

# The true history of the bond market

There is a myth about the bond meltdown of September that political spin doctors are busily propagating. To understand the market we need to see that as the price of bonds falls so interest rates rise. If a Central Bank wants to move the long term rate of interest up from 1% to 2%, the price of a bond with no repayment date halves. If you lent the government £100 at 1% there would be a fixed promise to pay the bond holder £1 interest every year. If people then want 2% interest they will only pay £50 for the £100 loan, so the £1 of interest is 2% of the amount they pay for the bond.

The spinners claim the market fell away sharply owing to the Kwasi Kwarteng decision to announce tax cuts without forecasts. They do not mention the fact that the energy price package was far dearer than the estimated impact of the tax cuts. They claim the Kwarteng strategy damaged the economy and put up mortgage rates. They need to understand that mortgage and other rates were deliberately driven up by the Bank over a period of many months, as it battled to correct its over lax money policy of 2021. The ten year interest rate started 2022 at 1% and was at 3.5% before the Chancellor spoke. It is at 3.55% today.

I agree the Chancellor should have put all three elements of his growth Plan together – tax cuts, spending proposals and the supply side measures. It would have been sensible to have some forecasts of borrowing and show interest in keeping borrowing to realistic levels. I do not agree that this was the only or the main cause of the falls in the bond markets. The main causes of the rises in rates were the actions the Bank of England and the US Fed.

The bond market was falling well before the Mini budget thanks to the stated intentions of the Fed and the Bank of England to put up interest rates. On 21 September the market fell in response to a very hawkish Fed, where the US was leading advanced country markets down and rates up. On 22nd September the bond market fell again on the announcements from the Bank of England. The market was particularly worried when the Bank announced its plans to get rid of £80 bn of its portfolio of UK government bonds, selling too many onto a falling market. On 23rd September concerns about the mini budget led to further falls.

The falls were larger on 26th and 27th September. On those days the dominant conversation in markets and media was not the mini budget but the need for many pension funds to sell bonds or shares to find the cash to pay sums to LDI funds. These are funds bought by pension investors allowing them to own more bonds than the fund can pay for by buying bonds through the fund on margin. When bonds fall in price the funds demand more cash payments to cover the losses.

The Bank stepped in to reverse its position of selling bonds into a falling market and announced it would temporarily buy up bonds again to deal with the special selling pressures from the pension funds. The market rallied strongly

on the news. By 27th October the interest rate on the 10 year bond was back below the level it had reached the day before the mini budget.