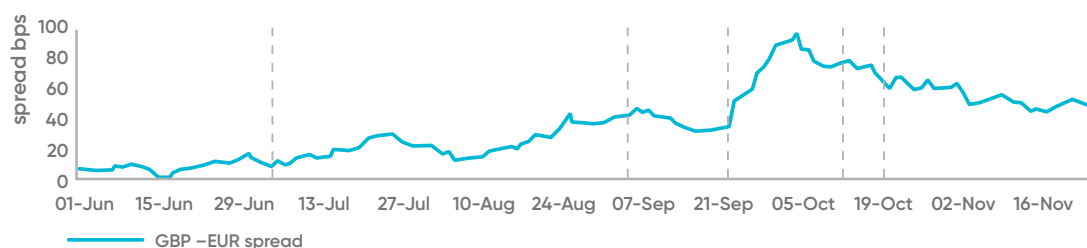
# Britannia Unhinged

The UK's experiment with *Trussonomics* seen through the eyes of the rates and inflation markets.

For interest rates, the last six months in the UK have been a rollercoaster to say the least. With increased volatility in both the public and OTC markets, we've outlined exactly how the interest rate options market reacted to the political and economic events from Boris Johnson's resignation in July, through the protracted Conservative Party leadership campaign and the chaos of the Truss government.

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The chart below shows the expected basis point volatility of Sterling and Euro 5yr swap rates in one year's time over the last six months. Below this we show the spread between the two series. For the chart we've taken a sneak preview of our Interest Rate Swap Volatility Index which is constructed using mid-market swaption ATM and skew data.



To break it down in a simple timeline:

|                                                                                                  |                                                                                                                                                                                                                                                                                                |
|--------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>7th July</b><br>– <b>Johnson resigns</b>                                                      | The spread between Euro and Sterling 1Y5Y volatility averaged around 9 bps in the weeks leading up to Johnson's resignation.                                                                                                                                                                   |
| <b>6th September</b><br>– <b>Truss appointed PM</b>                                              | By the time Truss was appointed PM in early September, the spread had widened to around 45 bps, perhaps reflecting the political uncertainty surrounding the new PMs economic plans.                                                                                                           |
| <b>23rd September</b><br>– <b>the "mini budget"</b>                                              | The shock of the mini budget saw expected GBP 1Y5Y volatility rise to a peak of 280 bps with the shock also being felt in EUR volatility. Euro volatility recovered from the early shock quicker than GBP with the spread between them peaking at nearly 100 bps in early October.             |
| <b>14th October</b><br>– <b>Kwarteng sacked</b><br><b>20th October</b><br>– <b>Truss resigns</b> | The government U-turns on the Mini Budget, the sacking of the Chancellor Kwarteng is sacked and six days later Liz Truss resigns as Prime Minister. These events saw the expected GBP volatility decline.                                                                                      |
| <b>25th October</b><br>– <b>Sunak appointed PM</b>                                               | GBP volatility continues to decline through the first month of Sunak's premiership. However, although the EUR GBP spread has halved from its peak it still remains significantly higher than midsummer levels arguably reflecting the lasting damage of the UK's experiment with Trussonomics. |

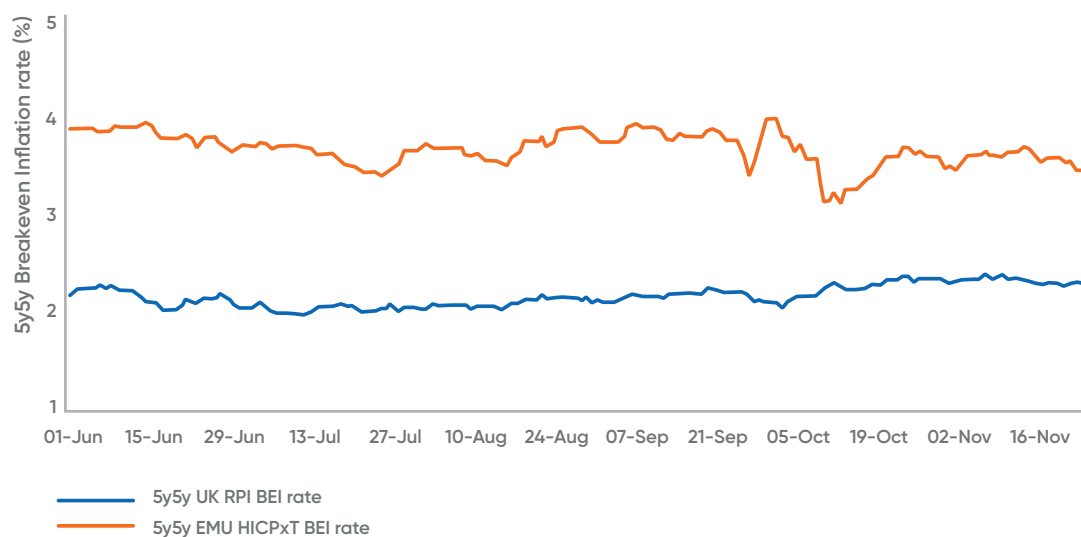
## UK RPI Inflation expectations:

Although UK inflation has been higher than the Bank of England (BoE) target of 2% since the spring of 2021, increased volatility has also been witnessed in the zero-coupon inflation swaps rates that represent forward looking expectations of inflation.

Charting UK and EMU HICPxT 1 year breakeven inflation (BEI) we can see that the UK inflation expectations have been much more volatile than in the euro zone. This is most pronounced during August with the economic uncertainty mentioned above, and again during the period of intervention by the BoE at the beginning of autumn. However, there seems to be a relative calm in the inflation swaps market through November following Sunak's appointment as PM and Hunt as Chancellor. Despite this, it is notable that the spread in the one year average inflation expectations have widened between the two regions since early summer.

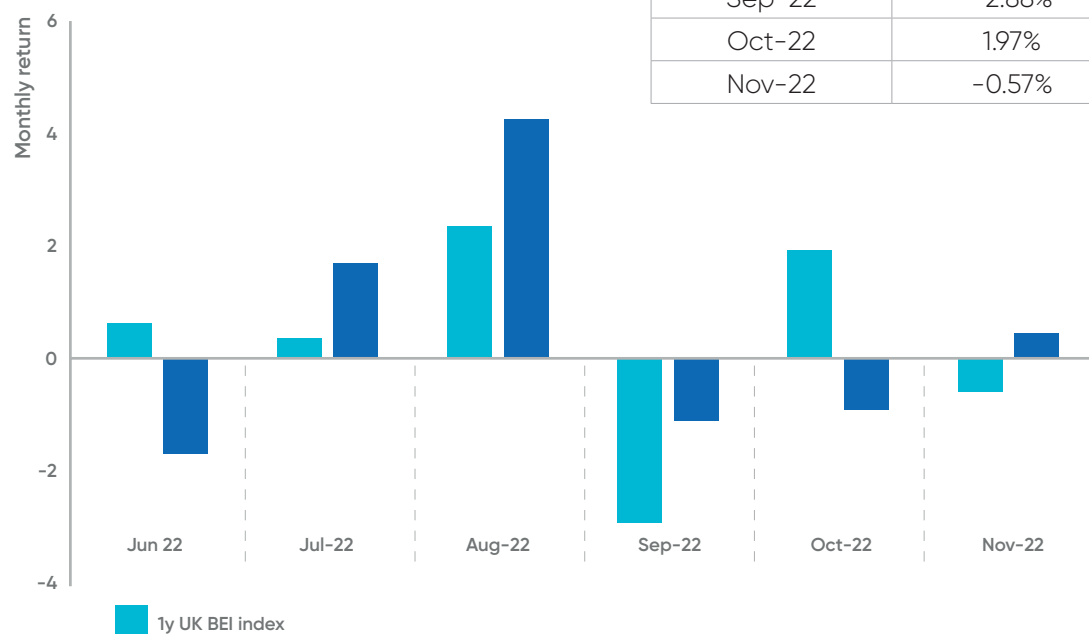


Looking at longer term inflation expectations for the two markets we can see that 5yr5yr breakeven inflation rates (which represents the average inflation rate over 5 years, beginning in 5 years) also exhibits higher volatility in UK inflation expectations during the summer. By November, the 5y5y UK RPI BEI rate was trending lower during November, even though it is way over the BoE target of 2%, compared with the Euro zone 5y5y BEI rate from the ECB inflation target (also 2%).



Investing in a monthly rolling strategy in zero coupon inflation swaps on the 1y and 5y UK RPI BEI, would have yielded the following returns over this period.

| Monthly Returns | UK 1y BEI index | UK 5y BEI Index |
|-----------------|-----------------|-----------------|
| Jun-22          | 0.66%           | -1.65%          |
| Jul-22          | 0.37%           | 1.73%           |
| Aug-22          | 2.39%           | 4.26%           |
| Sep-22          | -2.88%          | -1.05%          |
| Oct-22          | 1.97%           | -0.90%          |
| Nov-22          | -0.57%          | 0.47%           |



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